

June 30, 2004

Cisco Systems, Inc. 170 West Tasman Drive San Jose, CA 95134-1706 Phone: 408 526-4000 Fax: 408 526-4100 http://www.cisco.com

Letter of Comment No. 3078
File Reference: 1102-100

Suzanne Q. Bielstein
Director of Major Projects and Technical Activities
Financial Accounting Standards Board
401 Merritt 7, P.O. Box 5116
Norwalk, CT 06856-5116

VIA EMAIL: lrtatore@fasb.org, director@fasb.org

Re: File Reference No. 1102-100

Exposure Draft: Proposed Statement of Financial Accounting Standards, Share-Based

Payment, an Amendment of FASB Statements No. 123 and 95

Dear Ms. Bielstein:

Cisco Systems, Inc. ("Cisco") appreciates the opportunity to comment on the Financial Accounting Standards Board ("FASB" or "Board") Exposure Draft, Proposed Statement of Financial Accounting Standards, Share-Based Payment, an Amendment of FASB Statements No. 123 and 95 ("Exposure Draft"). Please note that Cisco had provided an initial response to the Board dated June 4, 2004. This document represents our final written response to the Exposure Draft and supercedes our initial response. Additionally, we did participate in the Board's public roundtable meeting that took place in Palo Alto, California on June 24 where we provided further comments. We thank the Board for the opportunity for companies to provide their written views through comment letters, as well engage in discussion through the Board's public roundtable process.

Overview and Summary

We do not agree with the proposal to expense employee stock options as we do not believe there is a theoretical basis within the existing conceptual accounting framework established by the Board. While we do agree that issuing employee stock options ("ESOs") represents a cost, that cost is to the enterprise's shareholders, in the form of dilution, and not an expense of the company to be recognized in its income statement.

The valuation of ESOs raises a multitude of issues. Although the Board has described in the Exposure Draft its understanding of the differences between ESOs and exchange traded options, the lattice binomial based approach supported in the Exposure Draft cannot derive appropriate values unless significant adjustments are made to the model to develop values that are representative of ESOs and their distinct characteristics. Numerous academics and valuation

experts have concluded that current option pricing theory and the resulting valuation methods, including the lattice binomial and Black-Scholes models as proposed in the Exposure Draft, cannot reliably measure an ESO's value. Additionally, the Exposure Draft has other fundamental issues such as income tax accounting, cost of implementation, and practicality concerns which are not addressed.

We believe that the Exposure Draft violates the Board's stated objectives of increased transparency, relevance, and comparability. It will result in incorrect and potentially grossly misleading information to investors that is not comparable across companies. The reliability and validity of reporting under "generally accepted accounting principles" from the perspective of investors would be seriously weakened by applying this proposed standard. The expensing of stock options would result in fictitiously reported net income that has no correlation to a company's actual business performance. The difference between a company's net income and its cash flows would be unreconcilable and not transparent to the average investor. Additionally, as we discuss later in this document, external valuation experts have concluded that there can be wide deviations in ESO valuations for the exact same grant based on differing approaches to the underlying modeling. A recent study we reviewed indicated that the difference in valuation results for the same grant can vary by a factor of over 400% using the lattice binomial approach supported in the Exposure Draft. A further detailed analysis of ESO values based on actual Cisco data using the lattice binomial model over a fourteen year period resulted in variations of up to 365% using reasonable inputs provided by the valuation experts. Cisco's net income for our fiscal year 2003 could have varied 62% depending on the specific inputs used. This range of estimation variability dwarfs any other possible estimation error that we could possibly experience in our financial statements. Furthermore, it is widely recognized that the models currently proposed do not adequately address the lack of transferability and marketability, therefore grossly overstating the actual value of the option and producing misrepresentative financial statements. It should also be noted that Mark Rubenstien Ph.D., one of the developers of the lattice binomial model, concluded to the Board at the public roundtable meeting in Palo Alto, California on June 24 that the lattice binomial model is not appropriate for valuing ESOs and should not be used. He also noted that several other extremely well respected academics shared his views. The reliability of the valuation models at this time is certainly in question. The introduction of an expense based on an unreliable and inaccurate valuation model cannot result in increased usefulness, relevance and comparability in financial reporting.

