To: Chairman Robert H. Herz  
From: Brian Morgan  
Subject: File Reference No. 1102-100, Employee Stock Options

Dear Mr. Herz,

I am writing you this letter because I am extremely concerned with the direction FASB is heading towards, expensing of employee stock options. This concerns me a number of different ways, not only for my own compensation, but because I actually see a huge negative impact for my company as well as shareholder value.

Over the long term I can think of no greater tool to align the interests of the company, shareholders and employees than employee stock options. Granted many negative things have been written about conflicts of interest in the short term regarding employee stock options and a stock price, but that typically occurs at the executive level. When executives have a short term incentive to drive up a stock price in order to reap personal financial gain, there is obviously a problem. However, expensing of employee stock options will not deter this activity. The legislation proposed by FASB will mainly be directed at reducing the amount of options granted, due to the large expense calculated using the FASB method. It will not prevent companies from issuing options to the highest level employees, rather it will be employees such as myself, a non-executive, that will lose out. At companies like Cisco, no longer will all employees who receive stock options have financial incentives aligned with those of shareholders and the company over the long term. People might not give it that extra 110% because the perceived additional value of making that extra effort will be zero for the employee. Going above and beyond regular duty might no longer be a daily occurrence for Cisco employees, but a thing of the past. How does that strengthen shareholder value?

This leads me to my next point. I am not just a Cisco insider concerned about losing a potential source of income. Granted I was counting on these stock options to help me afford a house someday, and it will be very difficult if not impossible without them, but that is beside the point. Before coming to Cisco, I was very interested in the concept of employee stock options and I chose to do my Master's Thesis on them and their affect. In my research I found that the companies that gave out the most employee stock options, per the Black-Scholes methodology obtained in companies footnotes, had the highest revenue per employee. Plain as day, black and white, the companies that gave out the most employee stock options had the most productive employees. I have statistical proof that employee stock options align employees incentives with those of the company and the shareholders.

Discussion of the Black-Scholes method brings me to my next point. The valuation proposed by FASB for Employee Stock Options is not correct. Black-Scholes assumes that options are liquid, yet employee stock options are non-transferable. Therefore, unlike regular stock options, if employee stock options are out of the money, their financial worth is nothing. Regular stock options still have a value because they can be sold and transferred to someone else. If an employee is terminated, he looses his options. Black-Scholes does not take vesting into account as well. If an employee is terminated before any of his shares are vested, the expense for those options would be incurred per FASB, however this expense would never materialize. How does FASB account for this huge discrepancy in its proposal? For that matter, how does FASB plan to account for employee stock options that were expensed but never exercised? In addition, Black-Scholes uses historical information to predict perceived value. Since
when have potential future expenses to a company, actual exercise of ESO's, been recorded now, based upon valuations of the past. Every stock broker out there says past performance does not guarantee results in the future, but apparently it does with ESO's. It sounds crazy.

Lastly, I am of the opinion that employee stock options are currently being accounted for through dilution. It does not take a rocket scientist to look at dilution and the effect on earnings per share to account for the employee stock option 'expense'. If stock options were to be expensed, would this not be a double counting of expenses? Even more confusing, what if there were huge expenses for employee stock options but those expenses never materialized through dilution because the options were never exercised. Cisco would have seen huge expenses in late 1999 and 2000 due to ESO's being granted, however given the fact that the options are so far out of the money currently, they might never be exercised. Large expenses followed up by no dilution or exercise of stock options sounds like we are creating more confusion, not reducing it. The expense is incurred upon exercise of the option and that is realized through dilution of the stock. I am unclear why we would want to account for this any other way. The current proposed FASB method wants to record potential expenses as real expenses now, even if they do not materialize.

Please reconsider the stance FASB is taking on employee stock options. A disservice is being done to the employees, companies and shareholders as well as creating further confusion on what is an expense.

Regards,
Brian Morgan