

Occasionally, we read an article dealing with a contentious accounting and financial reporting issue that bears examination. Tim Pick's articles on expensing stock options fall into that category. We believe you will find them very insightful and pithy. Your view of the issue may not be the same afterward. We welcome comments and suggestions at [mcheffers@ivesinc.com](mailto:mcheffers@ivesinc.com).

Mark Cheffers

## CEOs as Central Bankers (Part 2)

by Tim Picks

Market Ruminations

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If you've not read [Part 1](#) of this article, please do so first.

In this 2nd part, I'll discuss many of the more common arguments against expensing employee warrants, and exactly why they are so ridiculous and insulting. I'll also attempt to show that if CEOs really believe their own arguments about not expensing employee warrants, then they need to resign immediately for the benefit of shareholders. And if they refuse to resign, their Board of Directors must immediately move to fire them or else the Board members are opening themselves up to being sued personally. Then, in the final part of this article (Part 3), I'll talk more about why I believe employee warrants are/were a form of private-sector inflation and why all of this is relevant to today's economy.

### The Common Arguments

The arguments against expensing employee warrants tend to rely on accounting tricks, fallacious reasoning, and misdirection (similar to what a magician does when he wants to divert your attention). The magician gets you to look at all the activity happening in his right hand, while he's palming the ace of spaces in his left. Likewise, the executive attempts to get you to focus on the accounting details, pretending like the whole thing is just a simple bookkeeping matter, so as to keep you from looking at the bigger question of criminality. Start looking at this as the criminal behavior that it is, and things become much clearer.

In Q & A format, in **bold** are some of the more common arguments used for not expensing employee warrants, with the answers below each.

**"True, the warrants have value to the executive (otherwise, why would he want them), but they cost the corporation nothing."**

Essentially, this is the Tooth Fairy defense. If you put a tooth under your pillow, \$5 just magically appears . . . from the sky! It didn't have to come out of anybody's pocket. It's not a *quid pro quo* world at all, don't you see? Just because one person receives value, doesn't mean the other person gave up anything of value. Wealth appears magically. Nonsense. The warrants could have been sold. The company didn't receive that money, and it should have.

**"No cash leaves the balance sheet when the employee warrants are granted, therefore they have cost the company nothing."**

Ah yes, the Lois Lane defense. With his glasses on he's Clark Kent, but with his glasses off he's Superman. It's all so confusing!! Focus on amount, not form. There was only one guy, no matter how he was dressed. Likewise, if a company hands \$10,000 to an executive, then it has handed him \$10,000. It doesn't matter if it comes in the form of the company's cash, gold, diamonds, warrants, or fish heads. If the company gives the executive a \$50,000 car, you can't claim there's no immediate expense.

The executive wants you to look solely at the cash line of the balance sheet, when he himself prevented the cash (from the sale of the warrants) from ever coming onto the balance sheet in the first place. He simply gave himself the warrants (and their cash value) directly. He creates a valuable security and gives it to himself for nothing. These warrants have huge time value that could have been sold for cash. There is a huge cost, absolutely huge.

**"But these warrants are granted exclusively to the executives and employees; that makes them different from publicly-traded warrants."**

True. But that goes all the more toward proving criminal intent. The executive made sure that only he and his cohorts, would be able to get these valuable company assets for free. That sort of eliminates the "It Was All A Big Misunderstanding" defense when the criminal trial comes. Stop thinking about the stock market for a minute and think of another fiduciary. Let's say I'm the Trustee of your Trust, and my job is to watch over and maximize all of your assets. I have a fiduciary obligation to act in your best interest. I get paid a salary for doing so. Now, in addition, I just decide that as Trustee I'm the only one entitled to get a free option to buy your house at today's price for the next ten years. I type up a document that says I am the only one who can be granted the option -- it can't be sold to anyone else for its fair market value. How does that make me look? When you ask me what in the world! do I think I'm doing, I reply, "I'm aligning my interests with yours. Now I'll have more of an incentive to act in your best interest." Yeah, right. Things look a little different when you think of it as your own money.

