Letter of Comment No: 5094 File Reference: 1102-100

June 25, 2004

Director of Major Projects
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Dear Sir or Madam:

We respectfully submit the following comments in response to the Proposed Statement of Financial Accounting Standards, Share-Based Payment, an Amendment of FASB Statements No. 123 and 95.

We oppose the proposals in the Exposure Draft on the following grounds:

- An employee stock option is not a corporate asset, and should therefore not be expensed, either directly or indirectly through the Board's notion that employee services are assets. The Board has not advanced a principled accounting basis for its suggestion that employee services should be considered assets solely for the purpose of causing employee stock options to be expensed;
- Even if accounting theory supported expensing employee stock options, the Exposure Draft proposals would cause companies to systematically and vastly overstate the impact of stock options;
- > The valuation models proposed by the Board are exceedingly complex, are untested, and would be costly to implement, particularly for private companies, and small and medium-sized public companies;
- > The proposals would significantly undermine the comparability of financial statements and the ability of both institutional and individual investors to understand the financial and operating results of companies; and
- > There are numerous critical issues and questions the Board fails to address or for which it has not sought public comment in its Exposure Draft, and the Board should not formally adopt the proposals until those questions and issues have been fully addressed both by the Board and the public.

The Board, in its Exposure Draft, offers four reasons for its proposed requirement to expense the fair value of stock options: (1) properly reflect the economic reality of an employee stock option transaction; (2) improve comparability between companies; (3) simplify U.S. GAAP; and (4) create international convergence on this issue. We find the Board's reasons unpersuasive; in fact, each of the four factors identified by the Board strongly suggests the Board should <u>not</u> implement the Exposure Draft proposals. We briefly address each of the Board's stated reasons before turning to the specific questions posed by the Board in the Exposure Draft for public comment.

Economic Reality. The economic and business reality of a grant to an employee of a stock option is that a portion of company ownership is shifted from existing shareholders to the option holder. A stock option grant does not result in an expense, as the term expense has been defined over a long period of time by the accounting industry the consumption of a corporate asset or the creation of a corporate liability. In the Exposure Draft, the FASB does not expressly take the position a stock option is a corporate asset. However, the Board, in an apparent effort to identify an asset to be expensed in relation to the fair value of options, is now proposing what we believe is an accounting fiction – some, but not all employee services should be considered corporate assets. The Board has structured its "employee service asset" concept such that employee services become assets, and are therefore expensed, only for companies that grant stock options, and the value of the employee services is deemed to be the fair value of the options. In other words, the "employee service asset" is merely a surrogate for employee stock options, and for all intents and purposes, the Board is proposing employee stock options be treated as a corporate assets. Stock options are not corporate assets – a company's capital stock belongs to its shareholders. The Board does not offer a technical accounting theory to justify its creative approach, and in our opinion, the "employee service asset" theory, selectively applied to result in the expensing of employee stock options, fails as a conceptual foundation for its proposals, for reasons we delineate later.

The proposals in the Exposure Draft would create confusion and a distorted view of company performance by blending a non-cash capital event – the granting of an option – with a company's operating results. In no fashion do employee stock options consume a company's assets, and if the options do not touch assets (or create a liability)<sup>1</sup>, there cannot be an expense. We urge the Board to reflect on the insights users hope to gain from company financial statements, in particular the income statement. A large number of users review the income statement in an effort to assess a company's ability to generate future cash flow. Employee stock options do not generate cash outflows, and as a result, expensing options would reduce the ability of users of financial statements to evaluate a company's future earnings potential. We do not understand, and would respectfully request the Board to elucidate, how users of financial statements would benefit by widening the discrepancy between GAAP income and actual cash flows.

At the same time, the Board's proposal would distort economic reality with respect to another important accounting measure upon which many users of financial statements rely: paid-in capital. Under the proposal, companies would record as paid-in capital the amount of the non-cash expense associated with stock options, which would lead all but the most sophisticated users of financial statements to conclude the company had received more paid-in capital, in the form of cash, than is actually the case.

