



March 4, 2003

Via Email and Overnight Courier

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Re: ED 2 – Invitation to Comment

On behalf of the National Venture Capital Association, I am writing to offer comments on ED 2. We view the IASB proposal reflected in ED 2 as particularly problematic for three primary reasons: First, employee stock options and similar share-based transactions do not meet the definition of an expense under current International Accounting Standards (“IAS”). Second, current option pricing models simply cannot accurately value employee stock options. Required expensing of employee stock options will not result in financial statements that are more accurate, reliable, or comparable. As we discuss below, the IASB proposal is even more troublesome in the context of stock options issued by pre-public and newly public companies. Finally, mandatory expensing of employee stock options will have a significant, negative impact on the European venture capital industry, goes directly against the European Commission’s stated goal of encouraging innovation, and will negatively impact the European economy as a

whole, hurt international trade, international investors, international employment, and international R&D.¹

The NVCA is particularly interested in this issue. Employee stock options are essential to the venture capital business model. As we discuss in more detail below, a mandatory expensing standard would directly, adversely, and disproportionately impact venture-backed companies, particularly pre-public and newly public companies. Moreover, ED 2 would make financial statements less accurate, reliable, and comparable.

We note that ED 2 is not seeking comments on whether employee stock options should be expensed. We believe that it is essential, however, that this issue be addressed. Simply put, there is no consensus among accounting experts that employee stock options constitute a corporate expense. For example, several accounting groups, including KPMG and the Institute of Chartered Accountants in England and Wales, have already told the IASB that they did not believe that employee stock options should be accounted for as a corporate expense.² The Federation of Swiss Industrial Holding Companies and the London Investment Banking Association voiced the same position. In sum, there is no liability created and there is no decrease in corporate assets when an employee stock option is issued, vests, or is exercised. In fact, corporate assets increase if and when an option is exercised. When there is this much

¹ Similar results would also occur in any country subject to a proposal similar to ED 2. We focus on Europe because of the European Commission's specific innovation goals and because, outside of the U.S., the European venture capital industry is the most developed.

² These comments were made in the context of the G4+1 Discussion Draft – Accounting for Share Based Payments, that was originally issued by the G4+1 and then reissued by the IASB.

disagreement among accounting experts as to the fundamental issue of whether employee stock options should be accounted for as a corporate expense, we believe it is completely inappropriate for the IASB to just assume away this fundamental issue. Indeed, it calls into question whether the IASB has cast aside due process in exchange for accounting rules that may reflect the views of some of its members, but not of the accounting community at large, including auditors, financial statement preparers, and users of financial statements. As the European Commission told the IASB previously, “In our view it is unrealistic to expect reasoned and informed debate of such controversial issues if the initial discussion document commences by simply dismissing opinions to which the authors do not subscribe.” European Commission Letter in Response to the IASB’s Reissuance of the G4+1 Discussion Paper, February 12, 2001. We hope that the IASB will heed the advice of the European Commission so that any new international accounting standard that is ultimately issued is sound and will, in fact, improve financial statement accuracy, reliability, comparability, and consistency.

A mandatory expensing standard implies that stock options are, in fact, a form of compensation. In general, the NVCA agrees that stock options can be compensation where there is an explicit exchange of options for cash or other direct forms of payment. But that is seldom the case in the context of employee stock options. Most grants are unilateral, and not explicit exchanges of value. Many employers grant options to all employees. There is no bargaining. In the absence of options, few companies would pay the majority of their option recipients more. New economic evidence confirms this and concludes that employee stock options are not labor income, but, instead, are capital. *In the Company of Owners: The Truth About Stock Options and Why Every Employee Should Have Them*, Blasi, Kruse, Bernstein (Basic Books 2003), at 214-15

(emphasis added). Mischaracterizing a capital transaction as compensation expense will not improve financial reporting or result in more reliable or transparent financial statements.

Whether or not one agrees that employee stock options are capital and not an expense, one thing is clear. Under existing IAS, any recognition of an expense item is appropriate only when the value of the exchange can be measured with sufficient reliability and in a manner that promotes comparability between companies. Simply being valuable is not enough to justify a charge; that value has to be reliably measurable. ED 2 correctly concludes that it is not possible to measure reliably the value of the services that, in the view of ED 2, an employee provides in exchange for the stock options. Instead, ED 2 opts for the use of an indirect method – in the case of employee stock options, this would require the use of option pricing models.

Existing option-pricing models use complicated formulas based on numerous assumptions, including predictions of interest rates, dividend expectations, and stock volatility 10 years into the future. The same model can produce widely divergent results depending upon what guesses the company decides to use. There simply has been no agreement in accounting circles regarding option-pricing models for employee stock options since the current U.S. accounting rules for options were adopted in 1972. In short, although FASB believed that option pricing models that were developed to value a freely tradeable stock option could be used to value a very different instrument – an employee stock option that is not freely tradeable and which vests over time – the historical data that has developed over the last seven years proves otherwise. The shortcomings of these models are compounded by the fact that neither FASB Statement No. 123 nor ED 2 would allow adjustments to be made when options expire unexercised or when reality

turns out to be nothing like it was projected at the time the expense amount was determined. “An estimated seven to 10 million Americans hold employee stock options, according to the National Center for Employee Ownership. The value of options on the date they were granted approaches \$25 billion for the top 200 companies in the Fortune 500, says compensation-consulting firm Pearl Meyers & Partners, based on its annual survey. Corey Rosen, executive director for the nonprofit National Center for Employee Ownership, estimates that ‘maybe as much as half [of those options] currently are underwater’ because of the stock-market declines since early 2000.” Workers to Bear Brunt of Push for Firms to Expense Options, Wall Street Journal, August 7, 2002.