We do understand and appreciate that the Board has been under significant pressure to accelerate standard setting in an effort to improve financial accounting and reporting due to the reprehensible criminal acts perpetrated over the last several years by a few individuals in Corporate America. However, the proposal for expensing ESOs lacks theoretical accounting basis. Additionally, there is a lack of reliable valuation models available today. As a result, implementing this proposed standard would result in making financial statements less reliable, less transparent, and less accurate, creating more confusion in financial reporting and will further deteriorate investor confidence.

Basis of Accounting (Issues 1, 2, and 3)

The expensing of employee stock options is not consistent with the conceptual framework of accounting established by the Board. Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements ("CON 6"), defines expenses as "outflows or other using up of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations" (par. 80). The award of an ESO does not result in the consumption of an enterprise's assets or the incurrence of a liability that is required for the recording of an expense and, consequently, should not be accounted for as such. It is arguably an opportunity cost. To our knowledge, it is not appropriate to include opportunity costs in financial statements prepared in accordance with generally accepted accounting principles. It should be noted that the Exposure Draft requires the recognition of this economic opportunity cost but ignores the benefit realized by the enterprise of an ESO. It seems arbitrary and inconsistent to require the recognition of the expense for an ESO, while ignoring the value created for shareholders by aligning incentives. This value may be implicit in an enterprise's stock price, but is not reflected in its financial statements. Simple logic would indicate that if the opportunity cost based expense is to be recognized, then the benefit implicit in the stock price be recognized in the income statement as well. Obviously, this is not allowed in the current accounting framework; however, it is the same logic that the Board is using for expense recognition.

The Exposure Draft concludes that although there is no outflow of assets nor the incurrence of a liability that expensing the value of an ESO is appropriate. It indicates that the Board believes an entity does receive assets in the form of employee services in exchange for ESOs, however, as the entity cannot store services, the services qualify as assets only momentarily. The Exposure Draft references paragraph 81, footnote 43 of CON 6 which states that "...if the receipt of an asset, such as services, and its use occur virtually simultaneously, the asset often is not recognized because it would be derecognized immediately". We believe that an asset would exist, but not necessarily momentarily. There are significant benefits associated with the granting of ESOs that are not recognized in the Exposure Draft, which we discuss later in this document, which would support the recognition of an asset. Conceptually, this asset could be recognized and evaluated periodically for impairments, as is the case with goodwill. This view is, however, not considered in the Exposure Draft.

The current conceptual accounting framework requires the recording of the equity aspects of the exercise of an in-the-money employee stock option and the related inflow of funds to the enterprise. The actual granting of an employee stock option does not represent an accounting transaction; rather, it represents the potential future dilution to the enterprise's shareholders. Thus, the "cost" of an ESO is any actual dilution experienced by the enterprise's shareholders who have agreed to this cost to align their incentives with those of the employees of the enterprise. ESOs represent an agreed-upon risk sharing between employees and shareholders. The ESOs make employees into potential owners in the enterprise in order to allow them to share in the stock appreciation that they help to create. ESOs do not represent compensation, but an added element of employment to ensure the joint success of the enterprise and the employee. ESOs can have the effect of increasing revenues, reducing expenses or sparking innovation. While some of these benefits may be recognized in future financial statements, most of these

benefits would be reflected in enterprise value. Drs. Blasi and Kruse concluded in their book, *In the Company of Owners*, that broad-based stock option plans had the effect of improved employee productivity and greater stock market returns. They cited several studies including a survey of 229 communications, high-tech manufacturing, pharmaceuticals, and computer software companies where these companies' productivity grew 20 percent more than companies without broad-based ESO plans. The firms with the ESO programs averaged 9 percent more in market returns than comparable companies without such programs. The benefit of the ESO programs was reflected in these companies' enterprise values but not necessarily in the financial statements. Consequently, the cost of the options should be treated in the same manner.

