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**Letter of Comment No: 3794**  
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**Sent:** Tuesday, June 15, 2004 3:20 PM  
**To:** Director - FASB  
**Cc:** jcdowling@nvca.org  
**Subject:** FASB Draft Expense of stock options

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The following comments are the result of focused discussions for several years, as well my personal experience of the past 17 years as a general partner for Sevin Rosen Funds, and the prior 30 years as an officer and manager of new businesses at Texas Instruments.

The expensing of stock options as currently defined by the FASB will not meet its objectives, particularly for small private ventures, and will do harm by hindering their ability to motivate and hold strong, experienced entrepreneurs for an extended period of time.

New ventures must successfully navigate through three or four phases before their operations have the breadth and stability of performance that might be more consistent with fulfilling the requirements for this FASB directive. These phases span:

- a. The development and initial proving of the proposed product or service. In this period key personnel are recruited and the nucleus of a management team formed. Unless there is a subsequent restart, the majority of stock options are usually issued in this phase.
- b. The product is launched, and as it gains traction in the market place revenues build to \$10 million or more. The personnel resources gain critical mass and experience, successfully functioning as a team. Very likely, the venture's cash flow remains negative, and profits are attainable within the forecasting horizon.
- c. The development and launch of second generation products is made to capitalize on market knowledge and further improve the firm's competitive advantages. The team is broadened and some initial depth occurs as revenue increases to the \$30-70 million range. Positive cash flow has either been attained or is within the forecasting time horizon.
- d. More frequently, there is a miscue in matching the product to the market's needs, or a slip in execution and the venture must go back and retrace its steps through one or more of these phases.

For all of these phases, the venture is a "one product-one market" company. If there are any major errors or misjudgments, the company is in dire financial straits and must seek additional funds or be liquidated. As a consequence, the market value of the private venture as perceived by outside financial firms is very volatile and can change dramatically within a four to six months period of time. There are no other on-going businesses to fall back on, as exists in larger companies. Its performance in its singular product market sector is naked to all observers.

From my experience, there is no straight, extrapolated line that can be forecasted for increasing value of the firm during these phases. Ventures that appear to be making progress are likely to be in the ditch within six months, and conversely, a venture that is off track can sometimes be brought back, usually painfully and over a longer period of time than expected. In these later cases, substantial additional equity funding is required and this action seriously dilutes the stock ownership of the individuals granted options in the early phases.

Further during these phases, individuals leave the firm prior to full vesting of their stock options, and the terms of the options will require either a purchase within a short period of time or default them. This turnover affects the per cent age ownership of the all individuals, and further compounds the valuation of individual stock options for any forecasted time period. Attempting to define values of individual option grants will create wide distortions in the expenses and profits or losses of the firm.

Secondly, the granting of stock options is not an expense item for the firm, as no liability or out of pocket cost is incurred. Instead, it is a dilution of ownership for the stock holders and can be represented as a balance sheet item with appropriate offsets. Stock options are the only reasonable method under current tax laws to provide meaningful ownership to the employees of the company.

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Lastly, the record keeping for tracking the value for each individual option for each quarter will be a noticeable burden for small ventures. In the early phases, they usually have only one financial person, and revenues start, a few additional people will be added. Private ventures are "cash critical" and a good entrepreneur is always stressed to find alternatives for any additional expense item.

There have been major abuses of long term benefits by senior level personnel at public companies over the past ten years. Stock options have been only one part, but a large factor, of the total benefit package. However, the expensing and reporting of stock option costs as defined in this FASB directive does not bear directly on the cause of the problem, and will do harm, to many entrepreneurial ventures. As stock options are curbed, new creative schemes will emerge. The issues of total benefits for senior officers is the responsibility of the board, and the policies directly impacting these benefits will be determined by the board's composition and governance, as well as involvement of major stakeholders.

Thank you for your consideration on this important matter.

Charles Phipps  
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