Letter of Comment No: 14/ File Reference: 1102-001 Date Received: [-3/-5]

January 31, 2003

To: Mr. Michael Tovey, FASB Practice Fellow '

From: Professor Joseph R. Blasi, Rutgers University School of Management and Labor Relations (New Brunswick, N.J.) and Visitor, Institute for Advanced Study, Princeton, N.J.) and Professor Douglas Kruse, Rutgers University School of Management and Labor Relations (New Brunswick, N.J.) and Research Fellow, National Bureau of Economic Research (Cambridge, Ma.)

Subject: Comment to the Financial Accounting Standards Board on Aspects of Accounting for Stock-based Compensation

Introduction

We have been studying various aspects of employee stock ownership in the United States for the last quarter century and would like to provide input to the FASB for its deliberations. It is our view that the Board should consider broader economic, political, and social evidence in conducting its deliberations as well as a number of findings about the role of employee ownership in our corporate system. Specifically, we assert that the entire reason

for transparent corporate accounting and strong corporate governance is to help managers and employees increase the value of firms and ultimately benefit the investor shareholders and society as a whole. Proposed accounting and corporate governance rules need to be held to the high standard of determining the extent to which they will facilitate this end. We will organize our input to the FASB as a series of research findings and policy recommendations around this theme.

Finding #1. The United States has developed a system of broad employee ownership and profit sharing over the last century that requires the ongoing attention and support of both the government (e.g. Congress and the Executive) and self-governing organizations (such as the FASB) if it is going to continue to exist. While it may not be immediately obvious, the acion of government and accounting boards can seriously push forward or push backward the U.S. system of broad employee ownership and profit sharing.

In our recent book, In The Company of Owners: The Truth About Stock Options And Why Every Employee should Have Them (with co-author Aaron Bernstein, Basic Books, 2003), we provide a national census of employee ownership and profit sharing, In Appendix C (see attached Book Exhibit) on p. 249 we show that 24.1 million employees (or 23% of the workforce) own stock valued at about \$400. billion by August of 2002. On p. 187 we note that only about 2% of the workforce or two to three million employees only get options every year as part of broader-based stock option plans. About 6% of traditional corporations provide broad-based plans.

One of the pivotal conclusions of our research is that about 64% of this employee stock ownership is centered in stock that employees bought themselves with their paychecks and their retirement savings. The other 36% represents employee ownership that was provided to employees as a new incentive typically on top of their stanard compensation in the form of ESOPs (which

generally require no employee sacrifice or personal investment) or employer matches to 401k plans (which unlike company stock purchases with worker savings also require no personal investment of worker savings). In the recent economic crisis many employees suffered losses to their savings and retirement by concentrating their investments in the stock of their own companies which failed or were weakened. (Although, to be fair, employees lost money in the stock market virtually no matter where they invested it.) In general, we think that employee ownership based on the excessive and overly risky concentration of either retirement plans or personal savings or a large amount of one's investment portfolio in the stock of one company is too risky. This phenomenon has become known as the "Enronization of employee ownership" in the public's mind.

Our book reviews a hundred years of history of broad employee ownership and profit sharing (pps. 153-170). One key finding is that the unintended consequences of accounting regulations and Executive branch actions have seriously undercut broad employee owneship and profit sharing in the United States over the last decade and a half. In 1992, a change in the accounting for leveraged ESOPs was responsible for seriously eliminating the incentives for publicly-traded companies to adopt leveraged ESOPs for their employees. Our 1991 book, The New Owners: The Mass Emergence of Employee Ownership (HarperCollins) documented what appeared at the time to be an expanding use of ESOPs in public companies. In our new book we have documented the freezing of ESOPs in public companies as a result of this accounting change that took place in the ensuing years.

Another key finding is that regulatory changes over a decade ago in defined contribution plans seriously eliminated the tax incentive for companies to offer meaningful deferred profit sharing (p. 166-167). After strong support from Senator Vandenberg in the last century, cash profit sharing found itself without sufficient support from the government and has largely dried up while meaningful deferred profit sharing has all but disappeared.