**"True, the executive gets the warrants, but in return the company gets his services, therefore it's a fair trade."**

The same is true of cash. Is cash an expense? Is anything an expense?

**"The actual expense of the warrant is only known when it expires or is exercised. A warrant that expires has an economic expense of zero, so expensing wouldn't be right."**

Not so. Here, the executive gets you to look solely at the intrinsic value of the warrants, and ignore the huge time value they have. The company could have received cash--right now--for the time value of the warrants, even if the warrants later expire unexercised. Where is that cash? It is missing . . . right now.

**"Employee warrants are good, because they're granted to rank-and-file employees too. Everyone in the company is motivated to do a better job."**

The fiduciary obligation is to the shareholder and his money. The executives and the rank-and-file employees don't get to steal money from the company and then argue about how to divide up the proceeds. If you want to grant warrants, you must expense them. Don't lie about how much the company is making in order to bring in new purchasers of the stock at an artificially inflated price, based on artificially inflated earnings. Even better yet, don't grant warrants. The shareholder had to save enough money to buy his shares -- the same should be true of employees. Employees should be paid in cash and then they too can put their hard-earned savings at risk and buy shares in the open market at the market price. Only then would the employees' interests would be aligned with the shareholders'.

**"But if we expense employee warrants, it will be devastating to the high-tech industry. Just look at all the jobs that will be lost."**

The Senator Robert Byrd defense. "Yes, in my state there are bridges being built in the middle of nowhere. They are being built at taxpayer expense. These bridges have no connecting roads and will never be used. But if we stop the funding for this program now (pointing to the bridge construction workers), just look at all the jobs that will be lost." The truth is, the sooner those wealth-destroying projects are curtailed, the faster those people can be employed in wealth-creating enterprises. In making this argument, the executive shows no respect for the free-market concept that a business must provide a return on capital, after all expenses have been accounted for.

**"The only reason those other companies are willing to expense employee warrants is because they're not using them. We are."**

The steroid-user defense. "The only reason the 'clean' athlete is in favor of drug testing is because he's not using them." Well, duh! Exactly! No spit, Sherlock. That's the whole point. He's not boosting his current performance artificially and you are. He's having to compete with a cheater. The executive tries to make it sound like the clean athlete is the bad guy for not taking steroids. It's almost an admission that he can't compete without cheating.

## **The Executive Must Resign Or Be Fired If He Believes His Own Argument**

When examining the following argument, again keep in mind the magician. When he directs your attention to something, that's when you should be looking everywhere else . . . to figure out what's really going on.

The worst argument--the absolute worst--is the one most executives think is their best. And they use it all the time. You've heard it. They'll usually make a small confession that these warrants have some value, but then, referring to them improperly as options rather than warrants, the executive will say something like, "I have not seen an accurate way of determining what value should be put on stock options." Or, "There is no good valuation model to determine the fair value of unexercised stock options."

This is the most ridiculous thing I've ever heard. Why? Because the argument has to cut both ways. If there is no way to value these warrants, then why in the world is he handing them out? How can he possibly determine how many to hand out, and to whom? How can he possibly be watching costs? It's an admission that he as the CEO has no idea what the true expenses of the company are, and yet he insists on continuing to be allowed to operate in this fashion. Why did he give an employee 30,000 options as opposed to 3 million or just 300? He doesn't know. Not only does he admit it's all capricious and random, but the dollar amounts are not even known. Would you in a million years let a manager run your business that way?

If you owned 100% of a business and the guy managing it for you told you he didn't really know what the expenses were, you would fire him on the spot! He says, "I just sort of go by gut feel." Hey pal, that ain't a good enough answer. And keep in mind, we're not talking about deciding whether an employee's salary should be \$60,000 or \$80,000. Certainly, such a decision is always going to be somewhat arbitrary. No, what we're talking about here is the fact that the CEO says he doesn't even know what those two figures are! There is no way for a comparison, because he doesn't know what any of the salaries are!

In order to remain profitable, is he pricing the company's products based on where its stock price is this week? The entire concept is absurd. And he's arguing that it needs to stay in place! He is clearly reckless. There can be no doubt. He admits he knows nothing about the company's cost structure.

