AUTHENTICATED
U.S. GOVERNMENT
INFORMATION
GPO

S. HRG. 108–862

THE FINANCIAL ACCOUNTING STANDARDS BOARD AND SMALL BUSINESS GROWTH

HEARING

BEFORE THE

SUBCOMMITTEE ON SECURITIES AND INVESTMENT

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

ON

THE IMPORTANCE OF SMALL BUSINESS INPUT INTO THE DRAFTING OF ACCOUNTING STANDARDS AND INTERPRETATIONS

NOVEMBER 12, 2003

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

Available at: http://www.access.gpo.gov/senate/senate05sh.html

U.S. GOVERNMENT PRINTING OFFICE

23–827 PDF WASHINGTON : 2005

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

RICHARD C. SHELBY, Alabama, *Chairman*

ROBERT F. BENNETT, Utah
WAYNE ALLARD, Colorado
MICHAEL B. ENZI, Wyoming
CHUCK HAGEL, Nebraska
RICK SANTORUM, Pennsylvania
JIM BUNNING, Kentucky
MIKE CRAPO, Idaho
JOHN E. SUNUNU, New Hampshire
ELIZABETH DOLE, North Carolina
LINCOLN D. CHAFEE, Rhode Island

PAUL S. SARBANES, Maryland
CHRISTOPHER J. DODD, Connecticut
TIM JOHNSON, South Dakota
JACK REED, Rhode Island
CHARLES E. SCHUMER, New York
EVAN BAYH, Indiana
ZELL MILLER, Georgia
THOMAS R. CARPER, Delaware
DEBBIE STABENOW, Michigan
JON S. CORZINE, New Jersey

KATHLEEN L. CASEY, *Staff Director and Counsel*
STEVEN B. HARRIS, *Democratic Staff Director and Chief Counsel*
STEPHEN R. KROLL, *Democratic Special Counsel*
DEAN V. SHAHINIAN, *Democratic Counsel*
JOSEPH R. KOLINSKI, *Chief Clerk and Computer Systems Administrator*
GEORGE E. WHITTLE, *Editor*

SUBCOMMITTEE ON SECURITIES AND INVESTMENT

MICHAEL B. ENZI, Wyoming, *Chairman*
CHRISTOPHER J. DODD, Connecticut, *Ranking Member*

MIKE CRAPO, Idaho
JOHN E. SUNUNU, New Hampshire
CHUCK HAGEL, Nebraska
JIM BUNNING, Kentucky
ROBERT F. BENNETT, Utah
WAYNE ALLARD, Colorado
RICK SANTORUM, Pennsylvania

TIM JOHNSON, South Dakota
JACK REED, Rhode Island
CHARLES E. SCHUMER, New York
EVAN BAYH, Indiana
DEBBIE STABENOW, Michigan
JON S. CORZINE, New Jersey

GREG DEAN, *Staff Director*
ALEXANDER M. STERNHELL, *Democratic Staff Director*

C O N T E N T S

WEDNESDAY, NOVEMBER 12, 2003

	Page
Opening statement of Senator Enzi	1
Opening statements, comments, or prepared statements of:	
Senator Ensign	1
Senator Allard	19
Senator Bunning	37

WITNESSES

Robert H. Herz, Chairman, Financial Accounting Standards Board	6
Prepared statement	38
Response to written questions of Chairman Enzi	86
Peter A. Salg, President, QSC Restaurants, Fort Collins, Colorado on Behalf of the International Franchise Association	17
Prepared statement	62
James K. Glassman, Resident Fellow, American Enterprise Institute	19
Prepared statement	64
Richard Forrestel, Jr., Treasurer, Cold Spring Construction Company, Akron, New York on Behalf of the Associated General Contractors of America	22
Prepared statement	70
Walter K. Moore, Vice President, Government Affairs, Genentech, Inc.	23
Prepared statement	72
Jeannine Kenney, Vice President, Public Affairs and Member Services, National Cooperative Business Association	25
Prepared statement	76
Mark Heesen, President, National Venture Capital Association	28
Prepared statement	81

