

Len Tatore

Letter of Comment No: 1303
File Reference: 1102-100

From: ED Ryba [eryba@cisco.com]
Sent: Wednesday, April 21, 2004 8:02 PM
To: Director - FASB
Cc: savestockoptions@cisco.com
Subject: File Reference No. 1102-100

To:

Chairman Robert H. Herz

Re: FASB proposal to require expensing of employee stock options

Dear Mr. Chairman:

I am writing to you to urge that FASB not require the expensing of employee stock options. It is my understanding that there are two main objectives of the proposal that would require this expensing:

- 1) That the 'true' cost of issuing employee stock options be reflected in the financial results of the issuing company.
- 2) That current and prospective stockholders of the issuing company be better informed of the (sometimes very large) stock option grants issued to top executives at the issuing company, the intent being that this should better enable stockholders and the board of directors to ensure that such grants are reasonable, in line with grants issued to executives in similar positions at similar companies, and as such, are not abused to the benefit of those executives.

THE INSTITUTION OF A REQUIREMENT FOR ISSUING COMPANIES TO EXPENSE EMPLOYEE STOCK OPTIONS WILL ACCOMPLISH NEITHER OBJECTIVE.

With regards to point #1:

The 'true' cost of employee stock options to the issuing company is the dilution in earnings per share that is incurred when such options are exercised, and the stock issued; to that end, ***the fully diluted earnings per share reported by the issuing company already does reflect this dilution, and therefore already does reflect the 'true' cost of the options to the company.*** Potential future dilution of EPS is represented by the number of additional option shares currently authorized (but not yet issued) by the board of directors; to the degree that potential future dilution of EPS due to the future issuance of shares ***already authorized by the issuers' board of directors*** is of concern to current and prospective stockholders, perhaps a better resolution would be to require reporting of what the authorized but unissued shares represent as a percentage of outstanding shares, and what the theoretical impact to current EPS would be if 100% of the authorized but unissued shares were issued immediately.

The fact is that there is no accurate and fair method available today (at least of which I am aware) to place a current value on employee stock options at issuance; the actual value of these options (if any) is realized over future dates, determined by the associated vesting schedule, and is a function of the market price of the stock at those future dates. These options are not transferrable, cannot be hedged or traded, and are forfeited if the employee leaves the company before vesting; ***they have \$0 value to anyone prior***

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to vesting, and any post-vesting value is determined by future market price. Neither the Black-Scholes nor the binomial pricing models were intended to be used to value such options, and neither is accurate, applicable nor fair in this case. **Charging the cost' calculated by either method of employee stock options at the time of granting to reported earnings of the issuing company is arbitrary and inaccurate, and can only serve to artificially depress those reported earnings.**

Even if such expensing of options were proven to be applicable, fair and accurate, then a proposal to implement this expensing should be accompanied by a proposal to 'mark to market' the actual 'expense' realized when the options are, in fact exercised at a future date; in other words, at exercise, if the market price of the exercised shares proves to be higher than that used to calculate the 'cost' at issuance, then additional 'cost' should be charged to earnings to reflect this difference at exercise; **conversely, if the market price of the exercised shares proves to be lower than that used to calculate the 'cost' at issuance, then a credit representing the difference should be accrued to earnings at exercise.** This then becomes an exercise that is used to 'rationalize' predictions of stock price made arbitrarily in years past, still does not represent an actual cost or benefit to the issuing company, and leads to earnings reports whose results are a function not only of corporate performance, **but also of stock market performance**; such a requirement will serve no actual purpose and will actually lead to the reporting of less meaningful financial results.

The fact is, that, in many businesses, and in the technology industry in particular, the ability to issue employee stock options without taking an arbitrary impact to earnings is the fuel for innovation; smaller private and publicly-traded companies necessarily use the issuance of such options to motivate the future performance of their employees; these companies are riskier than larger established competitors, and usually do not have large cash reserves that can be used to compensate employees; the availability of employee stock options that represent the **potential** for employee ownership of the company at increasing value is what enables these companies to attract the intellectual talent that they need to prosper. **These companies will not be able to issue employee stock options if doing so will arbitrarily impact their reported earnings; as a result, they will not be able to attract the talent needed to make them competitive, and innovation will be stifled.**

With regards to point #2:

The fact that stockholders or even the board of directors of a company are 'unaware' of the size of option grants issued to their executives represents a failure on the parts of the stockholders and/or board to take an adequate interest in the operation of the company; it is not a failure of the system that enables the granting of employee stock options. Regardless of their size, these grants still do not represent a 'cost' to the company other than their eventual impact to EPS. **The way to address this problem is to change the reporting requirement for executive stock options and compensation, not to attach an arbitrary 'cost' to earnings of the company for the issuance of those options.** Maybe explicit reporting and shareholder approval for proposed stock option grants representing more than a fractional percentage of potential ownership of the issuing company to any employee whose overall annual compensation in a given year is greater than that of 95% of all employees would serve to make such grants more visible, and put in place a mechanism requiring definitive approval by the stockholders prior to grant; this would, in fact, address the latter objective.

As I understand it, the proposal to require expensing of stock options at issuance makes no sense, will impose additional layers of cost and bureaucracy to financial reporting activities of issuing companies, will serve to make actual corporate financial performance even less transparent and less meaningful, will stifle innovation, will arbitrarily impact reported earnings of issuing companies, and will do nothing to address the potential for abuse of excessive grants by corporate executives. **As such, it may be well-**

intentioned, but represents bad policy.

I am an employee of Cisco Systems, Inc.

For the reasons stated above, I respectfully ask that this proposal ***not*** be approved.

Sincerely,

-Edward Ryba