Hearing of the Senate Banking Subcommittee on Securities and Investment

on

FASB and Small Business Growth

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Good afternoon. I am Mark Heesen , president of the National Venture Capital Association (NVCA). My comments today reflect the views of the NVCA and its members. Our mission includes stimulating the flow of equity capital to emerging growth companies by representing the public policy interests of the entrepreneurial community. The NVCA represents more than 460 venture capital and private equity firms, both large and small, throughout the United States. As you know, private equity is the investment of equity money to support the creation and development of new businesses. Venture capital and private equity backed companies are very important to the U.S. in a classic economic sense and probably even more important in terms of creating and developing those businesses that are on the leading edge technologically. Many people argue that this entrepreneurial segment of the economy is the real growth engine for the U.S. in terms of employment, global competitiveness, and innovation.

A few years ago DRI/Wharton Econometrics undertook a detailed study of the role of venture capital in the U.S. economy. They reported that over the 30 year period that there has been a formal venture capital industry, more than 16,000 companies received $154 billion in equity financing from private capital sources. While most of these companies did not turn into big successes, and in fact, most start-ups fail, those that worked had become a huge portion of the U.S. economy contributing 11% of annual GDP worth over $1 trillion and employing over 12 million people. We have looked at these numbers since the economic downturn and they appear to remain valid.

The NVCA has a vital interest in the subject of this hearing because the future viability of our country's young start-up companies has, in the last year, been compromised by the hasty actions taken by the Financial Accounting Standards Board (FASB). While we recognize the tremendous pressure placed on the FASB to issue rules and standards more quickly, we have a grave concern that this rush to regulate has come at the expense of our country's small businesses who are often the unintended victims of rules targeted at large corporations.

We recognize fully that members of Congress are understandably reluctant to become the arbiters of accounting standards. However, the examples I will discuss in my testimony present a compelling need for checks and balances in our system. Recent FASB decisions have been steeped in flawed processes that provide little opportunity for input from the small business sector. Further, it appears the FASB is making more of its decisions in a vacuum, broadly applying accounting theories without any intention of testing whether such theories have practical problems before implementation. Unfortunately, FASB's rulings must be adhered to by real-life companies – often by the ones least able to bear a diversion of resources from their fundamental business purpose to piloting the latest FASB proposal .

Today, I will talk about two examples where FASB's actions have had or could have significant detrimental effects on small business. If left unquestioned to continue on this path, I submit that FASB's decisions will ultimately affect the growth of our economy by needlessly raising the cost of capital for young start up companies -- the fulcrum of our economic system. This is a dire prognosis and I hope that my testimony will convince you of the seriousness with which we view this situation.

FASB'S ISSUANCE OF FINANCIAL INTERPRETATION NUMBER 46 LACKED ADEQUATE INDUSTRY INPUT, GUIDANCE AND TRANSITION TIME, CREATING SIGNIFICANT CHAOS IN THE PRIVATE EQUITY AND ENTREPRENEURIAL COMMUNITIES.

The first instance involves the FASB's January 2003 issuance of Interpretation No. 46 ("FIN 46"), Consolidation of Variable Interest Entities ("VIEs"). FIN 46 was intended to provide new guidance on what constitutes a VIE and when a VIE is required to be consolidated with another enterprise. FIN 46 was issued as a rapid fire response to Enron's flagrant abuse of special purpose entities (SPEs) and was intended to prevent further manipulation by large corporations. However, the broad sweep of the rule would have also required many private equity funds to consolidate the assets, liabilities and financial results of selected portfolio companies. "VIE" is a new accounting term for the majority of entities we used to call special purpose entity, or "SPE." While VIEs are often entities created for a single purpose like securitizations, leasing, or R&D, FIN 46 considers neither an entity's purpose, nor its activities. Indeed, "VIEs" are defined only as *entities subject to consolidation under FIN 46*. In order to know if a portfolio company is a VIE, a fund would have had to evaluate each investment based on: (1) "the nature and amount of the equity investment in the entity;" and, (2) "the rights and obligations of the equity investors." These tests are complex and each must be passed to avoid VIE status.

The capital structures of many private equity funds' portfolio companies have characteristics that make it difficult to clear these hurdles. Therefore, FIN 46 would have certainly required private equity funds to consolidate the assets, liabilities and results of operations of selected portfolio companies. This consolidation requirement would severely impact the private equity fund, its portfolio companies, and its limited partner investors. Although we do not believe that this was the intended result of FIN 46, it would have been the practical consequence.

