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**SENT VIA EMAIL**

November 4, 2002

MP&T Director  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856-5116  
Email: [director@fasb.org](mailto:director@fasb.org)

Letter of Comment No: 43  
File Reference: 1101-001  
Date Received: 11/5/02

Re: File Reference No. 1101-001

Dear Director:

Cisco Systems, Inc. appreciates the opportunity to provide comments on the Financial Accounting Standards Board's ("FASB") Exposure Draft on Accounting for Stock-Based Compensation - Transition and Disclosure ("Exposure Draft"). We support the FASB's continuing efforts to provide more timely disclosure of relevant financial information to investors as well as improved comparability and clarity. However, we have significant concerns with the current valuation methodologies, which we believe would be further highlighted by expensing employee stock options. We also recognize that the purpose of this Exposure Draft is to address guidance regarding transition rules but we would be remiss not to articulate our more fundamental disagreement with the expensing of employee stock options, which we will outline at the end of our letter.

We concur with the Exposure Draft that the disclosure of relevant stock option information should be provided quarterly. We have always supported timely disclosure and agree that annually is not sufficient. We do have concerns that the FASB is proposing that such disclosures would be included in the "Summary of Significant Accounting Policies." While we agree that disclosure of stock option information is an important element of a company's overall reporting, it is arguable whether these disclosures are more or less important than the other information required in the footnotes to the financial statements. Consequently, we believe that only those disclosures focused on accounting policies relative to stock options should be included in the "Summary of Significant Accounting Policies" section and not all of the data elements described in Paragraph 2.d.c. of the Exposure Draft. These broader disclosures are more appropriately included in a separate footnote to the financial statements.

We believe allowing for multiple alternatives in transitioning to expensing fixed employee stock options will only further inhibit comparability, which is already severely compromised by the variability that inherently exists in the valuation approach. We fail to see how this guidance will



improve the transparency of financial statements. This will likely result in further confusion for the average investor. We believe that if there were a more accurate valuation methodology, the need for multiple alternatives would diminish.

The following represents a summary of the key issues that exist with the current valuation methodology:

- The use of option-pricing models as described in Statement of Financial Accounting Standards (“SFAS”) No. 123 to calculate hypothetical compensation charges related to fixed employee stock options is inappropriate. These models were developed to value exchange-traded stock options. There are key fundamental differences between exchange-traded stock options and fixed employee stock options including the following:
  - Exchange-traded options are short-term in nature while fixed employee stock options are generally longer-term
  - Employee stock options are subject to forfeiture by the employee and require continued employment for exercise
  - Employee stock options might be subject to internal and external company policy with respect to timing of exercise such as insider trading restrictions
  - Employee stock options typically vest over time
  - Exchange traded options are freely tradable in the financial markets while employee stock options are non-transferable
- When SFAS 123 was released, the FASB believed that the Black-Scholes and other similar option pricing models were appropriate to estimate the “fair value” of fixed employee stock options. We have seen with the recent significant downturn in the global economy that measures of the “fair value” of fixed employee stock options (including those employee stock options which are significantly underwater) for many companies calculated under such pricing models were grossly overvalued. Expensing of these values over the service period of the options would have resulted in material misrepresentations of companies’ operating results had such values been expensed. Alternatively, when the economic environment is improving, one could argue that the valuation is grossly understated from a realizable value standpoint. This kind of result certainly supports the view that the expensing of options would further add to the complexity of the financial statements and confusion of the reader in understanding a company’s financial results and performance. This clearly undermines the FASB’s ongoing objective to improve transparency in financial reporting. Regardless, the appropriateness of the valuation is subject to being able to predict the future.
- Option pricing models require the input of highly subjective assumptions including the expected stock price volatility, interest rates and other variables that are effectively surrogates for employee behavior. Not only are these assumptions extremely difficult to determine, but small changes in these assumptions can result in wide variations in the computed valuations. The comparability, and ultimately the usefulness, of such



- information across various companies, industries and geographies would be significantly adversely impacted with the expensing of fixed employee stock options.

We believe that these issues with the valuation methodologies are a significant cause of concern regardless of whether a company expenses employee stock options or merely discloses the same information. However, a vastly exaggerated charge in the financial statements will be more damaging than a disclosure.

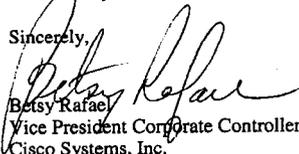
While we do not agree with recording a hypothetical charge on the income statement in an attempt to reflect the “fair value” of fixed employee stock options, we do recognize that some readers may find the disclosure information in SFAS 123 useful depending on their individual perspective of the relevancy of the data. Currently, under SFAS 123, those readers can review the financial statements with or without the hypothetical compensation charge for those companies choosing the intrinsic value method along with the other disclosure information required under SFAS 123.

We believe that the real impact of employee stock options is ownership dilution. This is already reflected in the denominator of earnings per share (“EPS”), and thus a reduction in net income (the numerator) for fixed employee stock options would create an inappropriate double-charge reflected in EPS. The result of fixed employee stock options is not an expense to the company, but rather a cost in terms of dilution to the shareholders. Possibly incorporating all outstanding options in this calculation as opposed to “in the money” options would be a more accurate alternative to expensing.

In summary, we concur that more timely disclosure of stock option information is appropriate. However, we disagree with any changes in the accounting standards that lead to the expensing of fixed employee stock options. Conceptually, it is not appropriate to record an expense, as the transaction does not result in the consumption of the company’s assets that is required for an expense and therefore, should not be recorded as such. Further, numerous issues exist with respect to estimating a fair value for fixed employee stock options including their lack of transferability and liquidity. Models other than Black-Scholes, which consider the differences in the characteristics of fixed employee stock options and exchange-traded options should be considered, including the minimum value method, among others.

We thank you for the opportunity to comment on the FASB’s Exposure Draft on Accounting for Stock-Based Compensation – Transition and Disclosure. Please feel to contact me at (408) 525-0164 for any further discussion of our comments.

Sincerely,



Betsy Rafae

Vice President Corporate Controller  
Cisco Systems, Inc.