

Hearing of the House Small Business Committee

on

Sarbanes Oxley 404 Relief

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Written Testimony of Keith Crandell

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Mr. Chairman and Members of the Committee, good afternoon. I am Keith Crandell, co-founder and managing director of ARCH Venture Partners located in Chicago, Illinois. ARCH is a 20-year-old venture capital firm that invests in emerging growth companies on a national basis. We fund primarily seed and early stage companies in information technology, life sciences and the physical sciences, often from inception until they go public or become acquired. As venture investors, my partners and I also sit on the boards of public and private companies where we have a first hand view of the challenges these small companies face on a daily basis.

I am here today in my capacity as a Board Director for the National Venture Capital Association (NVCA), which represents more than 480 venture capital firms like my own in the United States. As you know, venture capital is the investment of equity to support the creation and development of new, growth-oriented businesses. Venture capital backed companies are critical to the U.S. economy in terms of creating jobs, generating revenue, and fostering innovation. This segment of the economy, the entrepreneurial segment, is the true differentiator for the U.S. in terms of global

competitiveness. U.S. companies originally funded with venture capital now represent 10% of annual GDP and employment, despite accounting for only 2% of invested capital. These organizations include AOL, Intel, Cisco, Home Depot, Google, EBay, Starbucks, FedEx, Archipelago, and Genentech.

I want to speak today on behalf of the Genentechs of tomorrow - our country's small, emerging growth companies, both private and public, which are being stifled by a law that has burdened them in countless, unintended ways. As a venture capitalist that represents investors and shareholders first and foremost, I understand and appreciate the critical importance of financial transparency. But we have gone too far. The Sarbanes-Oxley law, specifically Section 404 (SOX 404), has drained capital and resources from these young enterprises, distracted management from growing businesses, diverted the major members of the accounting profession away from small companies, and threatened the future of the United States based capital markets system for growth businesses. And, in spite of its best intentions, I would argue that the SOX 404 law has done very little to prevent the massive frauds it was designed to detect.

Profitability is crucial on Wall Street and Sarbanes Oxley attacks profitability head on. From a pure financial perspective, the cost of complying with Sox 404 at smaller companies approaches \$1 million each year. If one assumes a healthy company can achieve 10% net income, then SOX dictates that such a company would have to garner up to \$10 million in additional revenue just to support the cost of compliance. For technology companies, this additional burden has coincided with one of the most severe downturns in demand in recent history – making such a hurdle impossible to clear. By penalizing the bottom line, we are weakening our smaller companies, making them less

attractive to investors and more vulnerable to consolidation acquisitions on unfavorable terms– neither of which serves our economy well.

For those who suggest that the cost of 404 compliance will eventually fall, and even cite studies that demonstrate this, I would argue that without exempting the companies from these provisions, the numbers will not fall *enough* to be remotely meaningful. Case in point, the recent CRA International study, which found that companies with market capitalizations between \$75 – 700 million experienced a significant 31% drop in SOX compliance costs last year, still has the average compliance cost at **\$860,000**. It is highly unlikely that SOX costs will continue to drop as precipitously in future years – and the cost will remain excessive.

Of perhaps even greater concern is the drain on human resources to achieve SOX 404 compliance. At larger corporations, there is a segregation of duties and entire departments to handle the compliance process. This is not the case at smaller companies where the financial staff usually takes on multiple roles – all critical to the operation of the business. As a result of the added burden of SOX 404, small companies today are being placed in the undesirable position of having to forgo increases in sales and technology headcount to hire additional financial staff. These hires do not foster company growth in any way. Rather they just keep the company's head above water against a tidal wave of ill considered regulation. Even more insidious is the distraction that SOX 404 places on company management which is pulled away from strategic business functions to monitor additive processes and procedures that do not help the bottom line.

To exacerbate the situation, at a time when small companies need their accounting firms more than ever, Section 404 has created an unhealthy motivational shift in the accounting profession as it relates to supply and demand. In response to Sarbanes-Oxley, the Big 4 auditor, I am familiar with have shifted their focus from auditing companies of all sizes to leveraging lucrative 404 practices at large corporations. Thus they are abandoning the smaller companies whose needs are equally as critical. As a case in point, I have served as a board member of a small cap public company that was informed by their Big 4 auditor last year that they were “too busy” with larger clients to complete the smaller company’s audit on time. The Big 4 auditor also informed the company that their audit would cost 16% more than the previous year. Effectively, they decided to put their talent to work against the big clients who would pay the most fees. The Big 4 provider suggested that the smaller company release its numbers late, which we all -- including the auditor – know equates to public market suicide. This situation was presented by the auditor to the company just a few months before the audit was scheduled to commence and sent company management scrambling to find a new auditor – which they did, but certainly paid for. Unfortunately, this scenario is playing itself out all around the country.

Although many have suggested that small companies turn to second or third tier accounting firms, this isn’t a realistic choice for many venture-backed companies. Already, fewer investment banks are willing to take our companies public. Those that are working with us generally request that the company use a Big 4 firm. It is a credibility issue and the end result is that venture backed firms are held hostage. SOX 404 has

reduced the choice of accountants, and consequently raised fees, as these businesses cannot compete with larger corporations for attention.

