

Hearing of the House of Representatives Capital Markets Subcommittee
on
HR 3574
Wednesday, March 3, 2004

Oral Testimony of Mark Heesen
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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. Venture capital backed companies are very important to the U.S. economy in terms of creating jobs, generating revenue and fostering innovation. 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. 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. Since the last Senate hearing in November on this issue and the last meeting of this sub-committee in June, the FASB has made no meaningful progress towards making any distinction between the effects of its proposal on large publicly traded entities vs. small private businesses, despite countless calls to do so and promises from Chairman Herz to members of this Committee that it would be done. 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. 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 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 this issue was addressed by Congress, 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. 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. But FASB's mandate will force them to address these accounting issues, distracting management, raising expenses 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.