

Stacey Sutay

Subject: FW: June 29th Roundtable

-----Original Message-----

From: Joel Jameson [mailto:jjameson@siliconeconomics.com]

Sent: Monday, May 17, 2004 3:30 AM

To: Director - FASB

Subject: June 29th Roundtable

Greetings:

I am an economist and have been doing research regarding accounting for stock-based compensation. I believe that I have very important useful and new insights regarding your Exposure Draft.

I would like to speak at your public roundtable discussion on June 29 in Norwalk, Connecticut.

My research has led to a very different method to account for stock-based compensation. The attached introduces the method, termed *Steady-State Equivalencesm*.

I look forward to hearing from you.

Sincerely,

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Steady-State Equivalence (SSEq)
A Solution for the Employee Stock Option Expensing Problem

Investors are demanding the accounting of employee stock options. The Financial Accounting Standards Board (FASB) has issued an exposure draft mandating the expensing of stock options. In opposition, Congress is considering legislation to overrule FASB. Steve Forbes criticizes FASB's proposal in his recent *Forbes* editorial entitled "An Option for Stupidity." Perhaps a paradigm shift is needed. Perhaps *Steady-State Equivalence* is the new paradigm.

Steady-State Equivalence (SSEq) is a simple solution to account for employee stock options and other types of equity-based compensation. Its foundations include the work of James M. Buchanan, Nobel Laureate in Economics; Modern Portfolio Theory; and accounting's "going concern" philosophy. It focuses on the interests of the existing shareholders, otherwise known as "Reference shareholders", as opposed to the interest of the corporation. *SSEq* asks and answers the following question: if the corporation were to perpetually repeat what it did in the current accounting period, what is the present-value-correct average earnings and dividends for the Reference shareholders? These are, respectively, *SSEq* earnings and *SSEq* dividends.

Expensing equity compensation based upon public market prices can result in erroneous earnings – even assuming the Efficient Market Hypothesis. This counter-intuitive result is demonstrated in a spreadsheet model of a company that has significant growth to a terminal period. Expensing stock grants results in all period earnings' being too low. Hence, the need to better account for equity-based compensation. (Spreadsheet model available upon request.)

In the following section, the economic foundations of *SSEq* are presented. This is followed by a description of a computer simulation used to determine *SSEq* earnings and dividends. The final section presents sample results.

***SSEq* Economic Foundations**

Reference shareholders bear a dilution cost when stock-based compensation is given to employees. This cost may or may not be offset by gains. However, with the dilution occurring, the interests of the Reference shareholders and the corporation begin to diverge. Consequently, *SSEq* focuses on the interests of the Reference shareholders, as distinct from the interests of the corporation.

To properly account for employee stock options requires considering accounting's traditional "going concern" philosophy. This philosophy has served investors reasonably well. It attempts to present financial results assuming that the status quo is maintained. The language of investment – per-share earnings, yield, etc. – suggests that investors assume, as a first approximation, that what has immediately occurred will continue to occur. Accordingly, *SSEq* determines per share earnings and dividends such that if the status quo is maintained, *SSEq* per share earnings and dividends properly reflect Reference shareholder interests.

The key assumption underlying *SSEq* is that shareholders demand that a corporation operate on a point of the Efficiency Curve. Such a point is characterized by the coordinate-pair:

mean-expected return and risk/volatility. This assumption unifies and generalizes two accounting presumptions. The first presumption is the appropriateness of discounting future values. The present value concept is generalized here to assume that the shareholders demand a minimum expected return – the inverse of their discount rate. So, for example, with a discount rate of 5%, the demanded minimum return is 5.26% ($0.9500 \times 1.0526 = 1.0000$). Within a *SSEq* simulation, an investment will, on average, appreciate by the demanded minimum return, then will be subsequently discounted. The second presumption is the appropriateness of using a volatility estimate.

Steady-State Equivalence Computer Simulation

Calculating *SSEq* per share earnings and dividends requires computer simulation that literally models a corporation as a “going concern.” This simulation entails thousands of scenarios, each of which typically consists of a hundred periods. What the corporation earned in the current accounting period and paid as dividends is assumed to perpetually repeat in each simulated period. Part of the perpetual repetition is the repeated issuance of stock options. The stock price is also simulated, as is the exercise and non-exercise of employee stock options. Both the retained earnings and paid-in strike price premiums are reinvested and appreciate according to the company’s point on the Efficiency Curve, satisfying the minimum shareholder demand. In these simulated scenarios, the interests of the Reference shareholders are tracked. Present-value techniques are used to convert these results into *SSEq* per-share earnings and *SSEq* per-share dividends.

Sample *SSEq* Results

Spreadsheet 1 shows results for a successful, hypothetical venture-capital-backed company that is founded in 2000, and goes public in 2004. Line 7 shows corporate earnings, Lines 24 and 18 respectively show per-share earnings with and without option expensing. Line 27 shows *SSEq* per share earnings.

If what occurs in year 2005 were to perpetually repeat into the future, then the shareholders, as of 2005, are in the same position, from a present value perspective, as if they had stock in a company that had no stock-based compensation and had an average per-share earnings of \$0.51 perpetually.

Spreadsheet 2 shows results, using publicly available SEC data, for Intel. If what occurs in year 2003 were to perpetually repeat into the future, then the shareholders, as of 2003, are in the same position, from a present value perspective, as if they had stock in a company that had no stock-based compensation and that had per-share earnings of \$1.19 perpetually and that paid per-share dividends of 0.08.

