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Letter of Comment No: 1235  
File Reference: 1102-100

**From:** Scott Poucher [poucher@cisco.com]  
**Sent:** Wednesday, April 21, 2004 12:20 PM  
**To:** Director - FASB  
**Subject:** Expensing of employee stock options

Chairman Robert H. Herz  
Financial Accounting Standards Board

Dear Chairman Herz,

As I understand it, a recent draft plan issued by your board, File Reference No. 1102-100, is likely to lead to a ruling under which stock options must be expensed when issued using the Black-Scholes pricing model. As an employee of a company, Cisco Systems, Inc., that issues options to essentially all employees and as a retiree from another company, AT&T Corp., that issues options to a substantial fraction of its employees, I think your board is making a big mistake. Here are my observations:

No money is received as compensation by an employee until an option is exercised, and no expense (other than minor administrative costs) is incurred by the company.

As soon as the option is exercised, the new shares are created and the earnings per share are correspondingly diluted. As long as there is clear public information about the potential dilution from options, everyone seems to be treated fairly, and be fully informed about the situation.

Black-Scholes is based upon market pricing of options that can be freely traded.

Employee stock option plans allow no trading and only very restricted assignment of options for estate planning purposes. Thus employee stock options have direct value only to the extent of today's market price of the corresponding stock and to the extent they are vested. When issued these options have no immediate value to the employee and will have no value in most cases for several years. Even when they can be exercised, the implicit time value under Black-Scholes is not available to the employee. All we can get is the value at the time of exercise, and the only value forgone by the company is the difference between that day's market price of the stock and the strike price of the option. I believe that expense is recognized then under the rules as they stand today.

When we sign on as employees of a company with a stock option plan, we're taking the risk that by working hard for years we will be able to make a difference in the success of the company and through that have a leveraged opportunity to participate in that success. Expensing options immediately on issue, at a seriously

inflated and artificial level, substantially alters the risk-reward incentive for employees. On a personal level, when I joined Cisco Systems over five years ago, I offered to take a larger than usual share of my compensation in bonus and options, linking my success to that of my company. The incentive was (and is) very strong to do what helps the company, and its customers, succeed. At some time we can exercise the options, get the current price minus strike price value of the options, discard the potential time value of the remaining time before expiration, pay taxes on our gains, and have the company expense its foregone value from the option. I have funded one of my son's college education from one block of options, and contributed to the government surpluses in 2000 through taxes on it.

Part of the options deal for employees and companies is that sometimes it doesn't work out as we hoped. Over 60% of my options are underwater and about 25% are unlikely ever to have exercisable value. I have other options where an acquisition is eliminating any chance to benefit from the potential time value implicit in the Black-Scholes valuation. Yet your rule making would have assigned major, immediate, expenses for all those options when they were issued, where no income or expense is likely to ever exist.

I willingly take the risks that I have taken, because I think those risks are fair, and are probably the only way that we can bring out major innovations, the research, products, services, processes, technologies, etc., which will change our lives. Take away, or at least badly damage, the incentive of employee ownership through stock options, and expect to see declines in innovation in our economy. I've personally been part of several such cycles of innovation as a professional, from nucleic acid sequencing in the 1960s, through high performance electronics and detectors for physics in the 1970s, telecommunications industry revolutions in the 1980s, and computer data network services and the internet these last 15 years, and I don't want to see it all end because we strangle it financially.

The bottom line, which I thought was the primary focus of accounting, should be to accurately represent reality, and in doing so facilitate the most productive investment of our time, energy, and capital. At best you should improve conditions, while at worst you should do no harm. Your proposed rule making seems to do serious harm and should be returned to the drawing board.

Sincerely yours,  
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