

Exhibit III: Barron's Article by Dr. Abraham Briloff

Pooling and Fooling

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Cisco's accountings for its fiscal years ended July 1999 and 2000 furnish vivid demonstration of the causes of my concern....

By my reckoning, in the two fiscal years ended July 2000, Cisco has suppressed a grand total of \$18.2 billion of costs by using pooling in accounting for its acquisitions. Even in today's wondrous financial world, when billions are commonplace, \$18 billion of costs not taken is mindboggling. Manifestly, the handmaiden of pooling is fooling.

But pooling is not the only accounting device that Wall Street's favorite company uses to enhance its operating results. Another, equally egregious, involves stock options and the way Cisco accounts for them.

How to account for options has been the subject of agonizing reappraisals in board rooms, among scholars in academe, at the FASB and even in Congress. The crucial questions are: Can options be valued and, if so, should they be entered into a company's accounts and when? Further, if they were to be recorded, should it be as a cost of doing business or merely a capital transaction?

The correct answer to the first question is yes, they should be entered into accounts and, to the second, as a cost of doing business. Let me elaborate, using Cisco as a prime exhibit.

In the statement of shareholders' equity in Cisco's 1999 10K, there's an entry described as "tax benefit from employee stock option plans." This item added \$837 million to the capital stock and additional paid-in capital and shareholders' equity columns. The implications of that apparently innocuous entry are, in fact, far from innocuous.

When the employee exercises his or her options, the resultant gain is deemed to be compensatory income, i.e., salaries or wages to the employee and, accordingly, subject to tax. Correspondingly -- and this is the critical side of the relationship -- Cisco was presumed to have paid wages or salaries equal to the income earned by the employee and thus the company is entitled to a tax deduction (all spelled out in Section 83 of the Internal Revenue Code).

Now then, that \$837 million tax benefit means that at an assumed 33% tax rate, the related deduction for Cisco's tax return would have been \$2.5 billion in the fiscal year ended July 31, 1999. If \$2.5 billion is a cost for tax purposes, logic dictates that it is also a cost for determining Cisco's operating results.

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More specifically, for fiscal '99, Cisco's pretax income should be reduced by \$2.5 billion; its income tax cost would be cut by \$837 million. Net income, accordingly, would be slashed by a whopping \$1.6 billion, or by nearly 80% from the reported figure of \$2.02 billion, to \$423 million.

The impact of options on Cisco's fiscal 2000 results was even more pronounced and even more stunning. According to the 10-K (footnote 11), the tax benefit derived for the exercise of options amounted to \$3.077 billion. At the assumed 33% tax rate, that amount translates into over \$9 billion of salaries.

Especially noteworthy is that fully \$2.147 billion of that \$3 billion-plus was generated during the final fiscal quarter, the May-July time span. Clearly, as Cisco's share price dropped, options holders made a mad dash to cash in their chips, in the process triggering roughly \$6 billion of imputed salaries and wages.

How should that humongous full-year figure of \$9 billion of imputed wages and salaries be factored into fiscal 2000 operating results? Let's assume only \$310 million of tax benefit is "normal" for the fourth quarter (the average of the first three quarters of the year) rather than the actual total, hugely swollen by the period's extraordinary stampede to sell. That would make the "normalized" tax benefit from exercised options for fiscal 2000 a not exactly modest \$1.246 billion, implying an addition to the year's operating expenses of \$3.7 billion and an after-tax reduction of the bottom line by \$2.5 billion.

Put another way, if Cisco had treated the exercise of options as they should be treated -- that is, as a charge to income -- the company would have reported not the \$2.1 billion in earnings it did report, but a loss of \$363 million (excluding \$531 million of net gains on minority interests).

My restatement of Cisco's income to give due allowance to the cost of options is not a capricious exercise. For it's squarely in accord with underlying accounting precepts, especially Statement of Financial Accounting Standards No. 5, "Accounting for Contingencies." The statement, promulgated over a quarter-century ago, holds that a loss should be accrued as a charge to income when "it is probable ... a liability had been incurred" and "the amount of loss can be reasonably estimated." In other words, the charge to income from stock options kicks in when those options are exercised.

The result of Cisco's accounting aggressiveness, both in its energetic use of pooling and its treatment of exercised options, then, has been to enormously inflate reported earnings. And enormously inflated earnings have played no small role in elevating the company -- and its stock -- to the pinnacle of investor esteem.

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