TESTIMONY OF ROBERT E. GRADY
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MEMBER OF THE BOARD OF DIRECTORS,
NATIONAL VENTURE CAPITAL ASSOCIATION ("NVCA")
BEFORE THE
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND
GOVERNMENT-SPONSORED ENTERPRISES
COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES
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Good morning, Mr. Chairman and Members of the Subcommittee. My name is Robert Grady, and I am a Managing Director of the Carlyle Group, one of the world's largest private equity firms, and I am a member of the Board of Directors of the National Venture Capital Association ("NVCA"), which represents the majority of venture capital firms in the country. I have also served, for the last decade, on the faculty of the Stanford Graduate School of Business, where I am a Lecturer in Public Management. On behalf of the NVCA, thank you for the opportunity to appear before you this morning to discuss the Exposure Draft of the Financial Accounting Standards Board (the "FASB") regarding *Share-Based Payment,* which of course includes its proposal for the mandatory expensing of stock options.

The FASB has asked for comment on this exposure draft and our comment is simple. This proposal is inappropriate, incorrect as a matter of either financial or accounting theory, poorly thought out, and unworkable. In fact, it is surprising how little credence the FASB has given to either proper accounting treatment for options in the private company context, or the practical implementation issues that surround its proposal in the real world, where the use of broad-based employee stock option plans among by many thousands of private venture capital-backed companies in the Unties States is prevalent, and where the FASB has come up with no workable proposal to value those options or to address the increased uncertainty and unreliability that its proposal will introduce into income statement accounting. Instead, FASB has chosen to ignore the un-workability of its proposal so that it could respond in an entirely political fashion to what it perceives as a political issue. This is deeply disappointing, as it seems to be inconsistent with the mission of the FASB. Moreover, while the FASB's proposal may feel good in the short-term, in the long-term it is a disaster.

Before I comment directly on the Exposure Draft, please let me offer some statistics that make clear the typical real world use of stock options in our economy today. I am here today to speak on behalf of America's venture capitalists, firms that provide risk capital to job-creating companies, most of which do not have the resources or the history to borrow from banks or other debt providers or the size to raise capital in the public equity markets. The one thing they do have is the ability to create jobs as they seek to turn the innovative ideas of today into the big companies of tomorrow. The two funds I directly

manage, established in 1997 and 2002 respectively, continue to have investments in 38 startup companies that today employ over 4,000 people. In the private companies on whose board I sit – Blackboard in Washington, DC; Panasas in Fremont, California; USBX in Los Angeles; Secure Elements in Herndon, Virginia; and Ingenio, in San Francisco, California – incentive stock options are granted to every employee, from the receptionist to the CEO.

This is typical in the venture capital world. According to a recent survey by our association, the NVCA, in over 70% of venture-backed companies, stock options were awarded to ALL employees.

The standard type of grant in venture-backed companies is a grant that is vested to encourage the employee to continue to work at the company over time. A very typical structure, that commonly in use most venture-backed companies today, calls for an option grant to vest over four years – with so-called "cliff vesting" of one quarter of the options granted vesting on the first anniversary of the grant, and then monthly vesting of the remaining three quarters of the grant on a straight-line basis over the next three years. This is important, because under the FASB's Exposure Draft, the normal grant of stock options, the one used by virtually every venture-backed company in America, would have to be valued 37 different times – per grant! Somehow, the FASB believes this will make financial statements more understandable.

Members of the Subcommittee might wonder if venture-backed companies are a tiny subset of American business, but they are not. According to study performed for the NVCA by Wharton Econometrics/Decision Resources ("DRI-WEFA"), in year 2000 venture-backed companies directly employed 12 million Americans, and directly or indirectly accounted for 27 million jobs. Venture-backed companies had sales of over $1.1 trillion, or about 11% of GDP. They had higher than average R&D expenditures as a percent of sales and patents generated per employee or per dollar of sales. They employed people in 49 of the 50 states. And all of these benefits occurred on far less than 11% of the capital invested in businesses in the United States – the companies have secured a number closer to 1% of the invested capital in the relevant time period. In short, Mr. Chairman, venture-backed companies are the job-creating machines of the American economy.

With that as background, let us now turn to the FASB's Exposure Draft and how its policies will work – or not work – if implemented.