The current accounting framework does require the recognition of ESOs in an enterprise's reporting of earnings per share. Statement of Financial Accounting Standards No. 128, Earnings Per Share, requires the recognition of the potential dilution of ESOs as part of the denominator used in the earnings per share calculation through the required use of the treasury-stock method. An enterprise's reported diluted earnings per share includes the effect of the potential dilution of ESOs. This effect is a very real reduction of an enterprise's earnings. The Exposure Draft's required expensing of ESOs would, in effect, double-count the impact to earnings of ESOs. We understand that the FASB has considered this issue, but we do not understand how the Board has reconciled the inconsistency between the Exposure Draft and its own conceptual framework.

In summary, we continue to believe that the appropriate accounting for ESOs should be based on APB Opinion No. 25, Accounting for Stock Issued to Employees, ("APB 25") using the intrinsic value at the date of award grant. There has been no change requiring different accounting conclusions than those reached over a decade ago. Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation, ("SFAS No. 123"), which retains the ability to account for ESOs under APB 25, represents a more appropriate method than the Exposure Draft.

Valuation of Employee Stock Options (Issues 4(a), 4(b), 4(c), 4(d), 5)

There is a fundamental question as to what the Board is requiring to be expensed. On the date of grant, an ESO typically has an intrinsic value of zero as many companies grant options at the closing stock price at the date of grant. There is no debate that the intrinsic value at the date of award is zero. The question then is, what is being required to be expensed? The second component that represents potential value in an exchange-traded option is the call premium – that is, the time value of the option. This represents an investor's discounted present value of the stock's anticipated price appreciation. Option pricing models, including Black-Scholes and binomial lattices, have been used in the financial markets to estimate this value. ESOs and exchange-traded options are very different instruments as recognized in the Exposure Draft. Some of these differences are as follows:

- 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 (black-out periods),
- Employee stock options typically vest over time,
- Exchange traded options are freely tradable in the financial markets while employee stock options are non-transferable and non-hedgable.

An exchange-traded option provides the investor the ability to immediately convert the value of the option to cash realizing the intrinsic value as well as the call premium element. It is critical to note that ESOs are not transferable or marketable. The Board has not provided for any discount for this lack of liquidity. Numerous academics have noted that due to the vast differences between ESOs and exchange traded options, discounts should be applied to the values determined under any of the current option pricing models, including the lattice binomial. The Exposure Draft is not clear as to the appropriateness of the application of this concept. We encourage the Board to consider this critical issue and to require such adjustments. The Board's proposed solution to this critical issue through the use of a projected option term does not adequately adjust the value. A significant recent market case where large numbers of ESOs were purchased by an investment banking firm clearly proved that the actual value of the ESO to the investment banking firm was a fraction of the value, as determined using one of the current option pricing models. It should be noted the ESOs were required to be modified by the enterprise to create a market for the instruments with the investment banking firm. Absent these modifications, it could be inferred that the instruments would have had little to no value to the investment banking firm. We encourage the Board to evaluate these types of true market tests as a means to assess the accuracy of the available valuation models.

The reliability of the valuation models has been assessed by experts that have concluded that broad ranges of values can be derived for the same option grants depending on the model selected and the estimation approach used to determine the inputs. LECG Corporation recently completed an analysis of five option pricing models including four lattice models as well as the Black-Scholes model. A single hypothetical option grant was valued using each of these models. LECG attempted to adjust the models to reflect the unique characteristics of ESOs. The purpose of the analysis was to understand the variability and comparability of the models using the same option grant. The analysis concluded that the valuations varied widely depending on the model selected and approach used to develop the inputs. The assumptions used for the inputs to the model can have a significant amount of variability depending on the estimation method used. For instance, a broad range of volatilities can be developed depending on the time parameters selected and assumptions regarding the company's projected stock price. The values for the hypothetical option grant ranged from \$14.67 to \$80.27, representing a variation of over 400%. The data concludes that comparability cannot be achieved using the same grant using differing models and estimation approaches for a single company. Extrapolating this effect to multiple grants, employees, and companies would undoubtedly result in broad variability in earnings for all companies with significant employee stock option plans.