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

Statement of David A. Raymond, President, American Council of Engineering Companies	94
News Release from the Biotechnology Industry Organization	96

THE FINANCIAL ACCOUNTING STANDARDS BOARD AND SMALL BUSINESS GROWTH

WEDNESDAY, NOVEMBER 12, 2003

U.S. SENATE,
SUBCOMMITTEE ON SECURITIES AND INVESTMENT,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Subcommittee met at 2:03 p.m., in room SD–538, Dirksen Senate Office Building, Senator Michael B. Enzi (Chairman of the Subcommittee) presiding.

OPENING STATEMENT OF SENATOR MICHAEL B. ENZI

Senator ENZI. Since the hour of 2:00 o'clock has arrived, and since we are going to have two votes probably beginning at 2:45, we will have some interruptions today and we will have to work around that. When Senator Ensign arrives, we will have him give his statement. He and I were just in some meetings where there were some very important discussions going on, and I appreciate him arriving timely.

Senator Ensign, of course, is the Chair of the High Technology Task Force, and as such he has had a lot of insight into the effect on small entities. We will now welcome you and look forward to hearing your testimony.

STATEMENT OF JOHN ENSIGN
A U.S. SENATOR FROM THE STATE OF NEVADA

Senator ENSIGN. Thank you, Mr. Chairman, and thank you for this opportunity to testify.

Mr. Chairman, as Chairman of the High Tech Task Force for Republicans in the Senate, I get a lot of opportunities to go out and visit businesses and listen to them and find out how did they—some of these are big companies—how did they become big, how did they start up? Others of them are just starting up, and as a profession I am a veterinarian and started two different animal hospitals, so I have a lot of small business experience. There are unique things that happen to small businesses that they cannot afford that big businesses can afford. There is everything from regulation and complying with certain laws, and there are a lot of unique things. There is also a lot of lack of experience in small business people. They are learning as they go along.

Most small business people are entrepreneurs, and it is that entrepreneurial spirit that I want to talk about this morning. That is the thing that has made America so great and has driven that economic engine that has driven us to the top of the world.

Being an entrepreneur means you take risks. Small businesses, especially in the high-tech industry that want to go out there and compete—remember Big Blue, IBM, and way before Microsoft, you could never compete with IBM. It is the small companies like Microsoft at that time that saw an opportunity with the development of technology to get into a marketplace where there were needs that were not being met. One of the tools that they used was the idea of stock options. They could not afford to pay their employees what the big companies, like Big Blue could pay their employees. So they decided to attract people to their company who wanted to take risks with them. So not only the person with the idea to start the company, but also attracting highly talented people to come to them and share in those risks.

The idea of risk taking is so critical to innovation, and because small business is truly the engine that is driving our economy, we want to encourage more and more of those risk takers to associate with small businesses, not just big business.

Mr. Chairman, you and I have worked on this issue quite a bit, on the issue of stock options and expensing and what FASB is doing, I believe that they are completely misguided in what they are doing. We have been working with industry types to try to make it much more reasonable. I appreciate the legislation that you have proposed as a compromise piece of legislation, and I think that we can develop some momentum with that and try to do the right thing so that entrepreneurial spirit in business can be maintained so the start-up company that cannot afford the big salaries can attract the highly talented people that they need to be able to compete now with today's Microsofts, with today's Sun Microsystems, with today's Oracles, with today's whatever big business is today that did not start out as a big business.

Really, the summary of my testimony is that people who care about small business need to care about this issue. We need to continue to raise it up because as the Chinese are now talking about going to stock options because they have recognized how well it has worked in America, and now in America we are thinking about basically doing it in such a way that we cannot offer stock options. It would be a critical mistake for this country to do that.