From a macroeconomic perspective, SOX 404 has contributed significantly to a clog in the IPO pipeline in the United States. For companies we are familiar with, the cost of the legal and accounting work for the initial public offering process stands at close to \$2 million up from \$500,000 a few years ago. The costs and regulatory hurdles to go public in the US today are driving venture-backed companies away from our capital markets system to other exits and other markets. In 2005, only 56 VC-backed companies went public on US exchanges. This is a significant shortfall – a healthy IPO market should be at least double this level. With only 10 IPOs in the first quarter of 2006, we are on track for another dismal year.

We are seeing pre-IPO companies now embrace two viable alternatives to going public in the US. First is the preference for the acquisitions route which has grown in the last year. For many venture backed companies the cost and risk of going public is too high and when faced with a cheaper, less risky alternative, the acquisitions wins. From an economic standpoint, an acquisition is much less conducive to growth as jobs and technologies are almost always absorbed rather than developed. Imagine a world in which Google was acquired by Excite.... or Starbucks was acquired by Krispy Kreme... or eBay was acquired by Amazon. Imagine the jobs, revenues and innovation that would have been lost. The US economy is better served with active, innovative companies that stand alone and create value – not by those that get gobbled up.

The second strategy that is beginning to take hold is companies choosing to go public on foreign markets so as not to be burdened by heavy regulation. In 2005, there

were 195 new listings on US exchanges; there were 519 on the London AIM. In the first quarter of 2006, we saw two of the twelve US venture backed companies that went public choose the London AIM market over the NASDAQ. Eighteen months ago, if you queried a room of venture capitalists about the London AIM, few would have the market on their radar screen. Today, it is a viable and well understood option for every VC-backed company. We are also seeing US investment banks actively marketing these exchanges to US companies. The consequence is a declining use of the U.S. marketplace. This game is still ours to lose – but the threat is very, very real.

While specific provisions of the original Sarbanes Oxley laws have improved certain practices at US companies, including making Boards of Directors more active, accessible and accountable, Section 404 has done little in the way of advancing fraud detection. We have witnessed the information compiled from a 404 audit to be of little or no use to investors. It is unwieldy and out of date and does not reflect the current state of any company operations. In many cases, the information required defies logical comprehension. For example, as part of Section 404 diligence, small companies are required to certify that their vendors are SOX compliant. To have a \$20 million dollar annual revenue enterprise spend time and money to certify a multi billion dollar outsource payroll provider such as ADP serves no one's interests.

Further, there has been no evidence that Section 404 has been more effective at uncovering fraud. Such malfeasance is almost always discovered by people rather than from compiling documents. As has been the case historically, new employees or auditors entering a company are more likely to make these detections. Making the audit

committee accessible to employees through an 800 number costs a few thousand dollars a year to implement and advances the detection of fraud.

At private companies, contrary to what some may believe, GAAP accounting is not a matter of choice but a de facto requirement. Venture-backed start-ups generally report their financials under GAAP because they do expect to one day move through an initial public offering or become acquired by a public company. They also need this credibility with their vendors and commercial banks. They wisely choose to be GAAP – and SOX – compliant early on.

As a venture capitalist and committed investor in small emerging growth companies, I strongly support the recommendations of the SEC Advisory Committee on Smaller Public Companies. The Committee's work was thoughtful and accurately addressed the challenges that our country's small companies are facing under the Sarbanes-Oxley shadow each day. It strikes the right balance between investor protection, shareholder value and economic growth.

Specifically, I support the recommendation that the SEC tier its regulations to differentiate among microcap, small cap and large cap companies and that compliance with the most costly components of SOX 404 be staged based on company size. For those who suggest that a detrimental tiered system would create a second class of company, I disagree. Scaled or size appropriate structure already exists in other regulations such as the difference in listing requirements between the NASDAQ and NYSE. Investors will continue to look for value in small cap companies as they always have. In fact, I would argue that intelligent investors, if they could choose, would easily forgo a certification of compliance of little practical use in exchange for the extra million

in net income that would come with regulatory relief. Lastly, it is important to note that the committee's recommendations include several new governance provisions with which microcap companies would have to comply in exchange for a reduced SOX burden. As the companies moved up to the small level, there would be additional requirements. We are not recommending total exemptions – just reasonable tiers.

Further, I am very supportive of any provisions that will help stimulate more competition in the accounting profession, including allowing accredited firms to perform attestation work. Our supply of strong and qualified accountants to do work for smaller companies is not meeting the increased SOX demands and we would welcome additional resources and new entrants whole heartedly.

Right-sizing the SOX 404 burden for smaller companies will not undermine the law and its intentions. Sarbanes-Oxley has many provisions outside of 404 that will continue to address the issues that gave rise to the legislation. Companies that seek to thrive and create value will always comply with the highest standard. It is critical for market credibility. But the time has come to set the bar accordingly and reduce the unnecessary frictional cost – financial and human-- of SOX 404 in the best interest of our growing companies and growing economy.

Thank you for the opportunity to weigh in on this vital matter.