The same experts we consulted also valued ESOs using a sophisticated lattice binomial model using actual Cisco data annually for our fiscal years 1990 through 2003. We observed

substantial variability between the high and low estimates for the option values for each of the 14 years ranging from approximately 230% to 365% using reasonable ranges for each of the sixteen inputs required for the model. Even experts applying a very sophisticated model could reasonably conclude on valuations that varied up to 365%. To illustrate the impact this would have on Cisco's financial results, had Cisco applied the lattice binomial model and expensed ESOs based on the Exposure Draft, our net income for fiscal 2003 could have varied by 62% or \$1.8 billion depending on the inputs selected. This level of variability dwarfs potential misstatements of all other accounting estimates. For instance, if Cisco's allowance for doubtful accounts for fiscal 2003 was incorrect and had to be doubled, it would have had a 3.6% impact on net income as compared to the 62% impact for ESOs. No other estimate in generally accepted accounting principles could vary by this degree and be considered accurate.

The external experts we utilized also concluded that, overall, lattice models poorly value ESOs based on the reasons described below:

- The range of reasonable ESO values is overly large,
- The models do not adequately predict expected time to exercise and systematically overstate the value of ESOs,
- The models do not fully consider the other unique characteristics of ESOs as compared to exchange-traded options resulting in additional ESO overvaluations.

Consequently, the ESO valuations that were computed using actual Cisco data for the fourteen year period previously described, are overstated based on these additional considerations.

Our data analysis also concluded that employee behaviors cannot be reasonably modeled. Employee exercise behaviors are driven by numerous factors including, for instance: risk aversion, employees' tax situations, relative wealth, as well as, other factors that cannot possibly be modeled such as when an employee wants to buy a house, when and which college their children will go to, when they are planning on buying a car, etc. These behaviors change constantly depending on each individual's circumstances at a particular point in time. We observed that for each of the years we analyzed that there was no predictability in exercise patterns and no reasonable correlations could be made. This would indicate a further inability to consistently value ESOs from period to period.

These analyses seriously question the reliability of financial statements that would be based on the models that are currently available. As a result, financial statements will have less credibility due to the lack of comparability and the huge variation of values based on the assumptions used in the valuation models. Furthermore, Mark Rubenstien, Ph.D., one of the developers of the lattice binomial, concluded to the Board at the public roundtable meeting in Palo Alto, California on June 24 that the lattice binomial model was not the appropriate model for valuing ESOs and should not be used. He also noted that several other extremely well respected academics shared his views. His conclusion further questions the ability to measure the fair value of ESOs using any model available currently. It also questions the overall integrity of the Exposure Draft itself, as the valuation model supported by the Board ultimately could not be supported by its developer.

A number of other academics have concluded that currently available option pricing models systematically overstate the value of ESOs. Various academic studies by Rubinstein, Marcus and Kulatilaka, Detemple and Sundaresan, and Meulbroek identified various factors that caused the over valuations, including:

- Non-transferability
- Non-tradability
- Forfeitures
- Lack of diversification in employee's portfolio
- Employee risk aversion

Jonathan Mun, Ph.D. an expert in the development of lattice binomials, concluded in his May 14, 2004 response to the Board that, "it can be argued based on sound financial and economic theory that a non-tradable and non-marketable discount can be appropriately applied to the ESO. The author's suggestion is to allow the incorporation of marketability discounts be taken by firms issuing ESOs". The views of academics clearly indicate that option pricing models, including lattice binomials, are extremely sensitive to the subjective inputs required. More importantly, serious questions regarding the reliability of the models available today exist which will impact the accuracy and comparability of the resulting valuations. We encourage the Board to continue to elicit the views of valuation experts and further study valuation models in order to evaluate the need for adjustments to the models for attributes of employee stock options which could have a material impact on the resulting valuations.

In summary, we have strong concerns regarding the reliability of the current option pricing models. We understand that this concern is shared with numerous companies and valuation experts. We do not believe that the current models, including the binomial lattice supported by the FASB, can estimate the value of ESOs reliably. Including an expense in the financial statements based on these unreliable models will not only cause a lack of comparability but can result in significantly misstated financial statements for some of the world's largest companies. Those companies with broad-based option programs could potentially have grossly misleading income statements that are not representative of the companies' actual financial performance. This cannot be viewed as improved transparency, reliability, and usefulness of financial reporting.