Mr. Chairman, I appreciate working with you on this issue and your leadership, and for you calling the hearing to focus on items, especially with your background as an accountant, items that can so severely affect small business in this country. We have to continue to allow the incentives there for small business to flourish.

One last comment. If people say they care about minorities and women having opportunities, 80 percent of those opportunities come in small business. If we want America to be that opportunity society, we need to make sure that there are not regulatory entities out there that destroy that entrepreneurial spirit in America.

I appreciate your time and your indulgence, Mr. Chairman.

Senator ENZI. Thank you, Senator. I appreciate your comments, and I appreciate all of the work that you have done, not just in the high-tech task force area, but as one small businessman to another, all that you have done in the area of small business.

Senator ENSIGN. Thank you, Mr. Chairman.

Senator ENZI. The Subcommittee at today's hearing will explore the important role of small business in our Nation's economy and the important role played by the Financial Accounting Standards Board in establishing accounting standards.

The purpose of this hearing or any other hearing is actually to build a record on the issue, and full statements made by any of the parties will be a part of the record. We will ask all of you to summarize your comments so that we will have an opportunity to ask some questions to clarify what you had in your testimony. As I mentioned, we will be interrupted by votes today. That is fairly normal. As a result, there will be some necessity to submit questions in writing, and so I will ask you to help in getting answers to those.

Our country's small business and entrepreneurial spirit have become woven into the fabric of our Nation. Countries all over the world should emulate and replicate our high technology centers. Recent press articles cite efforts by a city in China to replicate the operations of Silicon Valley, as Senator Ensign pointed out.

Figures cited by the Small Business Administration demonstrate the importance of small business to our Nation's economy. I have some charts here that show that nearly 23 million strong, small businesses represent more than 99.7 percent of all employers in the United States. They employ half of all of the private sector employees. They generate 60 percent of the net new jobs annually. They create more than 50 percent of nonfarm private gross domestic product, and they produce 13 to 14 times more patents per employee than large patenting firms.

The Financial Accounting Standards Board also is very important to the health of our Nation's economy. This private sector, independent board is responsible for establishing and interpreting the accounting standards for our Nation's companies. I have been an ardent supporter of FASB and its independence. The importance of FASB was seen last year with the passage of the Sarbanes-Oxley Act. The accounting scandals of Enron, WorldCom, and others highlighted to us that an independent accounting body is essential to maintain the high standards and integrity of our Nation's public markets. With this high level of responsibility, it is vital that FASB retain an objective and open process so that accounting standards can be thoroughly discussed with all sectors of our economy. Sarbanes-Oxley worried about a "cascading effect" to small business. We concentrated a lot on that, and want to continue to concentrate on that. It was, and is, a justified concern, and it needs to be recognized by all boards and commissions.

Generally it is very difficult for a small business to participate in the Federal rulemaking process. Small businesses do not have the time or the resources, as compared to their large-business counterparts, to sift through the thousands of pages of Federal regulations, to analyze and comment on the effects on these small entities.

I remember my first year in office, holding a hearing for small business under the auspices of the Small Business Committee in Casper, Wyoming, and had about 100 businesses show up, very pleased. Afterwards the media said to me, "Aren't you a little disappointed in the number of businesses that showed up?" I said,

"No, this is small business. If they had an extra person that could attend an all-day hearing, they would fire him."

[Laughter.]

There just is not that kind of flexibility in small business. In 1980, Congress recognized this fact and passed the Regulatory Flexibility Act, Reg Flex. The Reg Flex Act requires Federal agencies to conduct an economic analysis on virtually all Federal rulemaking proposals to determine if there is a disproportionate burden on small entities. Congress also established a "small business watchdog," the Office of Advocacy, within the Small Business Administration, to monitor Federal agencies' compliance with the Act. In addition, Congress amended the Act in 1996 to allow small entities to sue in court, to have the implementation of an agency's rule set aside until an adequate small business economic analysis had been conducted.

