

# **ROCKWELL**

## **✚ MEDICAL TECHNOLOGIES, INC.**

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January 30, 2003

FASB  
Director@fasb.rog

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**RE: Comments on Stock Option Accounting**

To Whom It May Concern:

I am writing in response to the FASB's Invitation to Comment on Accounting for Stock-Based Compensation. I have been a member of the AICPA for nearly a quarter century. I hold an undergraduate degree in accounting and a Masters degree in Finance from highly rated academic programs. I am currently the Chief Financial Officer for a publicly traded small-cap company. I have chosen to comment to express my views and those of the shareholders I represent. I am on the front lines of dealing with investors, brokers, investment bankers, shareholders and other stake holders on a daily basis and I have formed clear views on this subject. I live in the real world of what investors do and how decisions are made and not in academia. My comments are based on fundamental guiding principles coupled with the pragmatic reality of how investors view stock options.

**Our opinion on current disclosure is that it is adequate and does not require change.**

We believe that the FASB in adopting FAS 123 provided adequate disclosure for investors to make informed judgments. Rather than adding to clarity, visibility and understanding to financial statements the proposed mandatory expensing of stock options will create more confusion among potential investors and shareholders. If companies conclude that they should expense stock options they can do so. If they conclude that stock options are not a contingent expense that should be recognized they can provide footnote disclosure that presents adequate disclosure.

**Stock options are fundamentally not an expense**

My view, which is shared by many investors, brokers, and other financial professionals, is that there is not clear theoretical support that stock options should be expensed. I concur that if there is disclosure required, it should be in the footnotes and not required to be included as an expense in the financial statements.

There are two fundamental guiding principles that form the basis of my views. These principles provide a context and perspective that is not evident in the FASB proposal.

**The fundamental principle in business is that Cash Flow creates value.**

Businesses are valued based on cash flow. Investors make investment decisions based on cash flow. Shareholders make investment decision based on cash flow. The income statement is the primary guidance of business performance used by investors. Investors look to net income to be the primary indicator of the cash flow capability of a business and that cash flow is the primary driver of its value, irrespective of the other financial statements. It is well understood by financial professionals that the theoretical value of a business is the net present value of the cash flows from that business. Indeed many investment decisions are made based on estimates of the present value of the cash flows. The price paid for most acquisitions and mergers is based on this very analysis of the cash flows from operations of a business. Certainly every sophisticated investor looks to the earnings power of a business based on its ability to generate cash flow and adjusted for the risk of volatility in cash flow and other market and non-market risk factors.

**Contingencies should not be reported in the financial statements.**

It is a well established principle that contingencies should not be included in financial statements. Events that have not taken place, may not take place or even those that could possibly take place are not included in the recognition of revenue and expense.

With the context of these guiding principles, my views as a CPA, CFO, financial analyst, investor and shareholder are the following:

- **First, Employee Stock Options are closer in nature to an equity transaction.** It is by its nature an investment transaction more than a compensation item for which an expensed should be recognized. An officer or an employee that is granted an option at fair market value has the option to buy shares at the fair market value price on the day of the grant. This is an equity transaction. If the grant were to be exercised on the date of grant, the Company will have issued shares at the fair market value. **This is clearly an equity transaction for which there is quite obviously no expense.**
- **Second, there is no guarantee that the employee stock option will generate value.** The Company could under perform, the stock decline in value and the option expire worthless. Under this scenario, the proposed rules would require a Company to have recorded an expense for an item that had no impact on its cash flow, its operating expenses or its real economic valuation based on its ability to generate cash flow from operations. This is a mistake to create an artificial expense on the financial statements. This procedure will not be understood by the vast majority of investors. It is clear an error in judgment to record an expense for stock options when they have no impact on operational results, cash flow, equity outstanding or business value.

- **Third, options are not expenses but equity investments by Officers and employees.** Officers are awarded the majority of option grants. Officers have the greatest potential to positively impact future results and to increase market value. This is seldom achieved without exceptional effort by a Company, its employees and Officers. Options are incentives to create future equity value. The Company makes a bet that the officers will add value and the officer makes a bet that the Company will increase in value by greater than the impact of the option on the value of the share price. The Company allows the officer to buy at the option grant date market price but not have to fund it until after the value is created. The Company takes the risk that the Officer will add net value for the shareholders.

The Officer's consideration paid to the shareholder takes two forms. One is the cash outlay to buy the shares and the other is his intellectual and time investment in striving for increases in market value. The Officer makes his investment in effort and time until value is created and then he makes a financial investment. The Officer or employee has used his or her intellectual capital and his or her time (opportunity) capital as his or her investment in the appreciation in the stock price. After the stock appreciates the officer makes a financial investment in the share price and may sell those shares just as any other investor would.

