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To:

Director - FASB

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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 (the "ED"). As a venture capitalist for the last 21 years, I have the opportunity to sit on a number of private and public boards. I have also served on audit committees, again both public and private. As an engineer and investment banker in a prior life, and as a venture capitalist focused on building large businesses from small ones, I view financial statements as a tool for communicating internally and externally the fundamental economics of a business to enable both operating and investment decisions. As such, the current efforts embodied in the ED appear to me as a potentially damaging side effect of the intersection of the efforts of two very unrelated constituencies. On the one hand, are theoretical accountants, who have pushed for expensing of equity related grants (ERGs") for years. (The term Stock Based Payments reflects a bias - in many cases these are not payments in any conventional sense.) On the other, are angry public market investors, upset over the simultaneous outrages of a plague of frauds and excessive executive compensation in large public companies, hoping they can accomplish through accounting legislation what they can't through elected compensation committees. I believe the result of this unlikely pairing of interests as embodied in the ED is murkier investor disclosure combined with a material increase in the barriers for small companies to become the large public companies of tomorrow. And lest you think this an unimportant side effect, consider that fully 71 of the top 100 companies by market capitalization on NASDAQ today were founded in the last twenty-five years. Essentially all cost and no benefit. I would like to explore why expensing of ERGs is often (but not always) misguided, and why the current proposal therefore fails to accomplish its goal of better disclosure. Finally, I would propose some alternatives to consider that would significantly mitigate these problems, resulting in both better disclosure and lower costs than embodied in the ED.

First, the purity of expensing "SBP"s has been well articulated by those concerned with the theory of accounting as a mechanism to account for value accretion to an enterprise as the result of business activity. However, for years, accounting theory has fallen far behind in its ability to account for even a fraction of many modern day companies' value accretion. If accounting purity is the goal, then ERGs are not the place to start. Consequently, today, accounting, and in particular, income statement accounting, is a tool used by investors to understand the inherent cash based economics of a business. It is not useful in trying to explain other forms of value accretion, and the investing world has adapted to that fact. No matter what accounting theory advocates would like to believe, capital markets have come to rely on accounting as currently practiced for this more practical objective. An income statement is viewed as a proxy for free cash flow; i.e., the inherent economic ability of an enterprise to generate cash. The market has accepted most changes introduced by accrual accounting (e.g., depreciation) as helping reflect that economic reality. However, some concepts, all motivated I'm sure by theoretically sound reasoning, do the opposite. In particular, ones that further disconnect accounting income from cash flow, and that simultaneously introduce complex assumptions (software

capitalization, mark-to-market, etc.), both obfuscate the economic reality and offer the opportunity for abuse. Given the simple fact that ERGs will never negatively affect cash flow, adding them to the income statement as an expense is yet another, even contrary, disconnect between accounting income and cash flow. Add to that the very complex and assumption driven valuation model suggested in the ED, and the proposed solution is not a solution at all. In fact, it is not helpful to the most important audience for financial statements, investors. That this is true has been well established by the lack of impact on the market valuations of some large cap companies as they have chosen in turn to disclose in footnotes the pro forma effect of expensing ERGs, and then recently to implement expensing of ERGs on the income statement. The market can see through the obfuscation created as long as the cash flow information it wants is accessible. This critical element does not appear (to the layman) to be addressed in the ED; the amount of such non-cash flow related compensation expense must be allowed to be disclosed, ideally as a separate line item in the income statement. As long as that key element is addressed, the silver lining here is that, contrary to some doomsayers opposing the ED, the market will not overnight devalue the large companies in America if they are forced to put ERG expense on the income statement. From investors' viewpoint, it is additional obfuscation, but they can live with it. They have analysts that follow these large cap companies, and that will de-obfuscate the numbers to provide the information they need from the financial statements. It is not clear to me why the nation's foremost accounting authority would go to great expense to make financial statements less understandable for those who use them, but to do so would not change the NASDAQ overnight.