Since the rise of accounting scandals, FASB has become more active in updating and establishing accounting standards. The Board, in its attempt to quell the accounting problems of companies in the Fortune 500 may have overlooked or have not paid enough attention to how the draft statements and interpretations may affect small entities. In addition, FASB may not have sought enough input from small firms.

I have another chart here.* For example, FASB relies upon the Financial Accounting Standard Advisory Council—I think that is called FASAC—for guidance and advice on draft accounting statements and interpretations. However, out of the 33 members of FASAC, there are only five small entities and three of those are financial entities. They are marked with stars there. That may not represent the operations of a typical small business.

In addition, FASB played a critical role in the early and mid-1990's on the Securities and Exchange Commission's Government-Business Forum on Small Business Capital Formation. FASB was represented on the Executive Committee and actively participated in the annual forum. Unfortunately, during the past 2 years FASB has withdrawn from the Executive Committee and did not participate in the forums. I understand that at this year's forum, held in September, the participants discussed the potential effects of FAS 123 and FAS 150 in detail, but FASB had already withdrawn.

Today, our second panel will highlight three separate accounting issues that if fully implemented would have substantial effects on small entities. The first issues concern FIN 46. In January 2003, FASB released FIN 46 and interpretation of the Financial Accounting Statement 46, requiring the consolidation of variable interest entities. Does that not sound exciting?

[Laughter.]

Two of our witnesses will discuss that the interpretation would have a serious effect on venture capitalists investing in small entities, as well as franchisees' ability to negotiate franchise agreements with franchisers.

The second issue concerns a soon-to-be-released proposal by FASB on Financial Accounting Statement 123 concerning the expensing of stock options. Two of our witnesses will discuss the det-

* Held in Committee files.

rimental effects if this proposal is not fully vetted, as it would place a tremendous strain for entrepreneurs trying to gain access to the equity markets. In addition, the adoption of this proposal may place U.S. small businesses at a competitive disadvantage with overseas companies, as Senator Ensign pointed out, that will not be bound by the standards.

With respect to this initiative I have had serious concerns about whether FASB has sufficient inclusion of small business entities in the drafting process. This is an extremely complex initiative. Even FASB recognized how complex and intricate a project this was when it established an ad hoc committee, the Option Valuation Group, to come up with a standard valuation model for stock option expensing. It is my understanding the group met for the final time in early October. However, the group was unable to achieve consensus on a valuation model. In addition, the FASB has stated that it will "road test the valuation model." I am very interested in how this will operate and how many small businesses will be involved in the road testing.

Finally, we have two witnesses who will discuss Financial Accounting Statement 150. Earlier this year, FASB issued a proposal that would require closely held companies to count its mandatory redeemable shares as liabilities. If implemented, it would have had a devastating effect on thousands of closely held businesses across the country.

With respect to FAS 150, the comment period ended on October 30. In lightning-fast speed, FASB reviewed the small business comments and immediately issued a statement that the implementation of this initiative was put on hold indefinitely. I applaud FASB for the quick action in this process and the result. In addition, I applaud the work of Mr. Forrestel. I believe that it was his hard work and dogged perseverance that made FASB see the potential effects of the proposal on small entities, and he will be testifying later today. However, the question that should be asked is whether the problems with the proposal could have been foreseen earlier.

In light of this, I am proposing that FASB immediately establish a Small Firm Advisory Committee to work with FASB and FASAC to address small business concerns early in the process. Currently, the National Association of Security Dealers effectively use its Small Firm Advisory Board to review all of the National Association of Securities Dealers' rulemaking prior to the rulemaking being issued for comment by NASD and by the SEC. I strongly believe that such a small business committee is essential for FASB.

With respect to FASB, there is no Regulatory Flexibility Act for small businesses. There is no small business watchdog, and there is no recourse when an accounting standard has been adopted. Once FASB adopts an accounting standard it is final until the FASB board members change their mind. Unlike the Regulatory Flexibility Act, small entities cannot seek a higher authority for appeal if the small entities believe an accounting standard was adopted with insufficient small business information.