The Exposure Draft requires that the intrinsic value method with re-measurement through the settlement date be the alternative accounting when it is not possible to reasonably estimate the fair value of ESOs. We do not support this view as it is inconsistent with grant date accounting and lacks any conceptual basis.

Accounting for Employee Stock Purchase Plans (Issue 6)

We are not supportive of the Exposure Draft's requirement to record compensation expense for share purchases under employee stock purchase plans. These plans align incentives of employees and shareholders in order to create future shareholder value. The purpose of the plans

is not for employee compensation, but rather for employees to become and therefore think like shareholders. The selling of shares at a discount to employees does not result in an expense based on CON 6 as no corporate assets have been used or liabilities incurred. Additionally, we believe that the regulatory restrictions typically placed on these types of plans create a need to record discounts to the valuation of the expense. The discounts provided to employees in these types of plans are analogous to share issuance costs that the companies are avoiding through the direct issuance of stock. We believe the rules currently in APB 25 as well as SFAS 123 and the related accounting are appropriate.

Attribution of Compensation Cost (Issues, 7, 8, 9)

Although we do not believe granting of an ESO represents an expense to the company, we do have comments with respect to the attribution method for compensation cost and treatment of awards with graded vesting schedules required in the Exposure Draft. We do not support the Board's views that an award with a graded vesting schedule is, in substance, separate awards with the effect of having each vesting period requiring separate accounting. The Board's conceptual position would create a number of various complex practical application issues. For instance, for Cisco this would mean the tracking of over 43 million awards based on the number of grants, individual vesting periods within each grant, and contractual life of the awards. In addition, both the management of a company and its employees do not view individual grants as multiple awards. We are not supportive of the Board's view that the recognition pattern of ESO expense be, in effect, front-loaded. This would be inconsistent with the actual rendering of the service which would be more appropriately represented on a straight line basis over the vesting period of the award. The front loading of costs would result in amounts that do not match the rendering of services, further distorting financial results.

Accounting for Income Taxes (Issue 11)

As previously stated, we believe ESO's should not result in an accounting expense upon grant. Therefore, we believe there should be no income tax effect upon grant of an ESO. However, even if the granting of an ESO represents a compensation transaction, we do not agree with the method of accounting for income taxes established by the Exposure Draft. Further, we believe there are numerous issues and complexities that have not been addressed in the Exposure Draft with respect to accounting for income taxes.

If the granting of an ESO represents a compensation transaction executed by the company, then we agree it would need to be tax effected. We do not agree with the Board's conclusion of the tax accounting on the exercise of an ESO. If the granting of a stock option is an expense, then any tax benefit derived from the grant should also be included in the income statement.

We also believe the Board should adopt a portfolio approach to tracking and accounting for the benefits realized upon exercise or settlement of share-based payments, as opposed to the individual employee approach in the Exposure Draft. The Exposure Draft's proposed requirement to calculate and account for the tax impacts of share based payments at the individual employee level, versus the portfolio approach allowed in SFAS No. 123, is

conceptually inconsistent with how such payments are valued under the provisions of the Exposure Draft.

In addition, to properly perform the accounting at the time that an award is settled, companies would need to have a system that tracks, on a grant-by-grant and employee-by-employee basis, the actual tax deduction compared with the cumulative "book" expense since adoption. From a practical perspective, the requirement to account for the deferred tax consequences at an individual employee level is not operational without a prohibitive amount of effort and cost. This model will also need to track legislative and regulatory changes on an individual employee basis. These requirements will impose a tremendous reporting burden and cost on companies and result in nominal added value, if any.

Additional guidance is needed relative to the transition rules and the impact on deferred taxes. A number of issues are unclear including the method of accounting for tax benefits realized from the exercise of options for which no compensation expense was recognized under existing rules. Clarification is needed as to whether the individual or portfolio approach would be utilized for purposes of determining the appropriate tax treatment upon exercise for options outstanding but not fully vested as of the date of adoption, and for options fully vested as of the adoption date for those companies that used the fair value approach under SFAS No. 123. Guidance is also needed with respect to the income tax effects of charging of stock options between members of a reporting group and the interplay with other tax benefits such as the research tax credit.

