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Sent: Tuesday, April 27, 2004 8:41 PM

To: Director - FASB

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Subject: An Employee's Experience and Questions for FASB

File Reference No. 1102-100

Chairman Robert H. Herz:

Like many employees within growth industries of technology and bio-technology, I am aware of FASB's resolve to force US based corporations to expense employee based stock options at the time of the stock granting based on a "fair-value" formula. You also won the recent support of Fed Chairman Alan Greenspan who informed a Joint Economic Committe of Congress that it would be a mistake for Congress to interfere with FASB's intentions.

Letter of Comment No: 2045 File Reference: 1102-100

I recall first hearing about the issue of expense treatment of equity-based derivatives in a Financial Statement Analysis class while attending business school, MIT Sloan, in 1994. At that time I thought of employee stock-options as compensation for senior executives. When I left a management consulting job and took a position with a semiconductor company in 1996, I realized firsthand what the value of a broad-based employee stock options offered. It is clearly a way to attract and maintain talent and to align the interests of employees. Corporations would not grant options if they viewed them purely as a liability. In fact there is an asset component which would arguably need to be quantified, perhaps as goodwill, if the liability portion were expensed.

I first exercised employee-based options in 1999 from Altera Corporation; the proceeds from this allowed me to meet the down payment on a house in Silicon Valley, an area known for expensive homes relative to almost anywhere else in the country. Without having the benefit of employee stock options, I'd either still be renting or would have moved out of Silicon Valley. It's how the valley runs. Today I value my options from Cisco as thanks for long-term employment (5-year vesting period) and as a way to survive in an increasingly taxing society. Of course, you're an accountant and I presume you would be impartial to any single employee's experiences or thoughts on the matter.

Therefore, I'll address a couple of questions based on your world, the world of accounting:

First, I tried researching your side of the issue and found detailed examples lacking. In the area of Implementation, I saw that you have a Derivatives Implementation Team but I see no concrete examples of how you would adjust the Black-Scholes Option Pricing Model (or Binomial Derivatives) to arrive at a fair value of employee-based options. If you have examples, could you please point these to us?

to wit.

- 1. If you value the "counter party" option at the time of the option grant and consider it a liability, and an employee leaves after one year (with only partial vesting (20 or 25% of initial grant), should the company then reverse the liability for the un-vested portion at the time the employee leaves? Generally no options become vested until at least a year after the grant date, so how could the company be "liable" at the grant time?
- 2. Black Scholes based methods use stock volatility, strike price, current stock price, and duration to approximate the price of exchange traded puts and calls. They work best when the durations are shorter. Employee-based options usually last 7-10 years with a full vesting of 4-7 years after the grant date. Do you really think that your Derivatives Implementation Group has an accurate Cash-based Model that can be implemented and that accommodates the unique features of employee stock option grants? Does the Group assume that stock volatility has the same mathematical function for employee-grant options as it does in exchange traded options?
- 3. Parsing the vested shares for each employee and tracking the anticipated cost to the company seems like duplicate expense given that dilution effect of stock options on EPS. Would that not be double counting a liability? Why decrease the numerator, namely earnings, when the corporation is already recognizing the increase on the denominator, namely shares. It's no secret to investors that Company-sponsored stock by back programs are essentially a way to control the dilutive effect of stock options. As an investor in Cisco, I applaud Cisco's aggressive stock buy back, especially when Cisco Treasury felt the stock was undervalued relative to the long term growth prospects of the

firm.

At the very least, it seems somewhat self-serving that the FASB is recommending that US based invest in the expertise required to comply with expensing employee stock options at time of grant rather than to inform shareholders of the dilutive effect at the time of employee exercise. To avoid the hassle and the expense of such compliance, I would guess that US-based corporations, Cisco included, would either cut back or abandon broad-based stock option grant programs, replacing that with either stock grants (eg. Microsoft) or less efficient ways to align employee and shareholder interests. In any case, one effect will be to shift new job growth overseas.

In hindsight, perhaps 5 to 10 years from now, it may well be on your watch, sir, that FASB became recognized by both US corporations and by our elected representatives as having impeded domestic job creation and employee stability in key areas of technology and biotechnology - by forcing the expensing of employee based stock option plans.

Sincerely, Stephen M. Lautzenhiser Finance Manger, Cisco Systems

p.s. This is the latest posting I saw from your website: http://www.fasb.org/news/nr031203.shtml

"The Board also believes there is a need for one consistent approach to recognize the costs associated with employee stock options. Mr. Herz stated, "While a number of major companies have voluntarily opted to reflect these costs as an expense in reporting their earnings, other companies continue to show these costs in the footnotes to their financial statements. In addition, a move to require an expense treatment would be consistent with the FASB's commitment to work toward convergence between U.S. and international accounting standards. In taking all of these factors into consideration, the Board concluded that it was critical that it now revisit this important subject."

As part of the project, the Board also will examine whether there are ways to improve the precision and consistency of measuring the cost of employee stock options, as well as whether to require additional informative disclosures. The Board has received extensive input on this subject in recent months, including many comment letters on its November 2002 Invitation to Comment, 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 FASB specifically sought input on the similarities and differences between the IASB proposal and the fair value approach under FASB Statement 123.

While some differences exist between Statement 123 and the IASB's proposal, both approaches would recognize stock-based compensation as an expense at grant date by using a fair-value based method."

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