CISCO SYSTEMS

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

March 7, 2003

Ms. Kimberly Crook
Project Manager
International Accounting Standards Board
30 Cannon Street
London, EC4M 6XH, United Kingdom

Re: Invitation to Comment on Exposure Draft ED 2 Share-Based Payment

Dear Ms. Crook,

Cisco Systems, Inc. ("Cisco") appreciates the opportunity to provide our views on the International Accounting Standards Board ("IASB") Exposure Draft ED 2 Share-Based Payment ("Exposure Draft"). The topic of accounting for employee stock options is highly controversial and has significant impact across companies on a worldwide basis. Consequently, ensuring an appropriate thoughtful due process including an extensive comment period is critical. Although Cisco is based in the United States, we are a global company and have significant operations abroad.

Overview and Summary

Our comments included herein relate specifically to employee stock options and generally do not address the other share-based payments discussed in the Exposure Draft. We focus on the employee stock option issues as we have significant fundamental concerns with the position the IASB has taken with the mandatory expensing of employee stock options required in the Exposure Draft. These concerns relate to what we believe is a fundamental flaw in the Exposure Draft that the granting of an employee stock option generates a charge to the profit and loss statement. In our view, and in the view of numerous global companies, trade associations, academics and other experts, the concept of recognizing a charge for employee stock options is at odds with the basic conceptual framework of accounting utilized by the IASB. The granting of an employee stock option does not consume any corporate assets or generate any liability to the corporation, but rather represents a "cost" to its shareholders in the form of dilution. We have other comments in addition to the fundamental accounting flaws as well serious concerns with "fair value" determination and the negative global economic implications that will no doubt be created if the Exposure Draft is issued in its current form mandating expense recognition.

We have also offered our views to the Financial Accounting Standards Board ("FASB") in response to their Invitation to Comment on "Accounting for Stock-Based Compensation: A Comparison of FASB Statement No. 123 ("FAS 123"), *Accounting for Stock-Based Compensation,* and Its Related Interpretations, and IASB Proposed IFRS, *Share-based Payment*". Our views expressed herein are consistent with those communicated to the FASB. It should be noted that the vast majority of respondents to the FASB's Invitation to Comment opposed the concept of expensing employee stock options. This overwhelming lack of support for the concept of recognizing a charge should clearly alert both the FASB and IASB that the basic expensing premise underlying the Exposure Draft is not rationale and supportable under the current accounting framework.

Additionally, we understand that the FASB and IASB are focusing on global convergence of accounting standards. While we agree conceptually with 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. We cannot overstate the importance of hearing views such as ours and the vast number of other organizations that express such opposition to the concept of expensing. Unfortunately the Exposure Draft treats mandatory expensing as a foregone conclusion. This is even in contrast with the European Commission's views as raised in connection with the IASB's reissuance of the G4+1 discussion draft. The European Commission indicated at that time that the concept of recognizing expense for employee stock options "need to be thoroughly investigated and resolved before any agreement can be reached on the accounting for share-based payments" (EC Response to the IASB Reissuance of the G4+1 Discussion Paper, February 12, 2001). Other groups had reached similar conclusions. The release of the Exposure Draft seems to have minimized and/or ignored these significant comments. We find it disturbing that the basic underpinnings of the Exposure Draft have not been thoroughly evaluated and opened for comment.

Flaws with the Accounting

Specifically, we cannot support the Exposure Draft because of its flaws in the underlying accounting concepts. The Exposure Draft requires the mandatory expensing of employee stock options, which we believe is inappropriate based on the IASB's own conceptual accounting 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. The grant of employee stock options results potentially in the further extension of corporation ownership to employees but not a corporate expense. In fact, the ultimate exercise of an employee stock option results in an increase to a corporation's assets as the employee purchases ownership shares. 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.

The Exposure Draft does not adequately differentiate the basic transactional differences between companies and their vendors from companies and their employees. Shareholders agree to a dilution of their ownership through the issuance of stock options to the company's employees to align the goals of the employees with those of the shareholders. U.S. transactions between companies and their suppliers and vendors are measured using the stock price and other measurement assumptions from the date on which both parties come to a mutual understanding on the terms of the agreement and commit to perform under the terms of the binding agreement. Consequently, it is appropriate to recognize expense in the financial statements companies' transactions relating to the purchases of goods and services via the issuance of shares or options. The entity must, of course, have the ability to accurately and reliably determine the fair value of these transactions prior to their recognition in its financial statements, probably through use of the fair value of the goods and services received, which will more reliably measure value than trying to assess the value of the instruments issued in the transaction.