Disclosure (Issue 12)

Cisco is fully supportive of additional disclosures related to ESOs. We provide significant disclosures that go beyond the regulatory requirements relative to our employee stock option programs on a quarterly basis in our filings with the Securities and Exchange Commission. We do support the pro forma expense disclosures of ESOs as required under SFAS No. 123. Although the valuation issues continue to exist in the disclosures, that option is clearly more desirable than to potentially materially misstate earnings by including the hypothetical charge in the income statement. Continuing pro forma disclosures in the footnotes is clearly a better alternative than including these amounts in the income statement which would imply a level of precision that clearly does not exist.

Comparability

Comparability of financial statements is critical to investors. The implementation of the Exposure Draft effectively eliminates comparability with companies that have broad-based employee stock option programs. The recent criminal behaviors exhibited by a few individuals in Corporate America will not be reduced with the Exposure Draft. In fact, due to the lack of reliability and sensitivity of the inputs of the current valuation models, those individuals with fraudulent intent will have an even greater ability to manipulate financial results, further disadvantaging investors.

Any estimate of ESO valuation would be critically dependent on the valuation model employed and the methods used to estimate the model's inputs as illustrated in the preceding discussion. These inputs represent surrogates for employee behavior which would effectively be impossible to model across a large employee base as we determined in our analysis of actual Cisco data. Therefore, unless all firms use exactly the same option-pricing model and exactly the same procedures to estimate the numerous subjective variables that are necessary model inputs, the final option values would be far from comparable.

Transition (Issue 13)

If the Board were to conclude that expensing of ESOs were required, we would urge that retrospective restatement be an allowable method in addition to the modified prospective method described in the Exposure Draft. Retrospective treatment would allow for greater financial statement comparability.

Statement of Cash Flows (Issue 16)

We are not supportive of the presentation in the statement of cash flows required in the Exposure Draft which would have the effect of effectively grossing up the statement for items that do not represent actual cash flows of the company. We believe that all ESO related tax effects, including subsequent adjustments, should be treated as operating cash flows as reductions of income taxes payable.

International Convergence (Issue 17)

We are supportive of international convergence, but not at the risk of issuing poor accounting standards. The Exposure Draft has numerous serious issues that must be addressed by the Board as described herein. Convergence should be a secondary consideration and not the primary driver of issuing the Exposure Draft.

Summary and Recommendation (Issue 18)

We believe that the Board will not achieve the objectives of improved accuracy, transparency and reliability of financial statements with this standard. The Exposure Draft is flawed both in the accounting as well as the underlying valuation requirements as we have described. We do not believe an appropriate accounting basis exists for expensing ESOs. Additionally, reliable valuation methods are not currently available. Implementing the Exposure Draft in its current form would result in significant misstatements and distortions of earnings across a vast number of companies, while the same time, eroding comparability and, ultimately, investor confidence.

We recommend companies continue to be allowed to account for ESOs under the intrinsic value method as described in SFAS No. 123 along with improved and broadened disclosures. Cisco and several other companies have voluntarily expanded their disclosures regarding their employee stock option programs and their impact on dilution as well as specific disclosures regarding option grants to top executives. Additionally, we would encourage the Board to

continue to work with valuation experts on improvements to the current valuation models so that the disclosures of pro forma expense can be further improved. We encourage broader field testing of the valuation models using actual company data in order to accelerate the development of more robust models. We suggest that such field testing include companies with broad-based employee stock option programs. We would certainly welcome the opportunity to participate in this type of expanded field testing. The Board has an obligation to ensure standards are developed that ensure the accuracy, comparability, reliability of financial statements. While we do not agree with expensing, it cannot be considered a viable option until more robust models are developed that can appropriately estimate the true value of ESOs.

* * * * * * * *

We thank the Board for the opportunity to provide our comments on this critical issue. If you have any questions regarding our letter or would like to discuss our views in further detail, please feel free to contact me directly at (408) 527 - 4087.

Sincerely,

Dennis D. Powell
Senior Vice President
and Chief Financial Officer
Cisco Systems Inc.

Cisco Systems, Inc.