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June 30, 2004

Ms. Suzanne Bielstein  
Director of Major Projects  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856-5116

**Letter of Comment No: 5537**  
**File Reference: 1102-100**

Dear Ms. Bielstein:

On behalf of Broadview, a division of Jefferies ("Broadview"), thank you for the opportunity to submit my firm's comments on the FASB Exposure Draft – Share-Based Payment, an Amendment of FASB Statements 123 and 95, File Reference No. 1102-100.

Broadview is an investment banking firm focused exclusively on the IT, communications, healthcare technology and media industries. We are deeply involved in advising the growth-oriented companies that generate much of the employment expansion in our economy. We provide these clients with advice on merger and acquisitions, private placements, and public equity finance. Broadview recently celebrated its 30<sup>th</sup> anniversary year and I have personally spent 20 years as an executive and/or advisor in the technology industry. As such, I have had the opportunity to accumulate extensive knowledge on the financial issues faced by development-stage companies and young publicly held companies. With that in mind, I am writing to address the ongoing debate over the expensing of employee stock options.

As you are well aware, employee stock options have been used to motivate employees to take to the risk, and share in the reward, in developing new businesses that create new jobs, oftentimes in place of more traditional means. The challenge before you is to determine what expense, if any, is incurred by the issuing corporation in connection with an option grant. I fundamentally believe no expensing should take place, for several reasons.

First, a compelling argument can be made that an option is not a corporate expense. I believe that there is a fundamental misunderstanding on this point. From the standpoint of the corporation that issues the employee stock option, the value (or cost) is neither a cash nor a budgetary expense, but rather comes in the form of dilution of earnings to its shareholders. That said, cost of issuance should be reflected not in a reduction in earnings, but in the allocation and

distribution of those earnings over a larger (by the number of vested option holders) fully diluted shareholder base. This already happens today. Hence, I consider expensing options to be an attempt to fix a problem that does not exist.

Second, even if one were to attempt to expense options as an operating charge, significant challenges exist. The Black-Scholes model, which has been accepted in the industry as the standard for option pricing, is flawed when it comes to valuing employee option grants for reasons related to liquidity, term and transferability. More important, the binomial or lattice models for which the Board's Exposure Draft has shown a preference suffer from the same fatal flaws when applied to employee stock options. What is deeply troubling to me on this point is that the primary objective of the regulatory bodies is to better protect shareholders, yet this solution creates the opposite effect: less accurate disclosure; less accurate financial reporting; less accurate investment decisions.

Third, the expensing of stock options has vastly different financial implications for different kinds of companies. Black-Scholes is based on five fundamental variables: equity price, option strike price, option time to expiration, risk-free interest rate and volatility of the underlying security.

Volatility alone is specific to the security, and, under both the Black-Scholes and binomial valuation models, can vary significantly. This variance has the greatest impact on option value, with the result making the cost of comparable option plans vary wildly across companies (unlike cash, which is a common and stable currency). In an analysis conducted by Broadview, it was found that not only are option prices incredibly sensitive to volatility, but the range of volatility varies tremendously across securities. As an example, the value of a 3-year Akamai call option is approximately 85% higher than the value of a Coca-Cola option, all else being equal. This will undoubtedly create a substantially greater expense for Akamai, although one might reasonably question which security an employee would prefer: the highly volatile and risky Akamai options, or the relatively stable Coca-cola options. Indeed, the analysis clearly shows that younger, smaller companies will be dramatically, and negatively, impacted by expensing, making it more expensive and difficult for them to recruit and retrain the talent they need to grow and create new high wage jobs.

Binomial models clearly don't address the fundamental problems inherent in the Black-Scholes model. The binomial models similarly require assumptions of employee exercise behavior, future dividends, future interest rate and future volatility of the underlying security. At a given volatility, the Black-Scholes and binomial models ultimately converge to a comparable value. Further, the chosen binomial interval results in vastly different option values, further undermining the accuracy of the binomial methods.

Fourth, and most importantly, it is my strong opinion that compelling enterprises to expense stock options will hamper innovation and new company formation. In light of the volatility impact, technology companies, in particular, will find themselves with tremendously high expenses for the issuance of options. Such an approach will create a disincentive for granting options broadly among

employees, resulting in decreased employee motivation and a more challenging environment for recruitment at the companies who have made the United States economy the global titan it has become over the past two decades. This phenomenon will be particularly acute among the early-stage technology firms I interact with daily, where recruiting is increasingly difficult and cash is increasingly expensive as a tool for employee retention.

In light of these four factors I strongly believe that expensing stock options is inappropriate. I find it ironic that those who fall on the other side of the debate and I are after the same thing - shareholder protection and full disclosure. The current system of not expensing options and disclosing dilution information to shareholders meets this need best. It would appear to me that instead of presenting a more convoluted income statement, companies should be required to present a more comprehensive and regular disclosure of option grants and the impact on earnings per share. The expensing of options would only serve to further muddle the financial message.

I very much appreciate the opportunity to offer these comments on what is clearly an important dialogue in the financial community. I look forward to further opportunities to work with the Financial Accounting Standards Board to improve financial reporting in the future.

Sincerely,

Paul Deninger  
Chairman  
Broadview, a division of Jefferies