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To: Director - FASB

Subject: Comments to FASB Exposure Draft - Share Based Compensation

June 30, 2004

Director of Major Projects
File Reference No. 1102-100
Financial Accounting Standards Board
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VIA EMAIL director@fasb.org

Dear Director of Major Projects

I am responding to your request for comments on the Exposure Draft issued March 31, 2004, the Share-Based Payment, and Amendment of FASB Statements No. 123 and 95 (ED). As the former Chief Financial Officer of a private, early stage, entrepreneurial company that went public during my 14 years with the company and now as the CFO of a venture capital firm specializing in funding the same type of companies, I have a great deal of experience in the use and impact of stock options in the entrepreneurial and public entity environments.

I believe that investors, the primary readers of the financial statements, are less concerned about the valuation and expensing of stock options and more concerned about executive compensation, corporate governance and their own dilution as shareholders. Executive compensation can be managed through appropriate corporate governance which Congress and the SEC is dutifully legislating and regulating. The issue of dilution might be better addressed through different and additional disclosures in the financial statements which should fall under the reach of this Exposure Draft. The proposed accounting treatment does not fully address investor concerns.

Although the argument remains as to whether stock options are the same as cash compensation or are rather a shift in equity ownership, the valuation of the options is not clear cut and the methods proposed in the Exposure Draft are difficult to implement and could result in values that are not meaningful or indicative of reality. Inclusion of a value of stock options in the income statement under these circumstances, particularly if buried in a single line item with other cash compensation or a broader category, obfuscates the financial information rather than enhancing it.

The Exposure Draft addresses two primary issues: (1) stock options as compensation expense and (2) valuation of the options. The discussion below assumes that option grants meet the definition of an equity award, as defined in the Exposure Draft.

Stock Options as Compensation Expense

As mentioned above, there is still room for debate as to whether options are indeed the same as cash compensation or are simply a shift in ownership. Stock awards in large public companies are generally made for different reasons than those made in small, private start-up companies. When awarded to avoid cash compensation, I do believe that there is a compensation aspect to the issuance of the award.

The second category of awards are those made to instill ownership in a management group that does not have the

means to acquire that ownership otherwise — "sweat equity". These awards tend to not have a compensation factor; they are made to instill the emotional buy-in of key employees to a common goal of creating the next generation of business. Their value is difficult to determine since there is not an opportunity cost to the company. The end result of the adoption of the proposed rules for these types of stock awards is an income statement burdened with excessive non-cash compensation charges that will make their transition to public companies much more problematic.

Valuation of Options

Setting aside the underlying reasons to issue stock awards or options, my primary concern with the ED is the proposed valuation method. The core of the proposed lattice or Binomial model is the presence of an active, predictable trading market for the underlying equity as well as a model of employee behavior as it relates to the exercise or forfeiture of the options. A valuation process based on these as well as other risk factors seems to result in an imprecise result. Markets are not necessarily stable and predictable nor is employee behavior, particularly considering the usual ten year exercise period of most option grants. (For example, many stock awards made in the late nineties are still "under water" and will more than likely not be exercised due to the market conditions today, yet under the ED, these options would still be expensed over their exercise period.) The required input factors for the valuation models are especially difficult to determine for private companies in which there is no active market and the company is usually too young to have much history in employee exercise patterns.

Most private entities will be forced to use the Intrinsic method of valuing options since the factors for the use of the Binomial model are non-existent in that environment until the company does have many years of experience. This creates another set of problems related to re-measurement of the option value over its life forcing the company into Opinion 25 variable accounting. The end result is a high likelihood of volatility of the value of the options presented in the financial statements during the exercise period of the options. Because stock awards are used heavily in this environment (more for the "sweat equity" result), the income statement will be overly burdened with non-cash compensation expense.

In addition, those companies initially using the Intrinsic method under the ED will at sometime transition to the Binomial method of valuation. This further complicates the understanding of the value of the options as the companies continue to value options granted to that transition date under the Intrinsic method while valuing any new option grants under the Binomial method. Any private entity going public, which is the goal of venture-backed private entities, will be forced into this dual valuation method until all options valued initially using the Intrinsic method are either exercised, forfeited or expired. This is an administrative burden as well as further complication in the clarity of the financial statements.

Accordingly, for those companies without the history to adopt a Binomial method of valuation, the status quo reporting of stock options seems to be more appropriate than reporting a value within the financial statements that can not be based on substantive assumptions.

Presentation of Information

Do investors care about the impact of options on the income statement? This information has been presented on a pro forma basis for almost ten years for public entities and the investors still tend to look at income without the impact of stock compensation. Particularly for companies in growth stages, free cash flow is the best indication of the financial health of the entity. The proposed accounting and financial statement presentation does not bring clarity to this situation.

If stock option value must be included in the income statement, then the reader should be able to easily discern income and earnings per share (EPS) before and after the non-cash stock compensation charges. In other words, the stock compensation charges should be a separate line item in the income statement and income and EPS should be presented before and after those charges. Under no circumstances should these charges be buried within other compensation expense. Separate presentation would highlight the valuation challenges and the unique nature of the charge.

To address the issue of dilution to the investors, additional disclosures should be made to clearly outline the impact of stock compensation on equity. This could be done in notes to the financials, additional information in the Statement of Stockholders Equity, or, more easily, in an additional financial statement, the purpose of which is to highlight dilutive transactions for the financial statement readers.

Summary

Does stock compensation have value? Yes and no. Is it easily discernible? No. Are the valuation assumptions subject to interpretation, suggesting that the values could differ based on those making the assumptions? Yes. Is there clarity in the information investors will see so that they can make informed decisions? No.

I understand the end goal of the accounting theorists and purists in the application of the Exposure Draft. However, I do not believe the investor outrages of the last four years regarding management integrity and over-compensation will be resolved through all of the points in the ED. My concern as a reader of financial statements for investment purposes is that the accounting results and financial statement presentation proposed by the ED do not provide me the information I need to make informed decisions. I ask that you consider the broader issues I have highlighted in finalizing these accounting regulations.

Thank you for your consideration.

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