His very own argument is an admission that he's running a stock scheme, not a business. He clearly can't be running a business because he's telling you he doesn't know what the costs are.

In getting you to focus on every tiny spec of the company's financial statements, the executive hopes you'll just miss the admission that he is a wholly inept manager. His own argument starkly reveals his complete incompetence in watching costs, and his unwillingness to ever do so. There's no possible way he should be left in charge. He needs to resign immediately. And if he doesn't, the Directors absolutely must fire him.

## **Directors And Other Financial Fiduciaries: Are You Being Set-Up?**

Think seriously about this. You had a fiduciary obligation to watch out for your shareholders and to keep an eye on management. They've been stealing, and you didn't stop them. It was your job to. Rather than prevent it, in many cases you actually joined in. Management knowingly devised, implemented, and participated in a scheme to transfer wealth from the shareholders to themselves. Does it get more egregious than that? And you approved it. You knew, or reasonably should have known, that this was theft.

Remember how at first it all seemed kind of funny when the tech bubble burst? Henry Blodget had pushed stocks that he knew were dogs, and then he was going to stick it to the public again by writing a book about it. But the public mood, and the mood of prosecutors, has changed. Mr. Blodget now has large legal bills. And Mr. Blodget's role as analyst and public commentator is somewhat less clear, legally speaking, than that of a direct fiduciary.

There is no doubt with you. You are a fiduciary. The name you need to think about is Alan Bond. He was recently sentenced to 12 years in prison for taking kickbacks and cheating pension funds out of millions of dollars. He was convicted in June of defrauding clients by sending unprofitable securities trades to their accounts, while directing most of the profitable ones to himself.

It's quite possible the before long, employee warrant schemes will be viewed the same way. Pension plans were looted, and the wealth of many was transferred to a few. You sent unprofitable securities trades to your shareholders (whether you're a Director, or mutual fund manager, or whatever), while directing the profitable ones to management (sometimes including yourself). You voted yes on a transaction to transfer valuable company assets to the executives for free. It's one thing for the CEO to try to transfer shareholder money to himself, and for you to stop him; but when you approved the transaction, you may very well have become part of a conspiracy to defraud your shareholders.

Nearly every tech company executive has made huge, huge gains, even while his shareholders have lost their shirts. This is not a random event. It is the case with nearly all of them. At this point, how can you possibly claim that these employee warrants are in the best interest of shareholders? And more importantly for you, what is going to be your defense if/when you are brought up on fraud charges? How on earth could you have approved a transfer of so much money to the executive for free? How could you possibly have voted that the reckless executive should stay in charge, even when he admits he has no idea what his company's expenses are?

All of these executives admit--in fact, their entire argument is--that no one can understand what's going on here. You and they are admittedly leading less-educated investors into something they cannot possibly understand. That has all the potential for huge lawsuits down the road when investors discover just how badly they've been deceived by the experts they trusted.

Think about what it would be like to spend years paying for your own criminal defense attorney. Going to court. Ruining your family. Tarnishing your reputation. And possible prison time. (Alan Bond has a wife and children he will not see for 12 years.)

Think hard about this, because you are not sitting in a good position right now. Start watching out for your own backside. When the criminal trials come, the CEO isn't going to be your buddy anymore -- it'll be every man for himself. He's going to say, "Well, the Board approved it."

Start showing some remorse and start doing what you should have been doing all along: watching out for the shareholder. Don't let yourself be strong-armed into believing that these employee warrant schemes have to exist **at all**. If no one knows what these employee warrants are worth, then the answer for you is simple: vote against them. Period. That way, you'll have a reasonable defense

if things come to a trial. You can say, "I couldn't approve a transfer of wealth to the CEO. That's wrong. And even if it's just an expense, he couldn't even tell me how much it was. I couldn't give him a blank check like that." Because right now, you're sitting on the opposite side of that argument. What, exactly, is your argument?

You Directors and financial fiduciaries hold in your own hands the free-market solution to ending this theft. You have the power to stop it. If you choose not to, remember that a legal system that convicts people of fraud is part of a free market system as well.