There is mounting evidence that companies are planning to or already are pushing lower level managers, professionals, the middle class and lower level workers out of their broad-based stock option plans in possible expectation of certain approaches to expensing stock options by the FASB. (Some of this evidence is discussed in a Business Week Commentary by Aaron Bernstein called "Options: Middle Managers Will Take The Hit" on December 9, 2002 [see Business Week Online] and an Associated Press column by Rachel Beck entitled "Cutbacks In Stock Options Can Favor Execs" [see

http://www.newsday.com/business/nationworld/wire/sns-ap-all-business0128jan28,0,6145718.story?coll=sns-ap-business-headlines]

We do not think that the correct public policy result of several years of corporate scandal – partly fueled by executive abuse of stock options – is for any particular approach to the expensing of stock options to have the unintended consequence of

seriously reducing the chance of access to this form of broad-based profit sharing by lower level managers, professionals, the middle class, and the working class. There are certainly many reasons to expense stock options, but any technical change in the rules for American corporations should not be considered in a vacuum. If a method of expensing is chosen that essentially leads to the punishing of the middle class for the excesses of top executives, that would be bad policy for the general public good. The role of accounting should not be to undercut or eliminate employee ownership as an unintended consequence, at least without a public debate.

This would also be potentially bad for shareholders. Our book reviews a quarter century of evidence and over seventy studies that broad-based employee ownership can improve corporate performance over the long-term and with a properly supportive corporate culture.. (Chapter 7). It also reviews a study that was the subject of a New York Times story by Gretchen Morgenson on November 10, 2002 called "When Options Rise To

the Top, Guess Who Pays? "This study examined ten years of comprehensive data from 1992-2001 for all 1700 public companies in Standard & Poors Execucomp (virtually the entire public market). It demonstrated that on average the greater amount of the stock option pie that went to the top five executives the worse the average shareholder return was for a company over the ten year period.

From a justice perspective, there are also powerful issues of equity involved in this public policy discussion. For several decades leaders of American corporations have argued that companies cannot afford meaningful increases in wages, bonuses, and profit sharing. Economic evidence demonstrates that those American families that had meaningful increases in family income got it as a result of capital gains not wage gains. (See The State of Working America:2002-2003 by Lawrence Mishel, Jared Bernstein, and Heather Boushey, Cornell Uiversity Press, 2002.) In an environment where inflation-adjusted wage increases for the middle class are modest, it does not make sense to cut the middle

class out of ESOPs, profit sharing, and broad-based stock options.

Yet this is precisely the direction in which our public policy is headed.

It is not acceptable that this be allowed to take place without a serious public debate. Ironically, in light of Enron and Worldcom, any potential elimination of broad-based stock options and any potential freezing in their expansion would in our opinion worsen the "Enronization of employee ownership." This is because average employees would be left with access mainly to types of employee ownrship that require them to buy company stock with their savings and retirement nest eggs.

The larger question to consider is why has public policy created forms of broad employee ownership that are overly risky for the average employee and overly protective for higher paid executives. One conclusion of our book's history of stock options (Chapter 3) is that we have improperly constructed employee ownership upside down. For those with high wages, high cash profit sharing, high wealth, high savings rates, and a higher

tolerance for risk, the top five executives of our corporations, we have structured employee ownership mainly as stock options which have upside gain and no downside risk and require no purchase with their savings. For those with lower or modest wages, little or no cash profit sharing, low wealth, low savings rates, and a much lower tolerance for risk, the average employees of the managerial, professional and middle class, we have encouraged a type of employee ownership that says "Buy it with your savings." For average workers, this type of employee ownership means no insulation from all the downside risk. In the last decade the move to share stock options broadly by some companies in our society has emerged as an alternative to this wrong-headed approach to employee ownership and profit sharing. If stock option expensing were to lead to the reduction of or the elimination of broad-based stock option programs, it would, as an unintended consequence, make this even worse. If this were to happen, expensing would ironically advance the financial and narrow interests of top executives at the expense of the middle

class. This would be a most ironic outcome of the public demand for reform of executive excesses!

Finding #2. While they have carefully found reasons over the years to eliminate or avoid broader profit sharing, employee ownership and use of stock options for the middle class, the top executives of American corporations and their captive boards of directors have systematically built a very carefully constructed system of partnership capitalism that applies these very same ideas to themselves. It would be bad public policy if a particular form of stock option expensing were to essentially collaborate with this miscarriage of corporate governance and let partnership capitalism exist for executives and be xed out for the managerial and the middle class.

The following table summarizes the data on compensation of the 1700 largest corporations in the country using Standard & Poors Execucomp database at Rutgers University:

Compensation: The Top Five Execs From 1992-2001.

For the 8500 top five execs at the 1700 largest U.S. corporations in billions of dollars.

	Salary	Profit Sharing	Other	Restricted Stock Grants	Option Profits	Remaining Option Paper Wealth
1992	2	2	-	1	2	7
1993	3	2	-	1	2	12
1994	3	3	-	1	2	11
1995	3	3	1/2	1	3	20
1996	4	4	1	1	4	29
1997	4	4	1	2	7	45
1998	4	4	1	3	10	75
1999	4	5	1	2	11	93
2000	4	5	1	2	18	80
2001	3	4	1	2	9	60
Totals					\$68.	

