

Hearing of the House of Representatives Capital Markets Subcommittee
on
HR 3574
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Good morning. I am Mark Heesen, president of the National Venture Capital Association (NVCA), which represents 460 venture capital firms in the United States. As you know, venture capital is the investment of equity money to support the creation and development of new businesses. Venture capital backed companies are very important to the U.S. economy in terms of creating jobs, generating revenue and fostering innovation. Many people argue that this segment of the economy, the entrepreneurial segment, is the real growth engine for the U.S. in terms of global competitiveness. U.S. companies originally funded with venture capital now represent 11% of annual GDP and employ over 12 million Americans.

I am here today because our country's small, start-up companies are being threatened by the Financial Accounting Standards Board's (FASB) quest to unilaterally mandate the expensing of employee stock options. The NVCA has a long history of working with FASB on the issue of stock options and our opposition to mandatory expensing is well known. I am testifying today in support of HR 3574 as this bill reflects a thoughtful and balanced approach to employee stock option accounting. The bill mitigates to a considerable degree the critical flaws surrounding the impact of expensing on small and emerging growth businesses, an impact that the FASB has refused to address.

Within the last year, the FASB has demonstrated an increasing disregard for the effects of its stock option accounting proposal on small businesses. This position is a stark contrast to FASB's stance in 1995 when it issued the current rule, FAS 123 in which exceptions were made for private companies. Despite countless calls from these small companies to make distinctions between themselves and large, publicly traded entities, the FASB has made no meaningful progress in this area. Promises from FASB Chairman Robert Herz made at the last Senate hearing in November on this issue and at the last meeting of this sub-committee have gone unmet.

In June, Chairman Herz noted several times that the FASB would address the small business issue. In response to Representative Kanjorski's question whether FASB is "able to establish a rule for accounting purposes that will cause greater transparency for the investing public and not interfere with or in some way compromise the growth of the economy of start-up and high-tech companies," Chairman Herz replied, "...in terms of the private companies, start-ups, we are going to look at that separately, apart from the large public companies."

In response to Representative Emmanuel's question as to whether anybody has looked at the difference of how you would expense stock options for a big public company versus an early stage company, Chairman Herz replied, "It is a question we intend to look at. Because certainly, if nothing else, the valuation issues when you don't have publicly traded stock become of another realm on valuing an option. ...So when you have a private company, a start-up, even if it is pre-IPO I think that is a real issue."

Despite the Chairman's assurances, the only visible effort the FASB has put forth was the announcement, in direct response to the November 2003 Senate hearing, that a small business advisory group will be created. However, this group has yet to be formed and is unlikely to be functional in time to contribute to the current debate.

We fully concur with Congress' reluctance to involve itself in the setting of accounting standards. Yet, with FASB's exposure draft expected in a matter of days, we have nowhere else to turn. In this instance, private companies are in a unique situation with little recourse. While public companies can look to the SEC for additional guidance on many issues, private companies do not fall under SEC purview. However, venture-backed start-ups generally report their financials under GAAP simply because they often do expect to one day move through an initial public offering or become acquired by a public company. Because both of those scenarios require GAAP reporting, venture-backed companies find themselves falling under FASB's domain, without having sufficient input into the discussions of the impact of FASB pronouncements on emerging growth enterprises. In fact, the voices of our country's emerging growth businesses have gone ignored by the FASB. We see an urgent need for checks and balances in our system at this time.

Employee stock options are a critical factor in fueling entrepreneurial innovation and economic growth. For example, the biotechnology industry simply would not exist today without venture capital and employee stock options. Almost without exception, young, growth oriented companies use options to attract the best and brightest talent when cash is scarce.

Employee stock options foster the American entrepreneurial spirit at all levels of organization, with an estimated 10 million workers holding these incentives. Should the FASB require stock option expensing, they will seriously harm an economic tool that has given U.S. companies a competitive advantage over our foreign counterparts.