## **These Executives Are Free Market Imposters -- Just Look At Their Inconsistencies**

The most annoying thing about these unexpensed employee warrant scams is that many of them are being run by executives who claim to be defenders of the free market. They are no such thing. They are thieves. They are giving business a bad name. That these executives try to take the moral high ground is appalling and shameful. They are responsible for malinvesting and misallocating huge amounts of capital, largely because of these employee warrant schemes. And now they want to blame it on someone else.

Someone who truly believes in free markets and liberty does not participate in fraud; he insists that the fraud be stopped, lest we devolve to Nigeria where nearly everything is a scam. Without morals, even capitalism will fall.

Just look at some of the big-picture inconsistencies in their arguments:

These same executives rail against the IRS tax code (and rightly so) for being so complex that nobody can understand it. But ironically, they insist on using a compensation plan that they admit no one (including themselves) can figure out. It is at least as confusing as the tax code. "Let each investor determine what the earnings are," they say. Yes, that's great. And let's just allow the IRS to come to whatever calculations they want on each taxpayer's return too. No rules known in advance. We'll let the IRS just sort of "eyeball" it.

These same executives denounce the Federal Reserve (and rightly so) for its ability to dishonestly print money at will. Yet the executives do the same thing, only in an even more confusing and circuitous manner. They print more currency each year and attempt to convince you that it's in your best interest. Dilution (inflation) is good for you, don't you get it?

These same executives excoriate the government (and rightly so) for spending the taxpayers' money on a public works project that can only show some sort of "psychic" return without factoring in all the costs that are not seen. Yet these executives insist that their own company's costs and expenses go hidden and uncounted, and that you should instead focus on some immeasurable, vague concepts like "employee motivation" and "aligning management's interests with those of shareholder."

These same executives decry lobbying (and rightly so) as simply a way to get into the pockets of the taxpayer. And yet these executives have formed large lobbying groups to allow themselves to continue their theft of the taxpayer. They

just steal from the taxpaying stockholder directly, rather than having the money go to the government first.

Why are legislators, regulators, and oversight boards even asking these executives for their opinion on employee warrants? It's preposterous. Headline flash from the newsroom . . . .

## **This Just In: Bank Robbers Not In Favor Of Laws Prohibiting Bank Robbery**

What a stunner! I mean, knock me over with a feather!

Why in the world are these executives even in-the-loop on the decision to expense warrants? They should be kept out of the building. You don't ask the bank robber what laws he thinks are appropriate -- you impose them on him. Bank robbers apparently just need a more powerful lobbying group and then they too could be seen as fine, upstanding citizens.

If warrants are okay to hand out and cost the company nothing, then logically there should also be no limit on their use. Why not supplier warrants? Vendor warrants, advertiser warrants, etc.? Then, when someone asks the executive what his advertising costs are, he can give the same answer as he does about his employee costs: "Well, no one really knows. We leave it up to the investor to judge for himself."

Let's just turn every company into a currency and make the whole thing a big confidence game.

To hear these executives tell it, you'd think capitalism itself is in danger of collapse if employee warrants are required to be expensed. This is insulting to all the companies that manage to get along just fine without using them. It's an insult to nearly every private company. Somehow they manage to be surviving.

They keep track in cash.

And everyone should keep track in cash. One currency. It provides the means for the participants in an economy to compare one investment versus the other. It provides the means for properly allocating capital. In our economy, do we want to make capital allocation decisions based on how well 10,000 different public companies can prop up their individual "currencies," or do we want to have one standard for all businesses so that participants can compare which investments are best? Otherwise, how do you know whether or not you're investing in a buggy whip business?

Are these businesses that just happen to have a stock price attached to them, or are they really stock selling schemes that just use some "business activity" as a cover?

I'll ask the same question I asked when I wrote about the CyberRebate fiasco: Couldn't you start a ponzi scheme this way?