<u>Comparability</u>. The Board's proposal fails to achieve its stated objective of comparability. In fact, the Exposure Draft proposal would make it significantly more difficult for users of financial statements to make company-to-company comparisons. The proposal in the Exposure Draft requires companies to make future predictions on many variables in the Black-Scholes or lattice models, and those models are highly

<sup>&</sup>lt;sup>1</sup> The Board has rightly concluded that no liability is created.

sensitive to the assumptions. It is a certainty that different companies – even companies in the same industry – will use different models and make different assumptions, and as a result, financial statement users will face enormous challenges in achieving comparability. Given the complexity of the valuation models the FASB recommends, users of financial models would need to have modeling consultants at their disposal in order to replicate and adjust the models used by companies in an effort to achieve comparability. SFAS 128, which is currently in effect, provides comparability of earnings because each company needs to disclose the dilution "expense" associated with stock options using the same valuation formula – the treasury stock method. Many comment letters explain why the treasury stock method is superior to the Black-Scholes and binomial/lattice methods.

Simplicity. We agree GAAP - and particularly the application of GAAP by companies - should be simplified wherever possible, and as a result, the Board should not adopt the Exposure Draft proposal. The Exposure Draft proposal will necessarily create a cottage industry of advisory groups around binomial/lattice models. That industry does not exist today – there is virtually no expertise available to companies to help put in place these extraordinarily complicated models. The binomial/lattice approaches require the creation of extremely complex algorithms, and the finance departments in the overwhelming majority of companies are not equipped to do this on their own. In addition, given the extreme complexity of the models and difficulty in achieving comparability, users of financial statements will need to spend significantly more time and effort trying to understand the meaning of company reports. We recommend the Board articulate its stated objective as follows: where possible, simplify the preparation of financial statements and the task of financial statement users of understanding company performance. Under this standard, the Board's proposal should be rejected. Today, companies are not complaining about the difficulty or complexity of accounting for equity-based transactions; if the Board's proposal is adopted, companies and users of financial statements will be challenged by the complexity, difficulty, cost and other challenges inherent in the implementation of the proposal.

International Convergence. The Board's proposal will not achieve international convergence. First, it is important to note the Board's proposal is inconsistent with the accounting treatment of employee stock options in almost every Asian country. For example, China has publicly declared, as part of its industrial policy, it will not permit employee stock options to be expensed. Second, the February, 2004 IASB proposal is only being considered by European countries, and will only be adopted if the European Union and the individual EU countries approve it. If the EU or a sufficient number of European countries fail to adopt the IASB proposal, the Board's proposal will be inconsistent with accounting standards in at least a portion of Europe, and in any event, in almost all of Asia. IASB proposals are not self-executing: France, Italy, Spain and Belgium earlier this month vetoed a purported "compromise" on IAS 39 dealing with derivatives. EU nations can and will weigh in to block standards they do not like. If the FASB wishes to achieve international convergence, it should keep FAS 123 in place in its current form, in which case Europe will almost certainly reject the IASB proposal, and there would be international convergence between Asia, Europe and the United States.

As you requested in the Exposure Draft, we are providing our comments in response to the specific questions you raised.

- 1. <u>Issue 1: Should Employee Stock Options Be Expensed As The "Employee Service Asset" Is Used? Are Employee Services Properly Considered Assets, And If So, Is The Value Of The Employee Services Equivalent In All Cases To The Fair Value Of Stock Options Granted To Employees?</u>
- a. Employee Stock Options Do Not Consume Corporate Assets. As stated earlier, no asset of a corporation is consumed when an option is granted to an employee the corporation has the same cash position, and other tangible and intangible assets, both before and after an option is granted. From both a business and accounting perspective, nothing on the balance sheet changes unless and until the employee exercises the option, at which time the cash on the balance actually *increases* by the amount of the strike price. A stock option is a capital stock transaction in which the existing shareholders of a corporation bring employees into the ownership group as a means of providing long-term incentives, which numerous academic studies conclude correlates positively to strong company performance. To be sure, the grant of a stock option dilutes the ownership interest of existing shareholders, and should be reflected in the outstanding share count; however, in no way can it be said to impact a company's operations, as measured on the income statement and, even for a magical moment in time, the balance sheet. The shares do not belong to the company, and dilution of shareholder ownership interests resulting from a stock option grant, therefore, does not create an expense.
- b. Accounting Theory. In the several hundred-page Exposure Draft, the Board devotes a single paragraph paragraph C13 to the fundamental technical accounting question of what asset is being expensed when a stock option is granted. Recognizing it needs to find an asset that is consumed in the employee stock option transaction in order to provide a conceptual accounting underpinning for its proposal, the Board offers the following: "...an entity receives assets employee services in exchange for equity share options. Because an entity cannot store services, they qualify as assets only momentarily unless those services are capitalized as part of another asset...An entity's use of an asset results in an expense, regardless of whether the asset is cash or another financial instrument, goods, or services." The Board offers no further detail or explanation on this foundational accounting issue. We are disappointed at the absence of detailed technical analysis from the Board, particularly given the complexity of and controversy surrounding this fundamental issue, as well as the novelty of the Board's conceptual approach.

