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From: John Neis [John@ventureinvestors.com]

Sent: Tuesday, May 11, 2004 7:23 PM

To: Director - FASB

Cc:

jcdowling@nvca.org

Subject: File Reference No. 1102-100

Dear FASB Representatives.

I am Senior Partner of a private venture capital firm and serve as chairman of the audit committee for one public company and three private companies, and also serve on the compensation committee for the same four companies. In the past week I have had audit committee meetings for two of the private companies for the purpose of reviewing and approving the year end audit, and in this process I became familiar with the details of FASB's exposure draft on share based payment. While I have been aware of proposals to expense stock options, I was stunned to see the form these proposals have taken and the implications, particularly for our emerging privately held entities.

Letter of Comment No: 2299 File Reference: 1102-100

Several aspects of this exposure draft are extraordinarily unreasonable and shortsighted:

- 1. I am accustomed to making business decisions based on having full knowledge of the costs I am prepared to incur. It is impossible to gauge what will hit the expense line during the option vesting period under this exposure draft. The greater the company's success, the greater the "intrinsic value" under this language, which means the difference in reported performance between an outstanding performer and poor performer will diminish. You are making it impossible for a company to have control over the factors that result in its bottom line!
- Two of the companies I referred to rely heavily on small manufacturing firms to supply them with custom components. These small, relatively unsophisticated suppliers routinely request financial statements before taking on a custom job. While the recording of this non-cash expense will have no impact on the financial condition of the firm or on its consumption or generation of cash, the inclusion of this expense will surely cause confusion about the company's financial condition and operating performance. Adoption of this provision will greatly reduce the ability of the typical reader of financial statements to accurately assess the financial health and operating performance of a company in way that is meaningful to them. The requirement for use of a binomial method of determining the expense defies the logic of trying to add clarity and completeness to financial reporting. While the methodology has a basis in theory, it is not a concept that will be understood by most and the explanation will only make sense to those with advanced training in mathematics (and even the majority of those individuals may still lack an intuitive understanding about why the formulas produce the results that they do). As a Chartered Financial Analyst, I have tried to provide as simple, yet reasonably accurate explanation of an option pricing model as possible (i.e. it takes the probability distribution of a stock's value on the likely exercise date, selects the area under the curve where the stock price is greater than the option exercise price, calculates the probability weighted average difference in value between the stock price and exercise price, and then discounts that future value to the present) to a sophisticated individuals, and I still see their eyes glaze over. Equity analysts are likely saying that this expense treatment will not have any impact on their perception of value because they have always considered or disregarded this expense and will continue to treat this component in the same way. However, no one but the most skilled analysts will be able to make these adjustments and appropriately consider this non-cash expense. Thus, rather than providing greater accuracy and transparency to enable investors to make better decisions, you are creating an elite set of financial statement readers that are more capable of understanding financial statements and making appropriate investment decisions. This is an enormous disservice to the less sophistocated investor!
- 3. The complexity and subjectivity of expense determination (the subjectivity is clearly the greatest in the earliest stages of company development) will mean that no one inside a company is likely to be capable of determining the expense. The company's auditors are conflicted and not able to provide advice on these matters. That leaves an early stage company with two difficult alternatives: hire an independent consultant to make the determination or use a compensation tool other than options. Most early stage companies are cash strapped and can't afford the consultants, or if they can, it is an extraordinarily poor use of their most limited resource. The lack of cash is also the reason for heavy reliance on options because they are a trade off when attracting highly skilled people that they can't afford to compensate in cash and to whom they want to provide an incentive to perform. However you cut it, this simple accounting change will result in an imposition of a real cost that will impede economic growth!

In general, I have found the concept of expensing options to be objectionable. The impact has already been identified in fully diluted earnings per share, the theoretical value has already been described in the footnotes, there is no consideration of whether

the options are actually exercised and the dilution occurs, it is the only "expense" that at worst has no cash outlay and at best results in cash inflow upon exercise, and it reduces financial statement transparency. However, if FASB is going to insist on placing the importance of recording a cost that exists in theory ahead of the importance of financial statement clarity and utility, I had hoped it would at least pick a standard that was completely objective at all times, measurable and predictible at the time of a business decision, and where the process of measurement and reporting wouldn't impose an economic burden that has a detrimental economic impact. This seems contrary to the objectives of generally accepted accounting principals and is not in the best interests of the public. I strongly encourage you to reconsider this exposure draft.

John Neis, CFA Senior Partner

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