

Letter of Comment No: 177
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February 1, 2003

Financial Accounting Standards Board
MP&T Director - File Reference 1102-001
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856

Dear Sir or Madam:

On behalf of Broadview International LLC ("Broadview"), thank you for the opportunity to submit my firm's comments on the FASB Exposure Draft – Accounting for Stock-Based Compensation, File Reference No. 1102-001.

Broadview is a global M&A advisor and private equity investor 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 and private placements, in addition to investing in them through both an early stage venture capital fund and late-stage private equity fund. This is Broadview's 30th anniversary year and I have personally spent nearly 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 of the same type as other forms of compensation. I believe that there is a fundamental misunderstanding on this point. While there is *potential* value being transferred, that value is very different in form and effect for the receiver and the issuer. For the receiver, the value is in the intrinsic and time value of the option. For the issuer, however, 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 find 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. Black-Scholes, 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. 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, again the currently accepted methodology for option pricing, 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. Each of these variables, with the exception of volatility, can be level-set across any number of securities (i.e. based on these four factors, two options with the same strike, stock price and time to expiration are comparable). Volatility alone is specific to the security, and 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 stable currency). In an analysis conducted by Broadview (attached), 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.

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. For example, a study found that in 1998 Microsoft's \$4.5 billion reported net income would have been a \$2.3 billion loss had the company expensed its option grants¹. 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 US 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.

¹ Parish & Company, 1998.

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.

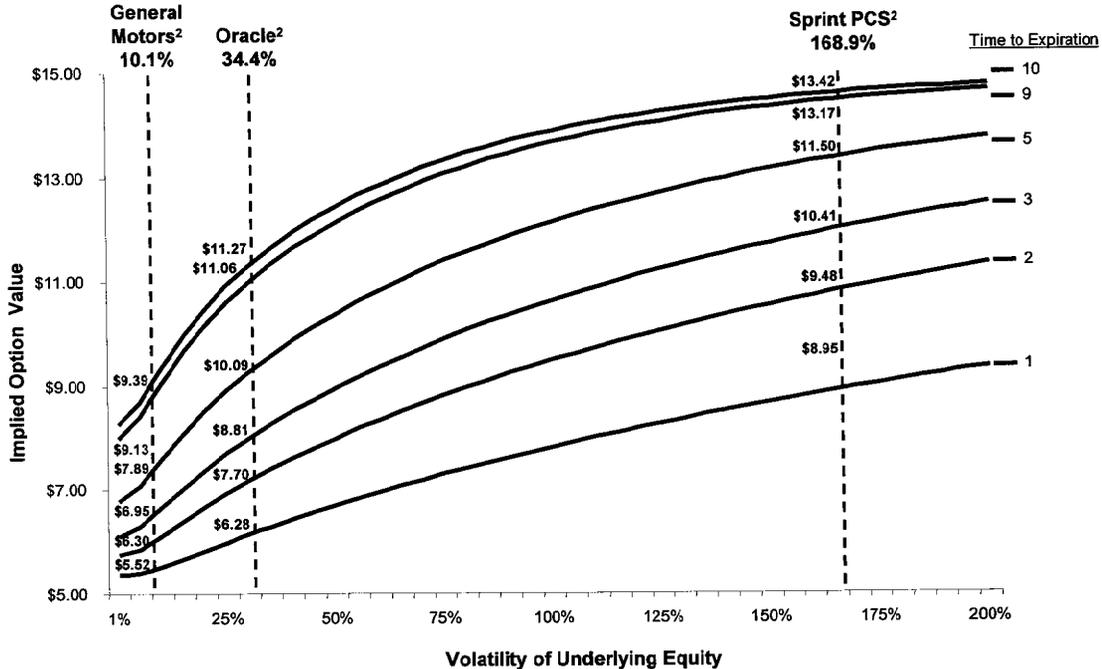
Sincerely,

Paul Deninger
Chairman & CEO
Broadview International LLC

Attachments:
Option Pricing Analysis

Variation In Equity Volatility Results In Vastly Different Option Values

Black-Scholes Option Valuation¹



¹ Assumes all equities trade at \$15 per share, all options have a strike price of \$10 and the risk-free rate is 4.02% (10-year T-Bill as of January 30, 2003).
² Reflects volatility of equity over one year only. While this is used as a proxy for visual purposes, implied option values are accurate for each time period.

A Select Group Of Equities Illustrates The Material Impact Of This Variability

Black-Scholes Option Valuation¹

Netegrity	208.4%	\$9.46	\$10.99	\$12.04	\$13.16	\$14.07	\$14.28
Akamai Technologies ³	175.2%	9.03	10.55	12.17	13.41	14.50	14.62
Sprint PCS ³	168.9%	8.95	9.48	10.41	11.50	13.17	13.42
i2 Technologies ³	160.6%	8.83	10.67	11.80	12.90	13.76	13.97
NVIDIA ³	92.9%	7.68	9.01	10.92	12.03	13.60	13.82
Sun Microsystems	45.6%	6.59	8.17	9.00	9.87	11.19	11.41
Yahoo ³	39.9%	6.43	8.14	9.33	10.85	12.36	12.66
Oracle	34.4%	6.28	7.70	8.81	10.09	11.06	11.27
Cisco	29.8%	6.14	7.89	8.67	9.57	10.69	10.89
Intel	25.9%	6.02	7.12	8.12	9.10	10.18	10.45
Microsoft	12.4%	5.59	6.29	7.34	8.34	9.47	9.71
General Electric	11.3%	5.56	6.36	6.97	7.76	8.89	9.10
General Motors	10.1%	5.52	6.30	6.95	7.89	9.13	9.39
Coca-Cola	7.1%	5.45	5.95	6.59	7.60	8.85	9.08
ChevronTexaco	5.4%	5.42	5.87	6.36	7.17	8.45	8.72

¹ Assumes all equities trade at \$15 per share, all options have a strike price of \$10 and the risk-free rate is 4.02% (10-year T-Bill as of January 30, 2003)

² Reflects volatility of equity over one year only. While this is used as a proxy for actual volatility, implied option values are accurate for each time period.

³ As the Company has traded publicly for less than 10 years, volatility for certain options' time-to-expiration has been based on a maximum number of trading days in accordance with FASB.