It is crucial for those analyzing and commenting upon the Board's proposal to realize the Board asserts it is employee services, and not stock options, that is the asset leading to an expense charge. By adopting this asset theory, the Board implicitly recognizes a company's capital stock does not belong to the corporation or on the balance sheet. And yet, other than in paragraphs C13, where the Board, in an extremely abbreviated form, asserts its "employee service asset" approach, the Board clouds its

underlying "employee service asset" concept by framing the issue elsewhere in the Exposure Draft as whether there is a "compensation cost resulting from awards of share-based compensation," which would lead anyone not carefully parsing through the words of paragraph C13 and particularly footnote 5 to believe the Board has taken the technical position stock options are assets which need to be expensed.

We believe the board has an obligation to clearly and consistently state throughout its Exposure Draft what it in fact is proposing: companies must recognize as an asset the services performed by employees, expense the services as they are performed, and place a value on those services equal to the fair value of employee stock options granted. A review of the large number of letters submitted to date to the FASB – on both sides of the debate - indicates the vast majority of people believe the Exposure Draft calls for employee stock options themselves to be expensed, rather than the employee services.

There are several fatal flaws with the Board's analysis on the "employee service asset" question. Our opinion has been shaped, in substantial part, by discussions with many certified public accountants with whom we have spoken.

First, the Board fails to provide any technical or theoretical support for its notion that employee services are assets belonging on the balance sheet. With all due respect, the Board's discussion about how assets magically appear and disappear simultaneously in a fashion precisely designed to create an "expense" is strained and inconsistent with how business people and investors customarily think about assets. No executive we know believes for a moment the assets on the corporate balance sheet expand when employees are performing work for the company or contract after the services are performed. Users of financial statements understand assets to be cash, claims to cash (accounts receivable, e.g.) and things belonging to the corporation that can be sold for cash (buildings and inventory, e.g.). A company does not own its employees, and services should not be considered corporate assets. Frankly, the accounting theory does not seem grounded in principle, but rather appears to have been created for the sole purpose of causing employee stock options to be expensed.

Second, assuming for a moment the Board's theoretical approach was sound, then we need to ask the critical question: why does the Board conclude employee services are assets only for companies that grant employee stock options? The Exposure Draft does not offer any insight to help us answer this question. Under the Board's proposal, similar companies are treated differently with respect to the "employee service asset" based solely on the seemingly arbitrary distinction of whether or not they grant employee stock options. Take two identical companies, one of which grants options to employees and the other of which does not. Under the Board's proposal, only the company that grants options is required to record as an asset and then expense employee services, even though from an objective point of view the "fair value" of the services is exactly the same in both companies.

There is nothing in the Board's underlying theory, the Exposure Draft or any accounting literature cited by the Board to justify this distinction. We respectfully request the Board provide a principled theory as to why it is, under its proposal, only companies that grant employee stock options are required to expense the "employee service asset." In reality, the Board is using the "employee service asset" as a surrogate for employee stock options, which effectively treats a company's capital stock as a corporate asset. The capital stock of a company belongs to its shareholders, and does not belong as an asset on the balance sheet. The Board has not advanced a plausible theory as to why capital stock is being treated as an asset, and in our opinion the discovery of an "employee services asset," implemented solely to be a look-through device to employee stock options, is not a principled or compelling line of reasoning.