This Small Firm Advisory Committee should review all pending and future FASB draft proposals and interpretations to ensure there are no unintended consequences on small business.

I would like to welcome our witnesses today and thank them in advance for their testimony. I do greatly appreciate, Chairman Herz, you for changing your schedule to be with us today. I guess I will give him a chance to get to the table before I have him testify. If you would move up there, I would appreciate it.

We welcome Robert Herz, who is the Chairman of the Financial Accounting Standards Board. FASB is a private sector independent body recognized by the SEC as the entity responsible for establishing accounting standards. As the sole accountant in the Senate I fought very hard for the independence of FASB during the debates on Sarbanes-Oxley, and I look forward to your testimony on this extremely important topic of small business and the accounting standards.

STATEMENT OF ROBERT H. HERZ
CHAIRMAN, FINANCIAL ACCOUNTING STANDARDS BOARD

Mr. HERZ. Thank you, Chairman Enzi.

I am very pleased to appear before you today on behalf of the FASB, and I want to personally thank you, Mr. Chairman, for inviting me to testify on this very important topic, because the active participation of users, auditors, and preparers of small businesses in our process is absolutely essential to the development of high-quality financial accounting and reporting standards.

I have some brief prepared remarks, and I would respectfully request that the full text of my testimony and all supporting materials be entered into the public record.*

Senator ENZI. We appreciate all 100 or so pages.

[Laughter.]

They will be.

Mr. HERZ. It is a principles-based document.

[Laughter.]

Mr. HERZ. Our independence from enterprises, auditors, and other constituents is fundamental to achieving our mission to establish and improve general purpose standards of financial accounting and reporting for both public and private enterprises. Those standards are essential to the growth and stability of the U.S. economy because investors, creditors, and other users of financial reports rely heavily on credible, transparent, comparable, and unbiased financial information to make rational resource allocation decisions.

The FASB's independence, which through your leadership and hard work, Mr. Chairman, was recently reaffirmed and enhanced, as you noted, through the Sarbanes-Oxley Act. That independence, as you also noted, is fundamental to our mission because our work is technical in nature, designed to provide preparers the guidance necessary to report their economic activities. That guidance creates the yardstick to measure and report on the underlying economic transactions of business enterprises. Like investors and creditors, I think Congress and other policymakers also need an independent FASB to maintain the integrity of a properly designed yardstick in order to obtain the financial information necessary to appropriately assess and implement public policy. While bending the yardstick to

*Held in Committee files.

favor a particular outcome or type of transaction or industry may seem attractive to some in the short-run, in the long-run an inaccurate yardstick, that is, a biased accounting standard, is, I believe, harmful to investors, creditors, and the U.S. economy in general.

The FASB's open and thorough due process is also fundamental to our mission. Because the actions of the FASB affect so many organizations, its decisionmaking process must be fair, and as far as possible, objective. The FASB solicits and carefully considers the views of all interested parties—users, auditors, and preparers of financial information. Our rules of procedure require an extensive due process. It involves public meetings, public hearings or roundtables, field visits or field tests, liaison meetings and other meetings with interested parties, and exposure of our proposals to external scrutiny and public comment.

As part of our due process, the FASB, and our Emerging Issues Task Force, regularly provide additional guidance to assist preparers in implementing the requirements of new and existing standards. For example, as described in more detail in the full text of my testimony, we have recently issued implementation guidance and a proposed modification pertaining to our Interpretation No. 46, or as you said, the exciting topic of Consolidation of Variable Interest Entities. That includes additional guidance addressing the application of certain provisions of the interpretation to franchises and other industries.

We have also recently issued implementation guidance for our Statement No. 150 on Accounting for Certain Financial Instruments with Characteristics of Liabilities and Equity. That guidance includes an indefinite deferral of the effective date of certain provisions of that statement relating to the accounting for certain mandatorily redeemable instruments. That particular deferral is applicable to all nonpublic enterprises, including cooperatives.