Under FIN 46, private equity funds that were required to consolidate their portfolio companies would have found that their GAAP-compliant financial statements resembled, a conglomerate of some of the companies in which it has invested. While the requirement to consolidate may not have applied to every portfolio company, only a few consolidations would render the financial reports of the fund nearly meaningless for limited partner investors such as universities, endowments and public pension funds. Furthermore, a portfolio company's variable operating results would obscure changes in the investment value of the total fund, impairing comparability of a fund's performance over time.

By their nature, private equity portfolios undergo significant changes in their composition as additional investments are made, companies go public or are acquired. As a result, from quarter to quarter, portfolio companies would go from being consolidated to being divested, or vice versa again and again. This variability impairs comparability of results and diminishes the overall relevance of the reports.

FIN 46 also would impact our small and emerging growth portfolios companies themselves. For example, if a portfolio company were to enter into a joint venture, purchase a minority interest in another enterprise, recapitalize, or engage in any kind of off-balance sheet activity such as synthetic leases, securitizations, or factoring, FIN 46 would force the addition or removal of assets and/or liabilities from the company's financial statements. This, in turn, could significantly change the company's financial picture and could impact loan covenants and other matters. When this is coupled with the fact that many of these very different portfolio companies may also have been consolidated with the financial statements of the private equity fund, the resulting hodgepodge of information would have met none of FASB's stated goals of producing, relevant, reliable and comparable financial statements. Private equity financial reports, which limited partners rely upon to make allocation decisions, would be so convoluted that firms would be forced to derive and maintain two sets of books – one to meet the FASB requirement and one that investors could comprehend.

Given the potential impact on the VC firms, their portfolio companies, and their investors, our industry spent an incredible amount of time trying to decipher FIN 46 and how it would apply to current *and* past transactions. Virtually no guidance was provided by the FASB despite numerous appeals for assistance from various constituents. FASB's deadlines further exacerbated the situation. Issued in January, 2003, FIN 46 was to be effective immediately for all VIE's created *after* January 31, 2003 and would have also applied to VIEs created before February 1. Although FASB had created a completely new terminology with broad ranging implications in its shift from SPE's to VIE's, there **was no new comment period; no new exposure draft and no attempt to solicit input.**

FIN 46 effectively created an emergency call to action to which we all responded. Thousands of hours were spent on this issue by CFO's of small start-ups and private equity firms, attempting to understand its application to our industry and to understand how it would affect each of us. While we are somewhat relieved that FASB has recently suggested that private equity funds should not implement FIN 46, we believe that a process that solicited input from the beginning could have averted this crisis. And the destiny of others still hangs in the balance. Even now, FASB determined that a limited deferral of the rule was necessary for all businesses. At this date, FASB is still mulling over these rules, determining to whom and how they should apply, leaving the small business, investors, and private equity community hostage to uncertainty and confusion.

FASB'S QUEST TO MANDATE THE EXPENSING OF STOCK OPTIONS HAS BULLDOZED AHEAD DESPITE MAJOR FLAWS IN THEIR APPROACH AT THE EXPENSE OF SMALL BUSINESSES.

NVCA has a long history of working with FASB on the issue of stock options and our opposition to mandatory expensing is well known. We assert that the mandatory expensing of employee stock options will transform a critical incentive utilized by the majority of U.S. start-up companies into a financial albatross that will harm small organizations to such an extent that they will have no choice but to negatively alter their option programs. The FASB accepted this conclusion in 1995 when it issued the current rule, FAS 123 in which specific provisions were promulgated for private companies. Yet, today FASB has inexplicably decided to change the rules to subject private companies to the same rules as public companies despite overwhelming consensus that such a move is fatally problematic.

Stock options are a critical factor in fueling entrepreneurial innovation and economic growth, and they embody a principle that employees should have a financial stake in, and financial responsibility for, the companies they help to build. Almost without exception, young, start up companies use options to compete for talent when cash is scarce. Stock options allow these organizations to attract the best and the brightest human capital to bring new ideas to life. The enfranchisement effect has fostered the entrepreneurial spirit at all levels of organization and has given U.S.-based companies a competitive advantage over their foreign counterparts. The mandatory expensing of these options carries with it a host of dilemmas with the most widely-spread concern today being the issue of valuation.

No viable method of valuing employee options exists today. Once thought to be the definitive answer, the Black Scholes option pricing model has now been virtually rejected by FASB and other experts as an appropriate method for valuing employee stock options, particularly for private companies. Other models, such as binomial methods, suffer from the same fatal flaws as Black Scholes and are even more complex. During the last year, we have implored the FASB to address the issue of valuation for employee stock options because without a common, accurate standard, an expense number will be meaningless to investors and too costly for young companies to derive.