First, I feel compelled to start with a fundamental conceptual point. Options are shares, or units of ownership. They are not claims of cash, or uses of the company's assets. They should be treated and disclosed as such: shares – in the denominator, if you will, of the Earnings Per Share (EPS) calculation. If the FASB were proposing in this Exposure Draft that when companies, public or private, report earnings per share, they be required to use a fully diluted share count, including all options outstanding, in the denominator, I believe that would be a fair and conceptually correct proposal.

This point is essential. At its heart, what this debate is all about is that many Americans (and people all over the world, for that matter), are willing to trade off cash compensation in favor of ownership. Our start-up companies are populated with people who are willing to work for "a piece of the rock". They are willing to earn less cash today, and thereby create less in terms of ongoing expenses by the company, so that over the long-term they can make the company worth more, because they are owners. They are thinking like owners. And this is a good thing for all those who choose to join them as shareholders along the way – because their interests are aligned as mutual owners of the securities of the company.

Even for those who believe that options are an expense, a rule which provided both formats – income statements with non-expensing, combined with pro forma footnote disclosure of the effect of expensing options, would allow such investors to see the effect and the magnitude of the purported expense.

Ironically, proponents of expensing say that requiring it will not have the dire effects on companies many predict because investors will merely strip out the effect of expensing to look at cash EPS. In other words, they will ignore GAAP, precisely because it will not be representative of the company's true expenses, and look to other measures. So the irony of the FASB's proposal is that it is likely to undermine confidence in and use of GAAP – which one presumes to be the exact opposite of the intended effect.

In the gymnastics the FASB has had to go through to get over this fundamental point – in trying to define units of ownership as expenses instead of shares – the FASB has tripped over numerous obstacles that simply underline why its proposal is flawed at the conceptual and accounting level.

The first obstacle is trying to define the appropriate measurement date at which to value the option. The FASB has suggested that the grant date is appropriate. The problem with this, of course, is that the value of the option at grant date is highly uncertain. It may never vest, because the employee may leave. It may never be exercised, because the stock may never be "in the money" in the appropriate time frame. This problem exists even for public companies.

For example, Intel has reported that it awarded options in 2000, 2001, and 2002, which, if option expensing had been required, would have required the taking of charges against income into the several billions of dollars, for options that remain underwater. An option remaining underwater is of course not exercised. The shares in question never exist – they are never issued. Yet FASB's proposal for expensing would require Intel to report these non-existent option shares in an identical fashion to what it would report if it spent billions of dollars of company cash. It is extremely difficult to understand how such a charge would make Intel's income statement more reliable. It is obvious that expensing would make income statements less reliable not more reliable.

Moving the measurement date to exercise date presents other difficulties. This would simply penalize the most successful companies – or those with the brightest prospects.

Consider the case of two companies, with identical revenues, an identical set of cash expenses, which have granted an identical number of options. The only difference between the two companies is that, because of good performance, one's stock price has grown substantially between grant date and exercise date and the other's has stagnated. The better performing company will have its income reduced sharply by nothing other than its superior stock performance. The poorly performing company will show higher "profits" because its stock has languished. The Subcommittee, and the FASB, may wish to consider the question of how this is in any way good for investors.

The second obstacle is in trying to determine what an option -- which is exactly that, an option to purchase stock -- which is most often granted at the fair market value of the stock, is worth at the date of grant. FASB has stated in its Exposure Draft that the market price of the option is the best indication of its fair value. But what about options which have never traded? The value of these must be modeled – and the choice of model and of methodology leads to radically different assessments of value.

The most common model currently in use today, of course, is the Black-Scholes model, named for the late Fisher Black and my former colleague on the Stanford Business School Faculty, Myron Scholes. Black-Scholes, of course, requires the use of several different inputs. Different inputs will yield different outcomes. So, once again, the use of models will decrease the reliability of income statements, not increase the reliability thereof.

This problem is especially difficult to overcome for private companies. So a third obstacle on which FASB has tripped is that its plan is totally inappropriate and unworkable for private companies. As a general matter, employee stock options in these companies have no trading history. Moreover, the underlying stocks of the companies have no trading history. In addition, in most cases, they are highly restricted. Even if there were a market in the options, many could not be traded. They are subject to vesting, as I have described, in an effort to retain employees. And most options granted to employees cannot be transferred, hedged, pledged or sold.

FASB implicitly argues in its Exposure Draft that no restrictions that exist during the vesting period – typically four years among startup companies – should be considered in valuing options. But this is utterly inconsistent with FASB's stated objective of recording options at fair value. Clearly an option subject to vesting restrictions is worth less than an option not subject to restrictions, yet FASB would have us record them at the same price.