More generally, with respect to the FASB and small businesses, which is the subject of this important hearing, I would like to make four brief points. Each of these points is discussed in more detail in the full text of my testimony.

First, small businesses are difficult to define. From our perspective different constituents have very different notions of what is a small business. To the extent that a small business is a registrant, under the Federal securities laws the enterprise is required by the SEC to prepare financial reports in accordance with generally accepted accounting principles, which include the FASB standards. For most other small businesses the use of GAAP is primarily a private choice. For many small businesses, their current and potential lenders, suppliers, and other contracting parties may influence or control that choice. To the extent, however, that one of those parties requires that financial reports of a small business comply with GAAP, that party has also made a private choice. That choice presumably reflects that party's opinion that GAAP results in better, more complete, and more transparent information than the use of other existing comprehensive bases of accounting, such as tax basis, cash basis, or regulatory reporting. And we are very pleased that they do make the choice for GAAP.

Second, it has been our experience that the views of representatives of small businesses about financial accounting and reporting

are not monolithic. Historically, the users, auditors, and preparers of small business financial reports have provided the FASB with distinct and sometimes conflicting input on FASB proposals and other activities. As I indicated earlier, our mission and due process procedures require that we carefully consider all views and make an independent, objective judgment on what will provide the most decision-useful information, subject always to the constraints of the costs and benefits of implementing changes to GAAP.

Third, the Board has long recognized that the cost of complying with financial accounting and reporting standards fall disproportionately on smaller businesses. In recognition of that fact, the FASB carefully considers requests received from small businesses to defer effective dates and provide for differential disclosures to alleviate the costs of implementing changes to GAAP. The Board has also explored on many occasions requests by representatives of small businesses to provide for differential recognition and measurement provisions in GAAP for small business. After public deliberations, the Board has generally rejected those requests. Why? Many of our constituents, particularly the users of financial reports, have expressed concerns that a big GAAP/little GAAP system could undermine the comparability and credibility of financial reports. They also say that such a two-tiered system would add costs to the users, auditors, and preparers of those reports that would likely more than offset any perceived benefits achieved by a differential reporting system.

Finally, the Board actively solicits the views of users, auditors, and preparers of the financial reports of small businesses in several ways, including through seeking their participation in our Emerging Issues Task Force, as you mentioned, our Financial Accounting Standards Advisory Council, the recently established User Advisory Council, and also on other less formal project task forces and working groups. By scheduling regular public liaison meetings and less formal private meetings with representatives of small businesses. Two examples include our public liaison meetings and regular contacts with the Technical Issues Committee of the AICPA Private Companies Practice Section, and with the Accounting Practices Committee of the Risk Management Association. And finally, through participating in many conferences and other speaking opportunities sponsored by or attended by representatives of small businesses around the country.

We are very aware of the significant focus over the past year on the financial accounting and reporting of public enterprises, in part because of the many activities relating to Sarbanes-Oxley, and also because of the increased attention on the movement toward international convergence of accounting standards. We, however, remain very committed to serving all of our constituents including private companies and small businesses, and not-for-profit entities.

Accordingly, Mr. Chairman, we very much appreciate the opportunity that this hearing presents to publicly encourage representatives of private companies, small businesses, and not-for-profits to more actively participate in our activities, and I very much like your idea of the advisory committee as well. Greater participation by those constituents will be very welcome. They will help ensure that consistent with the FASB's mission and rules of procedures,

the various perspectives of those constituents are effectively communicated to the Board and that they receive the careful consideration that they deserve.

Thank you again, Mr. Chairman, and if you do not break for a vote, I will take any questions.

Senator ENZI. I hope even when we break for a vote that you will stay for a few minutes, because I suspect that my colleagues who said they would be here are waiting until they vote because they just finished lunch. We started this little early, anticipating there would be afternoon votes, but not quite that early in the afternoon.

