

Hearing of the Senate Banking Subcommittee on Securities and Investment
on
FASB and Small Business Growth
Wednesday, November 12, 2003

Oral Testimony of Mark Heesen
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Good afternoon. I am Mark Heesen, president of the National Venture Capital Association (NVCA), which represents more than 460 venture capital firms in the United States. It is estimated that U.S. companies that were originally funded with venture capital now represent 11% of annual GDP and employ over 12 million people.

The NVCA has a vital interest in this hearing because the viability of our country's young start-up companies is being compromised by recent actions taken by the Financial Accounting Standards Board (FASB). While we recognize the pressure placed on the FASB to issue standards more quickly, we have a grave concern that their "rush to regulate" has needlessly burdened young companies in several ways.

My first example involves the FASB's January 2003 issuance of Interpretation No. 46 or "FIN 46" which has created havoc for the entrepreneurial and private equity communities. This highly complex interpretation sought to define what types of entities must be consolidated into a company's financial statements. The interpretation was extremely complicated, covered new ground, lacked adequate guidance, and allowed for no transition time. To remain GAAP compliant, private equity firms and the companies in which they invested would be forced to

consolidate the assets, liabilities and operating results of certain...but not all... investments, thereby significantly altering their financial statements. Given the frequency of transactions occurring in the start-up and private equity sectors, the resulting hodgepodge of consolidated information would be so convoluted that organizations would need to maintain two sets of books – one to meet the FASB requirement and one that investors could comprehend. This result is counterintuitive to FASB’s stated goal of producing relevant, reliable, and comparable financial statements for all investors.

Over the last several months, the CFOs of private equity firms and start-ups have spent thousands of hours attempting to decipher FIN 46 and how it would apply to them with virtually no guidance provided by the FASB. FASB’s aggressive timeline exacerbated the situation with rapid implementation, no new comment period, no new exposure draft, and no attempt to solicit input. We all reacted to this interpretation only to have FASB recently decide that private equity funds should not implement FIN 46, at least for the time being. While we are relieved at this reversal of opinion, we believe that a process that solicited input upfront would have averted this mess. At this date, FASB is still determining to whom and how FIN 46 should apply, leaving small businesses, investors, and the private equity firms in a state of uncertainty and confusion.

The second example is FASB’s quest to mandate the expensing of employee stock options. NVCA has consistently asserted that the forced expensing of these options will create a financial albatross for U.S. start-up companies, leaving them no choice but to negatively alter their critical option programs. The FASB agreed that these companies are fundamentally different when it passed the current rule, FAS 123, in which specific provisions were

promulgated for private companies. Yet, today FASB has inexplicably decided to change the rule and subject private companies to the same rules as public companies.

Since the early 1990's, we have implored the FASB to identify an acceptable option valuation standard for all companies. Otherwise, the option expense number will be meaningless to investors and too costly for young companies to derive. Their response has been to fall back upon two old models: the Black Scholes option pricing model which was tentatively rejected by FASB and other experts earlier this year **and** the binomial model which suffers from the same fatal flaws as Black Scholes and is even more subjective and complex. Further, while FASB has acknowledged that it is impossible to measure the volatility of a company whose stock does not trade, its recent reversal of course will not require that a volatility number be determined by private companies. We cannot comprehend FASB's sudden reversal on this issue, as there have been no material changes in option pricing theory since 1994 and determining the volatility of a company whose stock does not trade has not become any easier.

Both FIN 46 and stock option expensing will not only render a small company's financials meaningless but also both will require small companies who do not have large accounting staffs to hire costly outside experts. Further, implementing ill-conceived regulations 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 accounting burdens on young companies, FASB is needlessly raising costs, lowering profits and lengthening the reliance on expensive, high risk capital to the start-up sector. In other contexts, FASB has readily acknowledged the need for cost-benefit analyses prior to the imposition of new rules. Yet, to date, here the FASB is unequivocally pushing forward.

Today we urge Congress to engage in this discourse so that we might avoid serious consequences. Specifically, we believe that Congress has a role in reviewing FASB's due process system, how FASB determines which businesses will be impacted by its rules, how FASB fields test their proposals, and what the economic and practical impact of FASB pronouncements are on small and emerging businesses, as well as the U.S. economy as a whole.

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