

COMPLIANCE WEEK

Cisco's Stock Option Method Raises Eyebrows; More

By Tammy Whitehouse — May 17, 2005

Experts differ on whether Cisco Systems is on the right track with its recent trial balloon at the Securities and Exchange Commission—another new method of valuing stock options that is intended to create an otherwise elusive market value.

Cisco reportedly is meeting with SEC officials to determine whether it can offer a new type of marketable security based on its employee stock option plan and still comply with soon-to-be effective accounting rules that require expensing of stock options. The security would be offered to institutional investors on a limited basis under terms that align with the employee stock option offering, meaning they would be nontransferable and would vest over time.

The goal is to create a market value for employee stock options that would be used as the basis for determining the charge against earnings to comply with the Financial Accounting Standards Board's new expensing rule. The rule goes into effect June 15 with the start of a company's new fiscal year. For Cisco, that means July 31.



Beresford

"They're trying to develop a financial instrument that would mimic employee stock options," said Denny Beresford, professor of accounting and the University of Georgia and a former FASB chairman. "It sounds like it would achieve a more direct, reliable fair value of what an employee stock option is, and that's been the Holy Grail issue the whole time."

When FASB adopted its controversial standard requiring expensing in December 2004, it left companies wide latitude to determine how they would establish a fair value for options. This is a complicated and sensitive issue for most public companies, because options by their very nature have no marketable value.

Critics of the two most commonly adopted methods—Black-Scholes and binomial lattice—say those methods don't adequately consider the various restrictions, which results in an overstatement of value and ultimately a deeper strike on earnings.

"Cisco is saying they can directly measure the fair value of options using this new security," Beresford said. "At least from what I hear, it sounds like an appropriate approach."




Ciesielski

Others aren't as convinced Cisco's idea will pass SEC muster. "On the face of it, it sounds like it's based on shaky premises," said Jack Ciesielski, owner of investment advisory R.G. Associates. "The derivatives are sold to a limited number of institutional investors, who cannot sell them afterward."

Ciesielski has questions about what factors would ensure fair pricing. "They could put the derivatives into the hands of friendly institutions at prices that are favorable," he said. With no apparent liquid market, "it sounds like you could use the institutions as a straw person for setting the prices you want," he said.

Daniel Abrams, an expert in option valuation and managing partner with FAS123 Solutions, a firm devoted exclusively to compliance with FASB's new rule, said he would need more information about

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Cisco's proposal to predict whether it will fly. "The devil is in the details," he said, but he has his doubts about whether its possible to value options by selling derivatives.

While Cisco has been a leading opponent of FASB's rule, even proposing standard setters adopt another valuation method Cisco and other tech companies proposed in 2004, Abrams said he would speculate there must be some valuable basis to Cisco's method. "They're opposed to the rule, but they're not stupid," he said. "I doubt they are blatantly trying to skirt the rules. They're a very visible company."



Abrams

FASB did not directly comment on Cisco's proposal, except to point to two paragraphs in the appendix of its statement on share-based payments that describe how to assign fair value to options. The first defines fair value as a value based on a current transaction between willing parties and emphasizes that market pricing of identical or similar instruments is the best basis for establishing fair value.

PCAOB Seeks Nominations For Standing Advisory Council



The Public Company Accounting Oversight Board is looking for new recruits for its Standing Advisory Council.

Fourteen existing members will cycle off the 30-member body when their two-year terms expire in June. The remaining 16 members will complete their three-year terms next year. Going forward, all members will serve two-year terms so that half the council is up for nomination each year.


The SAG was created in 2003 to help the PCAOB establish and carry out its audit standard-setting agenda. The Board is looking for advisory council members from a variety of fields, including accounting, auditing, corporate finance, corporate governance, and capital market investing.

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