WHAT EXECUTIVES MADE OVER THE PERIOD IN TOTAL: \$161. BILLION

THEIR REMAINING PAPER WEALTH: \$60. BILLION

Source: In The Company of Owners: The Truth About Stock Options and Why Every Employee Should Have Them. Joseph Blasi, Douglas Kruse, and Aaron Bernstein. Basic Books, January 2003. Analysis of SEC filings from Standard & Poors Execucomp.

Note: The 1700 largest corporations represent more than 95% of the entire stock market. Profit sharing includes bonuses and Long Term Incentive Plan payouts. Profits are SEC reported profits on actual stock option exercises in that year. Paper wealth is the

12

paper profit on all unexercised options at the end of that year if they were exercised. Numbers are rounded.

This table demonstrates precisely how top executives have applied the ideas of profit sharing and employee ownership to themselves. As a group, their pay consists of annual cash profit sharing equal to 100-120% of salary, plus restricted stock, plus stock options, with hefty remaining paper wealth from options. IF the preliminary and suggestive evidence is correct that many corporations are or are planning to push managers, professionals, and the middle class out of their broad-based stock option programs if certain forms of expensing are adopted, then that would be tantamount to a social, an economic, and a, yes, political policy, to restrict partnership capitalism to the top. We do not believe that the Financial Accounting Standards Board has the intention to make such policy and we respectfully request that evidence be collected to clarify if indeed this would be the unintended consequence as some evidence suggests.

Certainly, the entire stock option expensing debate has been fueled by the need for a far-reaching reckoning and reform of corporate governance, executive compensation, and stock options. We strongly believe that all three of these practices require determined and meaningful and radical reform. If the expensing of stock options leads to a withering of broad-based capitalism among the professional and middle classes, then we wonder how it can be considered determined corporate reform. Certainly, there are many good technical arguments for expensing. We are not accountants and do not seek to parse each and every technical detail of these proposals. We are concerned that certain approaches to stock option expensing might simply hang out a sign for a company that says "This is what we are spending on options for our executives." without addressing the fundamental problems with stock options: who gets them, how many they get, and why dependent boards cannot distribute them in shareholders interests. These are additional real problems with stock options. There it little evidence that outsize option grants to executives really work. (This

is reviewed in our book in pps. 185-204). It would appear that many boards of directors are too dependent on top management to make decisions about dividing up the stock option pie that are optimal for all shareholders. In the New York Times article cited above, "When Options Rise To the Top, Guess Who Pays," we referred to 300-400 corporations each year from 1992-2001 that gave far more than the average 29% of their stock option pie to the top five executives. We fail to understand why a board of directors would want to give 100%, 90%, 80%, 60%, 50%, 40% of their stock option pie to only five people year after year if there is not a systematic distortion of proper corporate governance taking place.

How would stock option expensing address this question?

This needs to be examined. For the writing of In the Company of

Owners, we reviewed several decades of Conference Board reports

on executive compensation after 1950. Our conclusion is relevant
to beginning to answer the question of whether stock option

expensing alone would fix the fundamental problems: whenever

accounting rules or Congress made a particular method of compensating executives more difficult, other methods, phantom stock, bonuses, Long Term Incentive Plans, restricted stock, even stock options themselves, were created in the place of the disgarded and unpopular method. Indeed, it is widely conceded that the Clinton Administration's rule to limit executive fixed pay to \$1. million helped fuel the stock option explosion a decade ago. Beware of unintended consequences is our message and do not punish the midle class. Our concern is that top executives will always take care of themselves and extract their rents from corporations. No one should misread 50 years of Conference Board reports on executive compensation otherwwise. It is a mistake to think that merely expensing stock options in certain ways will reform either executive compensation or corporate governance. We respectfully suggest that the FASB articulate how any particular approach to expensing stock options will not lead to the result of penalizing the middle class and protecting top executives who are mainly responsible for stock option abuses.

Finding #3. Corporations do exist that share ownership and profit sharing broadly with all levels of employees. It is important that as an unintended consequence the FASB's rulings not eliminate the possibility that such corporations or corporate sectors can exist and contribute to society and the public good.

In 1991 we wrote The New Owners about the state of employee ownership and broad sharing with employees at that time. Five years ago, we decided to write the update of this book. At the time no one expected the expensing debate on stock options to come center stage in exactly the way it has now come center stage. The new book, In The Company of Owners, tells the history of the development of partnership capitalism in the first wave of technology companies such as Microsoft, Hewlett-Packard, and others from 1940-1990. It then focuses on 100 High Technology companies – such as Cisco, Amazon, Ebay, Yahoo, and others –

that invented the software and infrastructure that powers the Internet. Microsoft has shared more wealth with its employees than any company in economic history. The model must be closely examined before we decide on a set of actions that could potentially cast it aside.