Third, the Board itself does not adhere to its notion that employee services are assets, thereby undercutting its own theoretical foundation. Under its proposal, if an employee is terminated before her options vest, the expense previously taken by the company is reversed. Thus, the "employee service asset," under the Board's approach, never really existed, even though the employee in fact performed services. If an employee's services are assets that need to be expensed when performed, the expense should, in all cases, remain an expense whether or not the employee's options happen to fully vest. Any other result suggests the Board does not subscribe to its underlying accounting theory, and furthers our belief that the "employee service asset" theory was established to be a surrogate device, which in reality accounts for employee stock options as corporate assets.

Finally, the Board suggests a non-technical justification for its proposal — creating accounting consistency relative to how options granted to constituencies other than employees, such as suppliers, are treated. This argument by analogy must, of course, be a secondary consideration. We presume the Board would agree it must first establish a sound theoretical foundation, and only then should it engage in a comparative analysis. Even if the Board had succeeded in offering a sound technical theory for its proposal, the supplier analogy is unpersuasive. The Board should give the supplier option analogy virtually no credence because otherwise it would be bootstrapping to an accounting issue that is insignificant relative to the employee stock option issue, both in terms of prevalence in the market and impact on companies. The employee stock option issue is the central issue, and if it permitted the supplier option rules to determine the outcome of the current debate, the Board would be allowing the tail to wag the dog.

c. <u>History</u>. We have had discussions with numerous certified public accountants to seek their guidance on this issue. What was instructive for us was the number of highly experienced, thoughtful and well-respected accountants who disagree with the recommendation in the Exposure Draft. And there is a history on this issue we believe merits reviewing. Over 50 years ago, in 1950, the FASB's predecessor, the Accounting Procedures Committee, examined the issue of stock option expensing, and concluded as a technical accounting matter, that there should not be an expense: "From the viewpoint of the grantor corporation, no measurable cost can be said to have been incurred." We would submit to the Board that nothing has changed in the accounting

world since those determinations that should cause the Board to come to a different conclusion.

When the FASB last examined this issue ten years ago, it adopted a sensible approach: companies could elect to expense stock options in their income statements, but if they elect not to do so, they need to clearly disclose in a pro forma fashion the impact expensing would have on their earnings, using a uniform measurement determined by SFAS 123. Meanwhile, the income statement would consistently disclose the potential EPS dilution of stock options using the treasury stock method. This way, any investor who believes options are a true accounting expense need look no further than the company's financial statements. Under this approach, investors have access to all the option information necessary to make in informed decision. The history of the dialogue ten years ago is also instructive and worth considering. Of the "Big Six" accounting firms that existed in 1993, all six submitted comments letters to the Board recommending options not be expensed. Some of the comments merit reflection in the current debate. For example: "The FASB proposal would reflect, in effect, a double dip or double cost of capital." Eugene M. Freedman, Chairman, Coopers & Lybrand, February 5, 1993. And: "The potential effect of options is already reflected in the earnings per share calculation." Ernst & Young, December 6, 1993. In the current discussion, some of the Big Four have submitted comment letters that contradict their positions of ten years ago, but not a single one has offered a principled basis for treating employee stock options - or employee services, for that matter - as expenses.

## 2. <u>Issue 2: Is Pro Forma Disclosure Of Options, As Currently Permitted By Statement 123, Adequate Disclosure?</u>

FASB Statement No. 123 currently requires companies to either recognize as a compensation expense the "fair value" of stock options granted to employees, or alternatively, to disclose in the financial statements the effect of the accounting on a pro forma basis. We refer to the many comment letters, in particular the letter submitted by Kip Hagopian, that explain why this method is superior to the Board's proposal. This approach is sound from the perspective of users of financial statements - and there are a great number in this category, notwithstanding the two survey results cited by the Board - who believe a non-cash capital account transaction that does not consume a corporate asset should not muddle a company's cash-based operating performance. For those who believe employee services or employee stock options are corporate assets that should be expensed, the information is readily available, reported on a consistent basis that provides complete comparability.

In paragraphs C27-C30, the Board concludes current disclosure is insufficient because "many" financial statement users have said the FASB should require expensing, and goes on to cite two surveys of fund managers and institutional investors favoring expensing of employee stock options. If the FASB is basing its decision, in part, on opinion surveys, then the FASB should conduct a statistically significant poll of all constituencies of financial statement users, including individual investors, sell-side and

buy-side Wall Street analysts, company management, employees (including employees who do not currently have stock options, as well as the 14 million current holders of stock options, the overwhelming majority of whom are users of financial statements), private company investors and the community of individual certified public accountants.

