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POLITICAL PULSE

Stock Options Expense: One Step Ahead of the Law

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Coca Cola and Washington Post may be making a virtue of necessity by volunteering to expense options -- but they're an example of how free markets can enforce corporate accountability.

It went right down to the wire in **the Senate** yesterday, but now it looks like the **Levin-McCain** stealth stock options tax-hike -- Senate Bill 1940 -- has expired out-of-the money (see "Triple Witching Hour for the Stock Options Tax-Hike" July 15, 2002). **Democratic Senator Phil Gramm** managed to block not only this dangerous attempt to diminish the tax deductibility of stock options, but also even the mildest provisions that would have moved American accounting rules toward requiring that options expenses be included in income statements. In the midst of what **Republican Representative Michael Oxley** has called a "feeding frenzy" to rein in corporate crooks, this should be seen as a significant symbolic victory for the forces of *laissez-faire*, and may have had something to do with the market's sudden recovery yesterday afternoon.

But of potentially far greater interest is what's happening in the private sector. Over the last two days two major public companies -- **Coca Cola** and **Washington Post** -- have both volunteered to include options expenses in their income statements.

Warren Buffett is a board member and a major shareholder of both companies, and he has publicly advocated expensing options since he first wrote about them in his annual letter to **Berkshire Hathaway** shareholders in 1985. If it seems like it's taken a long time for Coke and WaPo to listen to Buffett, perhaps it's because they are doing little more now than making a virtue of necessity, staying one step ahead of the law -- volunteering to do what they feared they would be forced to do, anyway. Ironically, it now looks like they weren't going to be forced, after all.

And it won't make much difference to either company's bottom line. Neither is a particularly heavy issuer of options, and neither company's stock has been especially volatile -- so options don't cost them much. According to their financial statements, if Coke had been expensing options under **Financial Accounting Standards Board** Statement 123 for the last three fiscal years, its net income would have been reduced by only 6.3% on average. WaPo's would have been reduced by only 1.6%.

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But be that as it may, Buffett's influence in both cases is evident -- and both companies are doing the right thing. And it's an example of the right way to enforce corporate accountability -- from within the markets themselves, at the initiative of investors like Buffett whose own money is on the line.

In the 1980s, markets learned to unseat entrenched executives and maximize value for shareholders, first with leveraged buy-outs and later with hostile tender offers. Financiers put money at risk to throw the rascals out, and create a new generation of streamlined, modern and accountable companies.

But by the end of the 1980s, entrenched executives had figured out how to fight back with boardroom barricades such as poison pills, and with new securities laws, anti-trust laws and tax laws that made hostile tenders all but impossible. After that began the age of massive issuance of stock options -- and the aggressive and acrimonious lobbying to keep accounting rules from requiring options to be expensed. There was no way to stop it.

The secret transfer of shareholder wealth without shareholder consent was made *legal*. And the market's natural mechanisms to defend itself were made *illegal*. And it was all thanks to a series of laws passed with -- at least ostensibly -- the best of intentions. Jobs and pensions had to be saved from "takeover artists." Capital markets had to be saved from "junk bonds." And look what happened... when even one cat in the house goes off duty, the mice have greater freedom to dance.

Now American investors have to be saved from "corporate crooks." No wonder the markets have been in free-fall. The markets have no way of quickly sorting out the unintended consequences that may flow from the laws being passed now in haste, in the grip of high emotions. So in the meantime, they discount the worst.

We believe that the expense of options *should* be reflected in income statements -- although SFAS 123 does it poorly, and in a way that tends to minimize options expense. We have proposed a more robust approach that starts with options as risks on the balance sheet, and treats changes in their values as expenses or credits (see "Options Options" May 14, 2002). But, be that as it may, we are relieved that moving toward such reforms has *not* been made a matter of legislation. Now, as the Senate and **the House** reconcile their respective corporate crook bills in conference, we hope that they will remember that in legislation, as in architecture, *less is more.*

Just as it is far better to let the FASB and the **International Accounting Standards Board** deal with accounting issues, the market will be a better place if fewer obstacles were in the way of what used to be called “the market for corporate control.” What we are dealing with now is a version of the question **Juvenal** asked in the first century: *Sed quis custodiet ipsos Custodes* -- or, *who guards the guardians?* In a free economy, with respect to corporate governance the answer is: the market does -- but only when it is allowed to work. TM