A related fourth obstacle is that all of the methodologies for valuing options which have been traditionally used, on which the FASB's proposal is based, or on which it is seeking comment, rely on some estimate of volatility of the company's underlying stock price to determine the value of the option. In the case of private companies, the stock has of course never traded! So any estimate of volatility will be a guess. Moreover, the FASB Exposure Draft actually states that companies should be required to consider the extent to which "future experience is reasonably expected to differ from historical experience" in

estimating volatility. It will be subject to manipulation and inaccuracy. Since the estimate of volatility will be subjective, so will the "expense" associated with the options. It would seem that the FASB should want more objective, not more subjective, income statement reporting.

Fifth, because of the problems outlined above in estimating the fair value of options, FASB's proposal would allow private companies to elect the use of the "intrinsic value" method for valuing options. Under this methodology, the value of the option is adjusted for each reporting period. This form of variable accounting would change the value of any given grant in every quarter, depending in stock price – or in the case of private companies, depending on an estimate of stock price. It would be massively confusing.

Finally, in seeking to identify the proper time period to which to attribute the expense that its Exposure Draft would require to be recorded, the FASB introduces and trips over new hurdles and obstacles. For example, options which vest on a graded schedule similar to the four year schedule I described earlier in my testimony – one quarter vesting after one year and one-forty-eighth vesting each month thereafter – would be viewed as 37 different option grants that a company would have to value and account for separately.

The Exposure Draft suggests that companies should group their employees for purposes of predicting exercise behavior. This would be a completely speculative exercise that would be almost preposterous in its unreliability.

In the end, Mr. Chairman, what is clear from the FASB's proposal is that it is responsive – not to the voluminous comment that has been provided by experts and actual companies, not to the obvious problems that have been pointed out both this morning and over the past two years in consultations that seem to have been ignored, but to the political process. At its heart, this is a political proposal.

It seems the FASB and Mr. Herz feel they must respond in a political fashion to the news reports of senior executives at companies like Tyco, Worldcom, or Adelphia looting their companies and overseeing the preparation of false accounting statements. And there should be a response to these atrocities – if found guilty, the individuals responsible should go to jail. But the fact that dishonest people have stolen money from their companies and their shareholders is not related to how companies, especially private companies, should account for units of ownership granted for purchase by employees because they believe in their company's mission and prospects.

In fact, just this week, the FASB Chairman Mr. Herz basically confirmed that he was embarked on an explicitly political course. On a conference call with press and investors on Monday, April 19th, he said, according to Dow Jones, that investors and analysts should make sure that "you make your views known to people in Washington."

Because the FASB has chosen an entirely political course, we at the NVCA believe that the political system should engage the debate and at least come forward with a proposal that is responsible from an accounting perspective, more accurate from a financial

reporting perspective, and not likely to lead to mass confusion in the real world where investors and companies live.

In this regard, the NVCA believes that the legislation proposed by the Chairman of the Subcommittee, Representative Baker, H.R. 3574, represents a responsible approach that addresses some of the most obvious and egregious problems created by the FASB Exposure Draft. H.R. 3574 would exempt private companies from the requirement to expense employee stock options – which makes sense given the impossibility, as outlined above, of estimating the volatility of securities which have never, and may never, trade publicly, and therefore of accurately valuing options of privately held companies. It would also exempt companies from this requirement during their first three years as public companies, while a trading history is being established which makes an estimate of volatility more possible and less subject to manipulation or pure guesswork.

The NVCA has also previously endorsed the legislation which had been sponsored by Representatives Eshoo and Dreier, which would place a three-year moratorium on the requirement to expense stock options while more work is done to address the difficulties I have outlined above in accurately valuing options. In addition, both the Chairman's bill and the Dreier-Eshoo bill appropriately call for a study of the impacts of expensing on the U.S. economy. As I stated at the outset, startup companies that offer employees ownership have been some of the most job-creating enterprises in our entire economy, so it is appropriate to study the impact of disrupting this spectacularly successful system for before doing so for ill-thought-out political reasons.

Mr. Chairman, on behalf of the venture capital community and the start-up companies in which we invest, we appreciate the opportunity to appear before the Subcommittee this morning. We hope that the Congress will act now to take a more measured approach to this question and to address the multitude of problems associated with the FASB's ill-considered proposal.

Thank you.

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