Let's say you own a business and are keeping track in cash. You've tried everything you can to improve your business, but no matter what you try, the

best you can do is bring in \$10 in revenue for every \$11 in expenses. Thus, it's not a business; it's a wealth-destroying enterprise. It needs to go bankrupt. But wait! Thanks to the public capital markets, here's what you can do. Labor is likely one of the biggest expenses. If you can convince enough employees to take enough warrants, you can knock \$2 off the expenses. Now you have the exact same unprofitable enterprise that "appears" to be showing a 10% profit margin ( $\$10_{\text{rev}} - \$9_{\text{exp}}$ ). You turn an unprofitable business into a stock-selling scheme.

And my guess is, that's why many tech executives are fighting so hard to keep their thieving, corrupt accounting in place -- because they know they're not running a business.

### **Arguably Worse Than An Inflationist Central Banker**

At least an inflationist central banker would just print new stock certificates. But these employee warrant schemes are even worse, because in a bull market they are a self-fulfilling prophecy. The more warrants that are given out (in other words, the more embezzlement that occurs), the more the expenses appear to go down and thus, the more the earnings appear to go up! This boosts the price of the common stock, making the warrants even more valuable and ensuring dilution. But of course the whole thing depends on new buyers continually coming in to buy the stock at ever higher prices, in what is essentially a perpetual stock offering (should that even be legal?) that is not disclosed as such.

(To borrow from Churchill):

***This is embezzlement wrapped in a counterfeiting operation inside a Ponzi scheme.***

This is a terrible, terrible, terrible way to allow things to function. It is so misleading and so fraudulent on so many levels, that the SEC should have stepped in long ago. Much, if not all, of the real profits that a company makes are stolen in advance by management. And that assumes it has real profits. Many of these companies simply are not profitable. The appearance of profits is brought about by financial shenanigans. They are really wealth-destroying enterprises. They need to go away.

I believe the best solution is to no longer allow public companies to grant employee warrants. They simply make it too easy to start a ponzi scheme, or to turn an existing company into one. A worthy company that can provide a good return can always raise cash. If it's such a risky company that it cannot raise cash, then it should be private anyway. We need to weed out more of the garbage that has been coming public, and eliminating employee warrants would be helpful in doing so.

Right now, with these warrant schemes, there is no way to tell how much money a company is making. The executive acknowledges this, argues for such a confusing system, and demands that it stay this way. This system is eating away at the integrity of the public capital markets.

Warren Buffett describes his job in three words: "I allocate capital." Apparently, he thinks it's fairly important. If capital is misallocated into wealth-destroying

enterprises, we all end up poorer as a whole. Yes, in these warrant schemes, a few people appear to "get rich." But it is simply a wealth transfer from the unseen victims. No wealth is actually created.

Even if warrants were expensed, it still makes it an unnecessarily complicated and screwy system, often pitting management against shareholders.

When you really think about it, for a company to have its expenses determined by its stock price is ridiculous on its face. Absolutely ridiculous. That is no way to allocate capital.

## Why Is The Executive Making Life Difficult For Everyone?

If you're still having trouble thinking about this, step back and look at it using common sense. Ask yourself, "Why is the executive making things so difficult for everyone to figure out?" He claims to be trying to help the shareholder. He claims he wants the shareholder to make money. Yet he's making it all so confusing. Why? And even from his own standpoint, why spend all of the time required to formulate an employee warrant plan? Why spend all the time (and shareholder money) on attorneys, accountants, administrators, board meetings, etc., for such a plan? These things are not cheap. It's terribly inefficient compared to cash. And the executive certainly admits it's much more confusing. Rather than making you guess when and where the expenses are incurred, why doesn't he just use the simpler system and eliminate all doubt?

And similarly, when the guy on the streets of New York City offers to let you make money by playing his shell game, why does he keep moving the shells around and make you guess where the pea is? Why is he making you go to all that trouble? Why is he putting himself through all that trouble? Why make it so complicated? He keeps encouraging you to keep your eye on the pea, and he's going to help you find it this time. But if he really wants to help you, why doesn't he just lift all the shells and show you exactly where the pea is?

There's a wonderful old phrase:

***"What you do speaks so loudly I can't hear what you're saying."***

The final part of this article (Part 3) should be out in a week or two. [Part 1](#)

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