Unfortunately, it is not that simple, as there are those small non-public companies that are the basis of the growth of the U.S. economy for the next 25 to 50 years that could be much more materially affected. It is for these companies that the use of ERGs is so critical that, regardless of the accounting treatment, they will be used. In the earliest stages, ERGs are not compensation, and certainly not payments; they are a way to redistribute ownership to optimize alignment of interests between passive investors with capital and management shareholders that generally do not have the capital resources to invest directly. In such cases, the percentage of a company that might be conveyed can be very large. Most importantly, the value attributed to these grants by the models recommended in the ED can dwarf the operating results of an early stage company. While it is private, that is not so much an issue. But as such a company considers a public offering, its income statement may be overwhelmed by "expenses" that have no bearing on the cash flow potential of the business, and, in fact, are rather a positive investment consideration – a management team whose equity interest is aligned with shareholders. Moreover, newly public companies, in today's world, will not have analysts following them to aid investors in translating accounting income to cash flow. Consequently, it is imperative that, if FASB elects to go forward with any form of expensing of ERGs, it must allow such charges to be clearly separated from real expenses so that investors can easily remove them.

In fact, as a venture capitalist, my major concern about the ED is that it suggests that FASB has paid far too little attention to the application of its proposals to small companies, and assuring that the transition of small private company to large public company will not be disrupted by its rules. And, as I point out above, this is far too important to all of us to ignore. The valuation methodologies (Black-Sholes and binomial methods) proposed in the ED are questioned by many experts as overstating values for large steady-state companies. They are clearly only marginally related to value of ERGs in small private companies – many of the assumptions that are necessary are essentially undefined for a private company. The cost and effort to make unfounded assumptions and fill in the missing variables for these methodologies for small private companies are worse than painful – they impose precision on values that are wildly speculative. It is like the weatherman calculating the probability of rain tomorrow to three decimal places. Doing it is a waste of time. To spend money and time doing it is folly. Yet the only alternative described for such companies, the intrinsic value method, would most certainly render reported accounting earnings totally irrelevant for the first few years after an IPO, as they fluctuated wildly. As such, intrinsic value is a non-starter for any company that thinks it might at some point attempt to go public.

As an investor, I am actually interested in improvements to accounting that help me better understand the two things I care most about – the ability of a business to generate, now and in the future, free cash flow, and how much of it I own. From an investor's perspective, the only relevant measure of ERG related expense is the notion of avoided cash expense, as that is what is relevant to the cash flow economics of the business. While for large cap steady-state companies, a portion, perhaps even a large portion, of ERGs are indeed compensation (rather than realignment of ownership), for small companies, that ratio is reversed. Given the many things that can go wrong (not, by the way, considered in the recommended valuation methodologies), the compensation portion is tiny: ERGs are used mainly to

realign ownership. ERGs are at that point more akin to a lottery ticket – the payoff can be huge, but the value today is diminimus. FASB's solution to this issue must address these two different realities, and allow for a smooth transition between them. From an investor perspective, an ideal solution would include the following:

- Only the portion of any calculated "value" (see item two below) of ERGs determined to avoid cash expenditures should be included in income statement expense. If this were the standard, such amounts would not need to be separately itemized in the income statement.
- Value of ERGs should be determined as deemed appropriate by a company and their auditors before a
 trading market exists for the equity involved, and it should not subject to later adjustment as called for in the
 intrinsic value method as outlined in the ED. The currently recommended methodologies, while
 cumbersome, could be used for public companies. In either case, the calculated value would be the upper
 limit to the income statement charge in item one above.
- The dilution attributable to ERGs should be set forth in a Statement of Shareholders Dilution, setting forth beginning and ending shareholdings, changes in shareholdings, and potential future dilution from ERGs.

At the least, FASB should further study and understand the impact of these proposed changes on the overlooked, and very critical, segment of the economy represented by early stage and small cap companies. And to the extent any expensing of ERGs is undertaken beyond what I suggest in item one above, it must be easy for investors to get to the number they have demonstrated they care about – earnings before non-cash charges related to ERGs.

Sincerely,

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