## 3. <u>Issue 3: If A Company Is Properly Required to Expense Employee</u> <u>Services, Should The Expense Be Measured Based On The Fair Value Of Employee</u> <u>Stock Options?</u>

For all the reasons suggested under Issue 1 above, the fair value of employee stock options should not be used as a proxy to calculate the value of employee services. Nor should the Board use what we believe is an accounting fiction – the creation of an "employee services" asset – to mask what is in reality a proposal for employee stock options to be treated as corporate assets. The Board has an obligation to provide a more expansive explanation on this pivotal issue.

## 4. Issue 4(b): Can The "Fair Value" Of Employee Stock Options Be Reliably Measured?

Others have weighed in on this issue in persuasive fashion, so we do not feel a need to elaborate in detail. However, we do need to take issue with the Board's characterization of the measurement issue relating to employee stock options as one that is indistinguishable from other measurement challenges in the accounting world. In paragraph C22, the Board points out there are uncertainties in some accounting calculations, such as loan loss reserves and pension benefit obligations.

What the Board fails to acknowledge in the Exposure Draft is that its proposals will produce calculations that are known with certainty to vastly overstate the fair value of employee stock options. Black-Scholes and the binomial/lattice models were designed to value freely tradable securities that are not subject to black-out periods. The academic and anecdotal evidence we have seen suggests non-tradable employee stock options, which even upon exercise are subject to numerous and unpredictable black-out periods, have a value in the real world as much as 90% less than the value derived from the Black-Scholes and binomial models.

The Board states "uncertainties inherent in estimates of the fair value of share based payment arrangements are generally no more significant than the uncertainties inherent in" other accounting calculations. We disagree. In the examples cited by the Board, such as loan loss reserves and pension benefit obligations, the company uses its judgment to arrive at an estimate which the company believes is reasonable under the circumstances and has a fair chance of being a reasonably accurate prediction. The same cannot be said of the Black-Scholes or binomial calculations of fair value of employee stock options. The one thing we can all be certain of is that the resulting "expense" will systematically and vastly overstate the impact of the options. Per Price Waterhouse in a letter to the FASB dated December 17, 1993, when this issue was debated: "Our conclusion is that the methodology in the [Exposure Draft] for calculating the fair value

of employee stock options significantly overstates their fair value, but by how much is pure conjecture."

In paragraph C23, the Board says the lattice model can be used in a fashion in which the nontransferable nature of employee stock options is accurately taken into account. This is not so. The fact that the lattice model has variables for employee option exercise patterns and post-vesting employment termination does not mean the model adjusts for nontransferability and black-out periods. Nontransferability is a separate and independent variable the lattice model fails to consider, and is not solved by adjusting the option exercise pattern and post-vesting employment termination variables. The Board should also clarify whether it is recommending companies to input in the model employee exercise pattern expectations different than the company actually believes will take place in order to compensate for other missing variables. Given the enormous importance of this issue, the Board is under an obligation to produce studies and detailed field trials demonstrating the accuracy of Black-Scholes or the binomial methods as applied to employee stock options, and if those studies are not currently available, the Board should commence a study and comment period until it is able to develop compelling evidence that there is some model that can offer a reasonable estimate of the fair value of stock options.

<u>Conclusion</u>. The Board's stated reasons for its proposal do not justify its adoption.

If it is not now prepared to abandon its proposal, at a minimum, the Board should amend and seek further public comment on the Exposure Draft to address, in detail, the following important questions and issues, in addition to the numerous questions and issues raised by others. The Board should be certain that all issues are clearly raised and fully addressed before adopting the proposal. There is no merit in rushing to implement the proposal.