We document an emerging system of partnership capitalism in these companies that contrasts with traditional corporations. Specifically, these companies make an average of 19% of their fully diluted equity available to a broad group of employees, more than is made available to their top five executives (14%). For the broad group of employees, most of this is through broad-based stock options. Many of these companies give very low pieces of the stock option pie annually to their top five executives and give large pieces of the stock option pie annually to most or all employees. From 1994-2001, the non-(top five) executive employees of these 100 companies had an estimated \$78. billion in stock option profits. This was many times more than the top five executives of these companies.

Our book tells the story in detail about how many of these firms share the wealth broadly with their employees and replicate this system year after year in good and bad stock markets. (Chapter 4,5, and 6.) However, look at the chart above and note that the \$78. billion in stock option profits that these firms shared with their employees from 1994-2001 is also \$10. billion more than the accumulated stock option profits of the entire public corporate sector from 1994-2001, the same period. Certainly, depending on the company, its history, and long-term performance for shareholders, some or many of these stock option profits may have been undeserved. But it is important to recognize that a different corporate system does exist and to assess its usefulness or lack or usefulness to society and our economy.

We want to present this study to illustrate that an alternative to a narrow form of capitalism focused only on the top does now exist in the United States. It is our opinion that this sector has and will have to submit to a thorough review and reckoning and reform of its stock option customs, habits, procedures, and results

depending on its performance for its shareholders over the longterm. Our book provides some evidence of these extremes. But our study also strongly suggests that the corporate culture and innovation of many of these firms is dependent on the broad sharing of equity.

We document that another 6% of traditional corporations have also moved towards implementing broad-based stock option programs. With the door closed to significant public company ESOPs by accounting regulations, to cash profit sharing by the desire to conserve cash as much as possible, and the door closed to liberal deferred profit sharing by Federal regulations, broad-based stock options are one of the only ways for corporations to meaningfully tie corporate performance and innovation to the wealth of millions of citizens and also supplement the fixed wages of the middle class with capital income.

We therefore respectfully submit to the FASB the impact of different forms of stock option expensing should be weighed regarding the broad-based stock option sectors.

Conclusion

Our argument suggests that the focus should be mainly on the problems that we want to correct related to stock options and the aspects of the public good that we do not want to eliminate as an unintended consequence of "reforms." Certainly, the FASB will have to balance many considerations and many technical questions in coming to its decision on these questions. We are not in a position to second guess or evaluate many of these important issues.

After several years of work and research we have done a national accounting of stock options for executives and for broader groups in our society. That is our contribution to this debate. And we have assessed the evidence of how different approaches to partnership capitalism (closed versus open) impact long-term company performance and under what conditions that is likely to

happen. We respectfully submit our book, In The Company of Owners, as an exhibit with this comment.

We weigh the evidence on stock options as requiring three main reforms: a. rein in excessive options for executives and prevent them from simply taking excessive value in other forms of rent; b. insure that truly completely independent boards of directors can divide up the incentive pie to benefit the most shareholders versus a narrow group of self-interested individuals; and c. give shareholders significantly better disclosure. Expensing alone will not address these fundamental problems. What is needed is a coordinated effort on the part of the FASB, the SEC, the Stock Exchanges and the Congress to address these questions.

If, in the end, stock option expensing is destined to come about we would like to see the FASB consider ways to allow broad-based stock option programs to go forward. They can play a constructive role in corporations in all industries and a important role in having wide participation in our capitalist economy. One useful approach to consider is to expense stock options for

executives where the excess and the abuse are concentrated and common. We make the argument in our book that since executives basically set their own pay their options really can be seen as compensation. At the same time, other managerial, professional, and middle class employees do not set their own pay. Equity sharing on their part should be viewed as long-term risk sharing. These broad-based option programs should certainly be subject to much better disclosure and clearer information for shareholders in SEC filings. And boards of directors should regularly audit the corporate cultures of the companies with broad-based option programs to make sure that the options play the proper role in a high performance work environment.

Finally, it is clear to us that an intersection of important organizations will be considering these issues over the next year.

IF the unintended consequences are really to be properly assessed, a national commission should be formed to examine the fundamental issues requiring reform and the possible consequences

of actions by the FASB, the Stock Exchanges, the SEC, and
Executive and the Legislative Branch.

Thank you.

THE END