

# Cisco's option valuation proposal: Throwing gasoline on a burning fire?

Cisco has been working with both Morgan-Stanley and the Securities and Exchange Commission on an arrangement to sell options that are similar to employee stock options. The purpose is to obtain options valuations that are used as the basis to expense employee stock options.



## Comment

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Cisco's motive, of course, is to reduce the expense charged for employee stock options under the Financial Accounting Standards Board's (FASB) recent ruling that options be expensed on the income statement.

But Cisco's proposal has three serious flaws:

- First, it is questionable whether it will deliver accurate valuation results.

- Second, the valuation proposal is irrelevant as it fails to take

into account the impact on the shareholder.

- Third, the ruling will unfairly impact small businesses.

The first flaw is this proposed valuation will yield inaccurate results. The underlying theory of Cisco's proposal presumes that the market price or value of an option is the value that a willing buyer would pay to a willing seller. The problem is that a genuine public market is not going to be used to match willing buyers and sellers. Rather, only select institutional investors will be able to purchase the options under Cisco's plan.

It is in the interests of both company management and option buyers, such as Morgan-Stanley itself, to minimize the valuation. Under Cisco's plan, management is able to lower the expense of stock options, and the buyer is able to obtain a reduced or discounted price, all at the

expense of existing shareholders.

The second flaw is that the valuation itself is irrelevant. Whether stock options are valued at \$ 50 or \$ 100, is not the shareholder in the same position? Are not the existing shareholder's present and future claims the same? Stock options entail a dilution cost for the existing shareholders, and this cost is offset by the paid-in strike price premiums that employees may eventually pay when exercising their options. The economics for the existing shareholders are the same, regardless of whether the options happen to be valued at \$ 50 or \$ 100. Yet the option expense and therefore reported earnings reported under the FASB ruling will vary based on value-based irrelevant data. This contradicts FASB's charter to provide investors with clearer more meaningful financial results.

The third flaw is that while Cisco and other giants can engage an investment bank and establish special markets to yield favorable price data, most companies, particularly small start-up companies, are in no position to engage such assistance. Hence, the result could be that small companies are penalized, all resulting in a failure of the Financial Accounting Standards Board to fully address the issue of how best to fully and fairly account for employee stock options.

At this point, FASB has issued its ruling. Meanwhile, the SEC has largely endorsed FASB's position and is meeting with vested interests such as Cisco to make accommodations.

Congress needs to intervene by requiring that an appropriate accounting standard be developed that well serves the public, particularly small businesses and small investors.

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