- Are employee services corporate assets? The Board assumes this in the Exposure Draft, without elucidating this key assumption or clearly seeking public comment on it.
- ➤ If employee services are corporate assets, how should those services be valued? Should the value be the full value of the services, or just the portion of the services attributable to stock options? If it is the latter, what technical accounting theory supports that conclusion?
- ➤ By reversing expenses for stock options that do not fully vest, the Board is essentially saying it does not believe some employee services even for companies that grant stock options were assets in the first place. How does this square with the Board's theory?
- > Should employee services of companies that do not grant employee stock options be considered assets that need to be expensed as the services are performed? If not, why not?
- > Does the Board agree employee stock options are not corporate assets? If the Board agrees, then why has it architected its proposal so that the "employee"

- service asset" is merely a look-through device in which employee stock options, in fact, are being accounted for as corporate assets? If the Board believes employee stock options are corporate assets, we would respectfully request it say so explicitly and provide a detailed technical explanation of its position.
- ➤ Because the Board, in advancing its proposal has relied, in part, on comments from what appears to be a very small sample of financial statement users, the Board should gather statistically significant opinion survey data across all relevant constituencies.
- > Do the binomial and lattice models actually work in the field? The board should be certain to conduct detailed, thorough field tests of these models before encouraging or requiring companies to use them. The Board should publicly disclose the detailed results of its field tests.
- The Board asserts that, under the binomial/lattice models, companies can correct for the failure of those models to account for nontransferability and black-out periods by adjusting for expected employee exercise patterns. We respectfully request the Board explain in detail how it is adjustments in employee exercise patterns in the models can correct for the failure of the models to address the other, unrelated variables.
- ➤ How does the Board propose financial statement users, particularly less sophisticated users, understand a company's true, cash-based paid-in capital if the Board moves forward with its proposal to require companies to record non-cash paid-in capital equal to stock option expenses?
- > The Board does not address comparability problems that are certain to arise from different companies using different valuation models and different assumptions within the same models. We request the Board offer an assessment of the resulting comparability problems, and the impact on financial statement users.
- > Is there sufficient consulting expertise available to companies to be able to implement the binomial and lattice models? The Board should provide a detailed analysis of the current level of expertise available, as well as the likely cost for companies to implement.
- Companies are now engaged in the process of gearing up to comply by the end of this year with the Sarbanes-Oxley requirements, in particular Section 404. Has the Board analyzed whether the quality of implementation of its proposal would be hampered by the fact that its proposal would need to be implemented by public companies contemporaneously with Sarbanes-Oxley Section 404? The Board should survey public and private companies to gain an understanding of this issue and publicly disclose the results.
- > The Board should address the issue of international convergence if the IASB proposal is not adopted in Europe, as well as the absence of international convergence in light of current Asian accounting standards.
- > We would also request the Board seek public comment on whether, in making recommendations, it should be required to take into consideration economic, competitive and public policy issues.

We would be happy to discuss any of these issues in greater detail if that would be helpful to the Board. Thank you in advance for your consideration.

Respectfully submitted,

John Doerr

John Denniston

John Doerr and John Denniston are partners with Kleiner Perkins Caufield & Byers, a venture capital firm based on Menlo Park, California. Since 1972, KPCB has supported entrepreneurs in building over 450 companies including such household names as AOL, Amazon.com, Citrix, Compaq, Cypress Semiconductor, Genentech, Google, Intuit, Juniper Networks, Lotus, Netscape, Tandem, and Sun Microsystems. KPCB's portfolio companies have created over 260,000 jobs.

John Doerr joined Intel in 1974 just as it invented the famous "8080" 8 bit microprocessor. At Intel, he held various engineering, marketing and management assignments, and was one of their top-ranked sales executives. He joined KPCB in 1980. He currently serves on the Board of Directors of Amazon.com, Drugstore.com, Homestore.com, Intuit, PalmOne, and Sun Microsystems. His privately held company board seats include Elance, EndForce, Friendster, Good Technology, Google, and Segway.

John Denniston joined Kleiner Perkins in 2001. John came to KPCB from Salomon Smith Barney, where he was a Managing Director and head of Technology Investment Banking for the Western U.S., and also served on the Investment Committee for Salomon's direct investment venture fund and its venture capital fund-of-funds. Prior to Salomon, John was a Partner with the law firm Brobeck, Phleger & Harrison, where he was the head of Brobeck's Venture Capital Practice Group, Co-head of its Information Technology Practice Group and a member of the Investment Committee for its venture capital fund.