Conclusion

In the not so distant future, *SSEq* could handle all contingent transactions and agreements and could determine earnings and dividends for multiple types of shareholders. In parallel, balance sheet entries would be adjusted to equal actual current market prices.

Spreadsheet 1: Hypothetical Venture-capital Backed Company Financials

| | [A] | [B] | [C] | [D] | [E] | [F] | [G] | [H] | [I] | |
|---------------------------------|-----|-----------------------------------|----------------|-------------|-------------|---------------|-------------|-------------|-------------|--|
| [1] | | Start-up | Private | | | Public | | | | |
| [2] Year | | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | |
| [3] Stock Price | | 0.50 | 1.00 | 4.50 | 9.00 | 18.00 | 21.60 | 24.84 | 28.57 | |
| [4] Volatility | | | 240% | 220% | 200% | 50% | 30% | 28% | 25% | |
| | | Shareholder Demanded | | | | | | | | |
| [5] Minimum Return | | | 50% | 40% | 25% | 20% | 15% | 15% | 15% | |
| [6] | | | | | | | | | | |
| [7] Corporate Earnings | | | -3,000,000 | -5,000,000 | 200,000 | 1,000,000 | 1,500,000 | 2,250,000 | 3,375,000 | |
| [8] | | | | | | | | | | |
| [9] Founder Stock | | 25,000,000 | 25,000,000 | 25,000,000 | 25,000,000 | 25,000,000 | 25,000,000 | 25,000,000 | 25,000,000 | |
| [10] VC Stock | | 15,000,000 | 15,000,000 | 15,000,000 | 15,000,000 | 15,000,000 | 15,000,000 | 15,000,000 | 15,000,000 | |
| | | Employee Stock from Option | | | | | | | | |
| [11] Exercise | | | | | | | 1,500,000 | 4,000,000 | 10,000,000 | |
| [12] IPO Stock | | | | | | 10,000,000 | 10,000,000 | 10,000,000 | 10,000,000 | |
| [13] Outstanding Shares | | 40,000,000 | 40,000,000 | 40,000,000 | 40,000,000 | 50,000,000 | 51,500,000 | 54,000,000 | 60,000,000 | |
| [14] | | | | | | | | | | |
| [15] Granted Options | | | 1,500,000 | 2,500,000 | 6,000,000 | 2,500,000 | 2,575,000 | 2,700,000 | 3,000,000 | |
| [16] | | | | | | | | | | |
| [17] Rule 25 | | | | | | | | | | |
| [18] Diluted Per-share Earnings | | | -0.07 | -0.11 | 0.00 | 0.02 | 0.02 | 0.03 | 0.05 | |
| [19] | | | | | | | | | | |
| [20] Black-Scholes Expensing | | | | | | | | | | |
| [21] Unit Value | | | 0.98 | 4.37 | 8.59 | 7.94 | 6.75 | 7.44 | 8.00 | |
| [22] Charge | | | 1,471,805 | 10,922,486 | 51,564,402 | 19,855,663 | 17,382,328 | 20,085,195 | 23,999,310 | |
| [23] Corporate Earnings | | | -4,471,805 | -15,922,486 | -51,364,402 | -18,855,663 | -15,882,328 | -17,835,195 | -20,624,310 | |
| [24] Diluted Per-share Earnings | | | -0.11 | -0.36 | -1.03 | -0.30 | -0.24 | -0.26 | -0.29 | |
| [25] | | | | | | | | | | |
| [26] Steady-State Equivalent™ | | | | | | | | | | |
| [27] Per-share Earnings | | | -0.05 | -0.04 | 0.15 | 0.37 | 0.51 | 0.64 | 0.75 | |
| [28] Liquidation01™ | | | 0.11 | 0.00 | 0.00 | 0.01 | 3.54 | 3.44 | 3.34 | |

Spreadsheet 2: Intel Corporation Financials

| Amounts in Millions (except per share amounts) | 1999 | 2000 | 2001 | 2002 | 2003 |
|--|--------|--------|--------|--------|--------|
| Net Sales | 29,389 | 33,726 | 26,539 | 26,764 | 30,141 |
| Net Earning | 7,314 | 10,535 | 1,291 | 3,117 | 5,641 |
| Per Common Share | | | | | |
| Diluted Earnings | | | | | |
| No Option Expensing | 1.05 | 1.51 | 0.19 | 0.46 | 0.85 |
| Option Expensing | 0.99 | 1.40 | 0.04 | 0.29 | 0.71 |
| <i>SSEqtm</i> Earnings | 1.12 | 1.71 | 0.49 | 0.67 | 1.19 |
| Dividends | | | | | |
| Paid | 0.06 | 0.07 | 0.08 | 0.08 | 0.08 |
| <i>SSEq</i> | 0.05 | 0.07 | 0.08 | 0.08 | 0.08 |
| <i>Liquidation01tm</i> Value | 5.76 | 7.03 | 5.72 | 6.24 | 7.35 |

(*SSEq* earnings, dividends, and *Liquidation01* shown above are for illustrative purposes and are based upon summary publicly-available SEC-filing annual report and employee-stock-option data. Were actual disaggregate confidential company data used, then the results may be different.)