We believe the measurement date should be the grant date for accounting for fixed employee stock option awards. Employee stock options are used for employee recruitment and retention. Consequently, the transaction with the employee is effectively consummated at the time of grant with the employee's acceptance of an offer of employment. Use of the vesting date would introduce facts and events that do not pertain to the value of the award as perceived by the parties at the date of the award.

Inability to Value Employee Stock Options

The current option pricing models, including the broadly used Black-Scholes model, were not designed to estimate "fair value" 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 adjustments to Black-Scholes and binomial models allowed under the Exposure Draft are not adequate to address the significant differences between exchange-traded and employee stock options. 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(black out periods),
- 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 individual 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. Adding of a charge to the profit and loss statement based on these fatally flawed concepts will only serve to obfuscate the income statement and result in an inability by the investor to understand the actual economic performance of the enterprise.

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 total "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 total "value" based on the Black-Scholes model. The difference of approximately $1.6 billion, or $5.59 per share, is based solely on 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. The ability under FAS 123 to provide this information in the footnotes to the financial statements rather than a required charge to the profit and loss statement provides financial statement users the ability to evaluate the relevance of such disclosures in light of their inherent shortcomings. The disclosure requirements of FAS 123 with respect to stock options and related compensation allow companies to record or disclose the charge to earnings based upon their needs and the needs of their shareholders.

Other Considerations

Comparability of financial statements would be negatively impacted by the IASB's recognition based Exposure Draft. 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 United States 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 Exposure Draft. 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. The current rigor and diligence exercised by financial statement preparers to increase transparency would be seriously compromised by introducing this hypothetical and misleading element into the profit and loss statement.

Rather unfortunately, recent corporate fraud scandals have created a sense of mistrust of corporations 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 IASB to focus on valuation first.

Economic Impact of Employee Stock Options

Broad based employee stock option programs have enormous positive impacts on the productivity, competitiveness and profitability of enterprises as proven in recent studies. The wide financial ownership of an enterprise across its entire employee base results in greater employee involvement, motivation and individual productivity. Employees share in the growth and prosperity of the company, while at the same time increasing value to all shareholders of the enterprise. Employee stock options align shareholder and employee incentives which results in improved employee performance and ultimately, enhanced shareholder value. Entrepreneurship is positively enhanced, particularly in small and medium-sized enterprises, through a greater ability to recruit, retain and motivate top talent. The results of these various positive impacts is an overall improvement in the competitiveness of companies operating on a global basis.

The impact of recording an expense would have devastating repercussions on the current use of this critical form of employee incentive. Undoubtedly, enterprises would limit the use of broad enterprise-wide employee stock options programs. Those start-up enterprises that use broad based employee stock option plans would be significantly penalized with greater costs of capital for recording the additional hypothetical expense. This would severely negatively impact the ability of smaller companies to compete with larger multinational companies and would restrict competition, minimize entrepreneurship, reduce productivity, limit growth and ultimately reduce and limit shareholder value. On a global basis, employee stock options have been a key driver of innovation, especially with start-up enterprises. Many of today's large multinational enterprises would not have contributed as much to the global economy if employee stock options had not been in place to fuel their growth. The impact to the EU of effectively restricting the use of this tool on a broad basis would certainly be counterproductive to its stated economic aspirations.

Summary and Conclusion

We reiterate that we believe the Exposure Draft is based on flawed underlying concepts including the basic theoretical underpinnings of the accounting, inability to measure "fair value", significant negative global economic consequences and various other problems as we described above.

We would propose, similar to the decisions reached years ago by the FASB in the United States., that the IASB's standard be consistent with the approach currently in place in the United States under FAS No 123 (including its recent amendment) which allows for the intrinsic value method for expense measurement for fixed employee stock options based on the grant date combined with the timely and full disclosures relating to share-based payments, rather than requiring a charge to the profit and loss statement.

Again, we thank you for the opportunity to comment on the IASB's Accounting for Share-Based Payments project. Please feel to contact me at (408) 525-0164 for any further discussion of our comments. We would certainly welcome opportunities to discuss our views with the IASB and participate in other forums to further express our views and provide constructive feedback.

Sincerely,

Betsy Rafael

Betsy Rafael
Vice-President, Corporate Controller
Cisco Systems, Inc.