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Letter of Comment No: **243**  
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Ms. Suzanne Bielstein  
Director of Major Projects and Technical Activities  
Financial Accounting Standards Board  
401 Merritt 7  
Norwalk, CT 06856-5116

**VIA EMAIL: [director@fasb.org](mailto:director@fasb.org)**

Re: File Reference No. 1102-001  
Accounting for Stock-Based Compensation: A Comparison of FASB Statement No. 123,  
Accounting for Stock-Based Compensation, and Its Related Interpretations, and IASB  
Proposed IFRS, Share-based Payment

Dear Ms. Bielstein,

Cisco Systems appreciate the opportunity to provide our views on the Invitation to Comment (ITC), "Accounting for Stock-Based Compensation: A Comparison of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, and Its Related Interpretations, and IASB Proposed IFRS, *Share-based Payment*". The topic of accounting for employee stock options is highly controversial and has significant impact across companies on a worldwide basis. We understand that the FASB has indicated in the ITC that it is not seeking comments on certain issues including whether stock options granted to employees result in compensation expense for the issuing entity and whether the fair value of stock options can reliably measured, among others. While we understand the FASB's intent to focus respondent's comments on specific questions, we do not believe it is possible to provide adequate feedback and context without addressing the underlying fundamental issues. Additionally, we understand that the FASB and IASB are focusing on global convergence of accounting standards. While we agree conceptually with the concept of harmonizing accounting standards on a global basis, we are extremely concerned that critical issues such as accounting for employee stock options may be compromised merely for the sake of convergence.

Specifically, we cannot support the IASB standard because of its flaws in the underlying accounting concepts. The standard requires the mandatory expensing of employee stock options, which we believe is inappropriate based on the accounting conceptual framework. The award of an employee stock option does not result in the consumption of an enterprise's assets that is required for the recording of an expense and, consequently, should not be recorded as such. It is arguably an opportunity cost but to date, generally accepted accounting principles do not allow for such charges. We believe the real cost of employee stock options is to the shareholders of the

enterprise who agree to a dilution of their ownership to align their incentives with those of the company's employees. Stock options potentially dilute ownership but are not an impact to the financial performance of an enterprise. This cost is already reflected in the earnings per share computation through the dilutive impact on the number of shares used in the calculation. Consequently, the recording of an expense would, in effect, reflect this impact twice.

In addition, the current option pricing models, including the broadly used Black-Scholes model, were not designed to estimate values for employee stock options. Rather they were designed for exchange-traded stock options. Consequently, the use of these models to calculate hypothetical charges on the profit and loss statement is clearly inappropriate. The basic differences between exchange-traded and employee stock options are significant and include 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.
- and, exchange traded options are freely tradable in the financial markets while employee stock options are non-transferable.

The current stock option pricing models are also extremely sensitive to the often, subjective inputs required. Small changes in the underlying variables including expected stock price volatility, expected life of the option along with the other variables, which all attempt to simulate employee behavior, can cause wide variations in computed results. The use of these models to record charges to the profit and loss statement would hardly result in more accurate and transparent financial reporting, but in fact, would result in potential material misstatements of an enterprise's financial results.

To illustrate the impact of this sensitivity, consider the example of Cisco's fiscal 2002 employee stock option activity. During 2002 Cisco granted approximately 282 million options to employees at a weighted average exercise price of \$17.72. These options had a weighted-average estimated value of \$8.60 per share based on the Black-Scholes option-pricing model. This represents approximately \$2.4 billion of "value" based on Black-Scholes. Approximately two months later on October 4, 2002 Cisco's ending stock price was \$9.46 per share. If the Black-Scholes estimated value were updated for the stock price only (all other variables held constant) the value generated by the model would be \$3.01 per share which results in approximately \$850 million of "value" based on the Black-Scholes model. The difference of approximately \$1.6 billion, or \$5.59 per share, is based solely the change in Cisco's stock price over a two month period. Cisco's ending stock price for its fiscal 2002 was \$11.82 which would make all of the 282 million options granted during the year under water representing no value to employees at that date. This example illustrates the point that the valuation based on Black-Scholes is nonsensical for employee stock options. We are trying to predict future stock market performance, which even the experts cannot do accurately. Expensing of amounts that are subject to such ridiculous swings in value generated

from such flawed models would be at the very least be misleading as well as irresponsible.

In addition, Cisco's reported net income for fiscal 2002 was \$1.893 billion. The stock option charge disclosed for fiscal 2002 was \$1.520 billion. This means that our earnings per share would have gone from \$0.25 per share to \$0.05 per share. Yet, approximately 74% of the outstanding options were under water, or of no value to the employee. The company has no less cash on its balance sheet. Even using the opportunity cost theory doesn't work, as most of those options will not ever be exercised. How can this be a better representation of the financial results?

FAS 123 allows companies a choice as to whether to expense employee stock options or provide relevant disclosures in the footnotes to the financial statements. We clearly support companies providing additional timely disclosures as now required under the recent amendment to FAS 123. We encourage the IASB to adopt a similar standard rather than mandatory expensing, which will simply not meet the objectives the IASB is seeking. The valuation issues addressed herein would exist in the disclosures, but that option would clearly be more desirable than to imply legitimacy to a flawed concept by expensing a hypothetical and potentially misleading charge in the profit and loss statement. Those readers who find the hypothetical expense information of relevance could review the information if it were to be made available in the footnotes to the financial statements along with other relevant disclosures of employee stock options.

Comparability of financial statements is significantly impacted by the IASB's recognition based standard. The inability of option pricing models to accurately calculate a fair value of employee stock options and extreme sensitivity of the inputs will result in an even greater inability to compare information across companies, industries and geographies. The sensitivity of the current models will create an even greater ability for a company to manipulate its results further disadvantaging investors.

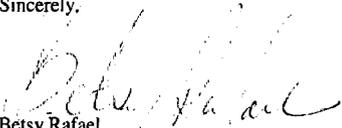
We also believe that the IASB's attribution method is invalid. The existence of vesting restrictions and potential for forfeiture differentiate employee stock options from virtually any other equity instrument. We do not follow the logic that the objective should be to measure the value of the services received. While we would suspect that prudent compensation policies would provide an appropriate linkage between the number of options granted and the overall value of the services provided, it is not demonstrable that the former equates to the latter. It is also not appropriate to recognize an expense for options that never vest as the IASB proposes. We are also concerned by the possibility that expenses recognized under the units of service approach can actually exceed the fair value of options granted. This would further exacerbate a flawed approach.

Significant debate transpired in the United States related to the discussion and ultimate adoption of FAS 123. Financial statement users in the U.S. have been better served based on this standard. We would rather continue to improve FAS 123 specifically as it relates to valuation and disclosure as opposed to moving toward the IASB proposal. We believe the significant valuation issues are not just relevant under an expensing standard. The only difference is in the presentation. However, most average people assume that an amount reflected as a charge to the company in its books is truth. Given our current tools, that wouldn't be farther from the truth.

Rather unfortunately, the recent corporate fraud scandals have created a sense of mistrust of Corporate America and a corresponding misplaced focus on employee stock options. The real issues surrounding employee stock options are executive abuses, which is a governance problem. Changing the accounting will only hurt the rank and file employee not the executives. Therefore, we support a continued emphasis on improving governance but we implore the FASB to focus on valuation first.

Cisco thanks the FASB for the opportunity to comment and consideration of our views.

Sincerely,



Betsy Rafael  
Vice-President, Corporate Controller