While public companies face a challenge of valuing these options, private and newly public companies are confronted with even greater problems. In August of this year, NVCA sat before the FASB and presented the facts that show that a valuation standard cannot exist for private companies because it is impossible to measure the volatility of a company whose stock does not trade. Volatility is a mandatory input to the 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.

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 are each month? Who will do this work? What will they charge? Can the Big 4 firms do this work? Who has the liability if there is a mistake? And exactly how does one compute the volatility of a company whose stock does not trade? FASB has provided no answers and is unlikely to do so. As I sit before you today, FASB has failed in its attempts to address the critical issue of valuation, but is nevertheless moving forward in its quest, at the expense of privately held and small businesses.

FASB'S DECISIONS ARE INCREASING MONETARY COSTS AND LOWERING FINANCIAL REPORTING CREDIBILITY FOR SMALL BUSINESS

While debating the substance of FASB's decisions on entity consolidation and stock option expensing may seem esoteric, the results of those decisions are not. They translate into significant monetary *and* credibility costs related to financial reporting that are disproportionately borne by small business.

Aside from the obvious issues of the financials becoming inaccurate and unstable, a more practical concern is the monetary and human cost that will be required for young companies to undertake the consolidation and valuation processes. These organizations cannot afford the outside expertise required to work through complex models. They can no more afford to spend the time to do this themselves. But FASB's mandate will nonetheless force them to spend time and money on these accounting issues, raising expenses and lowering the bottom line.

At a time when the overall costs for regulatory compliance continue to escalate for small business, FASB continues to place additional burdens on small companies, effectively lengthening the reliance on private equity to sustain a company until it can reach the profit levels necessary for an IPO or acquisition. This reliance on the most expensive form of risk capital will subsequently raise the overall cost of capital throughout the entire system.

Congress has frequently stepped in and compelled government regulators to perform a cost-benefit analysis prior to the imposition of new regulatory burdens. FASB too has readily acknowledged the need for this analysis but, apparently, has decided to ignore the approach they took in Statement No. 123 and in Statement No. 126, where they stated:

"The Board strives to determine that a proposed standard will fill a significant need and that <u>the costs imposed to meet that standard, as compared with other alternatives, are justified in relation to the overall benefits</u> from improvements in financial reporting . . . . The Board has long acknowledged that the <u>cost of any accounting requirement falls disproportionately on small entities</u> because of their limited accounting resources and need to rely on outside professionals."

---FAS 126, Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities, basis for conclusions ¶¶ *9, 10*

Implementing ill-conceived regulations also imposes a credibility cost that heavily impacts small companies. For example, if stock option expensing becomes mandatory, many analysts have said that they will "look through" those numbers to a company's' underlying financials. But who will protect the smaller companies who don't have analysts to make this interpretation? Over 50% of the NASDAQ companies do not have analyst coverage. With only 50% of the small ***public*** companies receiving analyst coverage, what is the implication for ***private*** companies? It will be up to the banks, customers, and creditors – who have little access to detailed financial statements – to try to determine the underlying financial health of emerging growth companies.

When we met with the FASB Board in August, one participant argued that the public needed to realize that GAAP financials are only accurate +/- 50%. With that view, it is perhaps understandable that FASB feels any number is better than no number when it comes to valuing stock options. Unfortunately, we believe that path will have the result of making GAAP financials increasingly irrelevant. For large public companies, analysts will look through the GAAP numbers to pro forma statements. At the end of the day, it will be the small start-up segment that is left holding the bag and bearing the burden of this unnecessary complexity.

To summarize, should the FASB move forward with its current consolidation and stock options proposals, private and young public companies will have inaccurate financial statements, prepared at a crippling cost. The entrepreneurial energy that now accounts for over 10% of the U.S. economy will be drained at a time when the competitiveness and the robustness of the U.S. economy is severely challenged. The FASB remains silent on these challenges and is unequivocally pushing forward.

Rapidly restoring investor confidence in the public markets has been a priority for many of us during the last two years. Reform continues to be required and we are all in favor of improving transparency and enhancing financial reporting. However, the FASB has fallen short in its efforts to enact meaningful changes quickly and has done so at the expense of small business. Ironically, large corporations, who are the targets of these reforms, are insulated from this "ready, shoot, aim" approach. Small start-up companies are not and feel the brunt FASB's lack of comprehensiveness and concern. We urge Congress to engage in this discourse so that we might avoid these serious consequences.

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