- **Fourth, shareholders have already approved and understand the impact of options on their investment based on current disclosure rules.** Employee Stock Options only have value to the Company, Shareholders and the employee when they translate into cash flow. Investors understand this and make decisions. First, shareholders generally approve stock option plans in advance or have, by proxy, approved a Board of Directors to act on their behalf. The investor has clear disclosure in the footnotes. The maximum number of total shares that could be issued under a plan is known. The number of shares underlying issued and vested options is known as well. The potential number of shares that could be issued that might impact earnings per share can be estimated by the shareholder. There is no evident reason that a non-cash expense should be recorded for stock options.
- **Fifth, expensing options creates no improved visibility on the performance of a Company for the vast majority of investors, shareholders and users of financial statements.** In essence, the Company permits the Officer to make an equity investment at a pre-determined price. If they succeed in generating value both the Company and its shareholders and the Officer or employee are advantaged by their actions. If they fail to do so, the options ultimately have no value.

The vast majority of investors will not understand why an option is expensed and will view an option expense as a cash outlay. Most investors are not accountants and do not have the financial acumen to understand the nuances of accounting rules not grounded in common sense. Sophisticated investors will be cognizant of it and will back it out of the Income statement in making their analysis. In any case, it is unnecessary, unwarranted and unwanted by the vast majority of investors.

- **Sixth, Stock options are a synergistic catalyst, not an expense.** Options are not dilutive when the behavior they promote results in increased shareholder value. In this case, stock options are an equity investment and that equity investment advantages all participants in the process. The passive shareholders are advantaged and the active officers and employees are advantaged in a synergistic manner when options are successfully deployed in increasing shareholder value.

Dilution is when the same loaf of bread gets cut into more slices. When a dozen more loaves comes out of the oven and the shareholders only got six before, that is synergistic. Stock options are a synergistic catalyst, not an expense.

- **Seventh, There may be a distinction between the purpose behind the use of options by large capitalization companies as compared to small or micro-capitalization companies.** In large capitalization companies that are stable, growing at moderate rates and which may offer employee stock options to a broad section of employees, these companies may view options as a compensation tool to reduce cash outlays for compensation. Under a stable company with predictable financial performance and a history of payouts to a broad base of employees, it is clearer that the use of options may have been to displace a cash compensation expense and the shareholders were “diluted” if the value of the Company (share price) was not improved by greater than the dilutive impact of the options. Here a case for expensing options could possibly be made. It could also be disclosed in footnotes providing the reader with a full understanding of the impact. In any event, the proposed accounting impact on earnings per share is a double negative impact. First, based on the option award an expense is proposed to be recorded when the only impact to earnings per share is to potentially increase the future number of shares, thereby lowering earnings per share, which is viewed by most investors as a proxy for “cash flow per share”. There is no cash outlay and therefore, there should be no expense. Cash is the only measure that matters.

In the case of a smaller or micro capitalization company where the options are granted for the purpose of increasing shareholder value and ultimately result in increasing shareholder value by greater than the impact of the options, the options would not be an expense but rather a tool to add shareholder value. Most investors understand the concept of “overhang” and most companies have 10-15% share “overhang” from options. Sophisticated investors know it, understand it and adjust their valuations because of it. They don’t need to be confused with another expense item that makes no sense. The less sophisticated investors will not gain any clarity, visibility or understanding by expensing options. In fact, they are more likely to be confused by expensing options.

The success of many small and micro-cap companies is driven by officers and key employees who are granted options. Shareholders often make investment decisions based on their confidence that these officers and key employees can increase shareholder value. They view these key personnel as their partners in developing value and expect that those granted options are taking a risk and if they are successful will be rewarded for the risk, just as they are as shareholders. Our experience is that few shareholders complain that options should be granted to key personnel and most seem to view the goal alignment of the shareholders with that of the option holders desirable and preferable. In addition, few of the brokers, investors, shareholders and prospective investors we deal with would comprehend an expense for options. However, they do understand the impact of additional shares in the public float.

- **Eighth, Employee Stock options are a contingent event and should not be expensed in financial statements.**

Even if the fundamental premise advanced by the FASB that options have value holds merit. There is no guarantee that it will be dilutive to earnings per share. Many employees never exercise options as they are terminated, quit, retire etc. or the options never “get in the money”. The FASB is proposing to recognize a contingency based on future events that have not taken place, may or may not take place, have no reasonable assurance of ever taking place and even if they were to take place increased the equity of the company and common shares outstanding, an equity transaction.

- **Ninth, Measurement is imprecise, inaccurate and assumption based.**  
As measurements derived from use of option pricing models are assumption based, imprecise and undoubtedly inaccurate the use of these estimates should be used only in proforma footnote disclosure. There is broad doubt that these measures are accurate or that they reflect economic reality. In order to encourage confidence in financial statements, the footnote should contain the disclosures of proforma earnings with and without option expense. However, the perception is that the reported expense can only be an inaccurate estimate that is not verifiable in any way.

In closing, the recurring theme is that the FASB is headed in the wrong path in requiring the expense of stock options. **It will be poor theoretical accounting, bad public policy and economically detrimental to shareholders and prospective option holders.**

Sincerely:

Thomas Klema

Vice President and Chief Financial Officer