The so-called minimum value approach allowed for non-public companies under FASB Statement No. 123 addresses the valuation issue to some extent by assuming that stock price volatility is zero.³ The FASB determined that “estimating expected volatility for the stock of a newly formed entity that is rarely traded, even privately, is not feasible.” Statement No. 123 at ¶174. We agree. Statement No. 123, however, would require newly public companies that choose to expense their options, to “estimate volatility based on the historical volatility of similar entities following a comparable period in their lives. For example, an entity that has been publicly traded for only one year that grants options with an average expected life of five years might consider the pattern and level of historical volatility of more mature entities in the same industry for the first six years the stocks of those entities were publicly traded.” Statement No. 123 at ¶ 285. The IASB proposal goes much further than Statement No. 123 in that it would

³ However, even this method grossly overstates the value of any employee stock options because it does not allow any discount for lack of transferability and also does not allow an expense to be adjusted to reflect actual option activity.

require all companies to expense their employee stock options and would require that even non-public companies estimate stock price volatility in doing so.

NVCA simply fails to see how newly public and certainly pre-public companies could reliably predict stock price volatility when there is no established, active market for the stock. One of the most widely cited appraisal references concludes that “When valuing the options of a privately held company, reliable historical prices are not available. Using the price series of a comparable public company to estimate the volatility factor may not be an acceptable proxy.” Pratt, et al., *Valuing a Business*, Fourth Edition, McGraw-Hill, New York. (p. 560). Yet this is precisely what the IASB would require. NVCA cannot see how this could possibly improve financial statement transparency, comparability, or reliability. In fact, just determining what companies are similar enough to use would be an impossible task. For example, there simply was no other company like Ebay when it went public, when it was newly public, or even today. New bio-tech companies that develop a new way to combat a disease or a national security threat would face the same problems. The same is true for the vast majority of venture-backed companies. Further, because there are far fewer venture-backed companies outside of the United States today, the problem with finding purportedly “comparable” companies is made even more difficult.

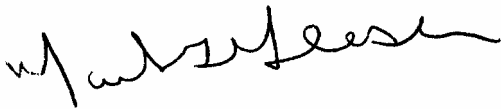
Another problem with the IASB approach (and Statement No. 123 to the extent it would require newly public companies to estimate volatility) is that the post-IPO experience of companies over the last five years is unlikely to be anything like the post-IPO experience of a company today or five or ten years from now. Predicting a value for employee stock options through reliance on

the past experience of any company, let alone a company other than the one whose employee stock options you are attempting to measure, will do no more than provide bad information to investors.

Question 1 of ED 2 asks if “the proposed scope of ED 2 is appropriate. If not, which transactions should be excluded and why?” We believe that all employee stock options should be excluded from the scope of ED 2. But at a minimum, we believe that pre-public and newly public companies should be exempted from the scope of any eventual international accounting standard. We continue to believe that current option pricing models, including the so-called minimum value model, simply are too unreliable to be used. Instead, the NVCA believes that the real “cost” of employee stock options is the potential dilution that could result to existing shareholder interests if the options are, in fact, exercised. We have long supported additional disclosures of information relating to potential shareholder dilution. These disclosures could take many forms. For example, there have been some concerns expressed that the use of the treasury stock method to compute diluted earnings per share understates the potential dilution of employee stock options. Perhaps the IASB could consider requiring the type of super dilution figure that at least one commentator has called for. *Business Week*, News: Analysis & Commentary, September 23, 2002. In this way, investors would know what the true worst case dilution would be if all outstanding options were exercised. We also would support additional disclosures relating to stock options awarded to corporate executives. These types of reliable disclosures would provide investors with information that they need to make informed investment decisions.

Europe has seen considerable venture capital investing in the past several years. In the first three quarters of 2002 European venture capitalists invested (Euro) 4.9 billion in 3,565 companies. In 2001 Europeans VCs invested an (Euro) 12.3 billion in 8,104 companies. In 2001, early stage investing made up (Euro) 4.2 billion going to 3,306 companies. High-tech was the largest industry category for investment at (Euro) 6.9 billion. The consumer-related, communications, and chemical and materials industries also received substantial investment. In 2000, venture-backed companies employed 12.5 million workers and a total of 27 million U.S. jobs were driven directly or indirectly by venture-backed companies. In addition, venture-backed companies have increased jobs while old-line companies have suffered. As an example, United Airlines is cutting jobs while venture-backed Jet Blue is hiring. As illustrated by the U.S. venture capital industry experience, this type of venture capital investment bodes well for the European economy and should be encouraged. ED 2 would be a step in the wrong direction.

Thank you for consideration of our views.

A handwritten signature in black ink, appearing to read 'Mark Heesen', with a stylized, cursive script.

Sincerely,

Mark Heesen
President