The mandatory expensing of stock options will place a serious burden on small companies so that most will be forced to curtail their broad-based option programs. Today, just as in 1994 when Congress addressed this issue, an acceptable method for the valuation of employee stock options has not been identified by the FASB. Therefore, the option expense number will be perpetually inaccurate, particularly for private companies where it is impossible to measure volatility, a mandatory input into the valuation models currently supported by the FASB. From a formulaic perspective, if one uses the “wrong” volatility there will be a meaningful distortion of the value of the stock option. FASB is familiar with this issue. In promulgating the current stock options rules contained in Statement No. 123, FASB determined that measuring volatility for private companies was too difficult. The FASB stated:

"An emerging entity whose stock is not yet publicly traded may offer stock options to its employees. In concept, those options also should be measured at fair value at the grant date. However, the Board recognizes that estimating expected volatility for the stock of a newly formed entity that is rarely traded, even privately, is not feasible. The Board therefore decided to permit a nonpublic entity to omit expected volatility in determining a value for its options. The result is that a nonpublic entity may use the *minimum value* method . . .“ Basis for conclusions ¶ 174. (The minimum value method allows the volatility input to be set at zero.)

While there have been no material changes in the theory of option pricing since 1994, and estimating the volatility of a stock that does not trade has not become any more feasible, the FASB has chosen to reverse their previous conclusion and move forward with a mandate that requires private companies to derive a volatility number. By requiring companies to disclose a highly-suspect option expense number, the FASB is creating a cost on the income statement that will have a significant, long term impact on an organization striving to reach profit levels necessary for an IPO or to become an attractive acquisition target.

Aside from inaccurate financials, a more practical concern is the monetary and human cost that will be required for young companies to undertake the valuation process. These organizations cannot afford the outside expertise required to work through complex valuation models nor can they afford to spend the time to do this themselves. In this regard, we have raised another series of questions: How often do we calculate the value of stock options? Public companies work on a quarterly basis. Private companies do not. They focus on results month-to-month. Should small companies hire experts to come in each month to derive the value of newly granted stock options each month? Who will do this work? What will they charge and from what strategic area will cash be redirected? Who has the liability if there is a mistake? FASB's mandate will force small companies to address these accounting issues, distracting management, raising expenses and lowering the bottom line.

Finally, implementing mandatory stock option expensing imposes a financial reporting credibility cost that heavily impacts small companies. Public company analysts have said that

they will “look through” numbers impacted by stock option expensing to a companies’ underlying financials. Yet, over 50% of the NASDAQ companies and virtually ALL private companies do not have analyst coverage. Who is going to look through their numbers? By placing this accounting burden on young companies, FASB is needlessly raising costs, lowering profits and lengthening the reliance on expensive, high risk capital to the start-up sector.

We believe HR 3574 seeks to preserve broad-based employee stock option plans and addresses the serious implications of expensing for emerging businesses. By limiting mandatory expensing to the top five executives, HR3574 targets executive compensation while simultaneously preserving the ability of companies to deliver option plans to rank and file workers. By exempting the expensing requirement for small businesses until three years after an initial public offering, the Bill relieves the compliance burden from young companies seeking to go public and allows a company stock to settle down from the volatility of the IPO. By setting the volatility at zero for valuation purposes as allowed under current FASB rules, HR 3574 removes a key variable that creates a highly inaccurate expense figure. Finally, by requiring the Secretaries of Commerce and Labor to complete a joint study on the economic impact of mandatory expensing, the Bill thwarts a “rush to regulate” effort by the FASB and prevents severe, unintended consequences for our economy and our international competitiveness.

Should the FASB move forward with its current stock option accounting mandate, all companies will have inaccurate financial statements, prepared at significantly greater cost. Yet, entrepreneurial businesses will be unduly impacted, as they do not have adequate resources to comply. The entrepreneurial energy that now accounts for over 10% of the U.S. economy will

be drained at a time when our global competitiveness is increasingly challenged by growing economies overseas. International convergence of accounting standards such as mandatory expensing will touch the US and Europe, not China and India where, we fear, accounting standards more supportive of stock options will drive more highly skilled jobs offshore. Today, we applaud the Congressional leadership for addressing the practical impact of FASB's stock option expensing proposal. We urge the passage of HR 3574 as it seeks to achieve consensus while upholding the financial integrity and enhanced transparency sought by all.

Thank you for the opportunity to express NVCA's views on these vital issues.