I do applaud your quick response to the indefinite implementation of the FAS 150 issue. I know that prior to the announcement many of the small businesses thought that FASB was not taking their concerns seriously. I do understand that the issue is not completely settled and that FASB needs to continue working with the small business owners and representatives on the issue as it is being studied further.

But in the process of reviewing comment letters, it appears that FASB quickly recognized the problems that small businesses would face with FAS 150. Why was the problem not found earlier though?

Mr. HERZ. I asked that myself, did a little bit of a postmortem, and I did that just for my own personal edification. I arrived at the Board in July 2002. The original exposure draft had gone out in late 2000, and a lot of the deliberations had been done, but I participated in many deliberations after that.

I think the particular issues, from what I can tell going back and talking to people and looking at letters, and field visits that had been done then, I think the issues related to the effect on loan covenants, bonding arrangements, all of those were identified or actually discussed fairly comprehensively with, for example, lenders, who actually preferred the proposal and said they could easily adjust to it.

This is only in my own mind, and as you know as a policymaker, you balance a lot of things. What swayed me from all of those letters—and then I came actually down here to Washington to meet with a group of contractors, and other groups went up to meet with us in Norwalk—was the biggest issue that I do not think had been identified, and I am not sure exactly why, was the ability to bid on contracts, that written into many State and local municipality requirements, to actually bid, are kind of hard-wired requirements relating to GAAP numbers. I, for one, when I heard that, got convinced that even a 2-year deferral, which is what we had been proposing, would not be enough, that we needed to step back and think about the issue more.

Senator ENZI. We do appreciate that, and depending upon what answers come out of that, I will shift gears a little bit on all of my questions. In the Federal regulatory process, small entities are able to petition a court to have a Federal agency's implementation of a final rule delayed until a correct economic analysis, and its effect on the small entities, is conducted. Since FASB is a private sector entity and not the Federal Government, a private right of action is not available to small entities. What is the recourse for small entities if they believe an accounting standard or interpretation

adopted by FASB was based on information that was faulty or incorrect?

Mr. HERZ. I think it is demonstrated by that episode. I think not only are our doors open, our letter boxes, our e-mail, our faxes, our everything, and I think our minds are open too. We get many, many letters every day through the transom and e-mails, and I think when you have gotten about three or four of them on the same topic you do start believing that there is an issue. So, I think that is part of it.

I also think that we do meet regularly, as I said, with a number of different groups, and on those groups, there are representatives of small business. They are usually industry-type groups. A lot of these issues tend to be industry by industry as well as being overall small business issues. But as I said, I really do like your suggestion of the advisory council.

When I first came to the FASB, one of the complaints was that users of financial information, investors, creditors, and bond rating agencies, did not have enough of an active voice, and so I formed a user advisory council, and I think the same model, if we can get the right people that can get engaged, would be a great thing.

Senator ENZI. I am pleased to hear you say that if four or five letters come in, and that over the transom thing rings particularly strong in Wyoming, but that it makes a difference to you, and I really appreciate that and hope that small business heard that as well. I know that the FASB staff has looked at alternative ways that small business can listen to FASB and the advisory committee meetings. Can you share with me some of those alternative ways? I think that currently small business has to either travel to Norwalk, Connecticut or pay 75 cents a minute to listen in. Do you have any other alternatives?

Mr. HERZ. Yes, that is correct. That is something that the foundation, the trustees, the commercial arrangements are kind of in their hands, but I will tell you, my own view is that this is a public service, and I would think it should be free. I know we are also exploring doing webcasts as well.

Senator ENZI. Good. I would encourage you to think of as many different ways as you can. For small business, 75 cents a minute on the phone sounds like a pornographic call.

[Laughter.]

Mr. HERZ. Not as exciting.

[Laughter.]

Senator ENZI. I had to notice in your testimony, and I read not only your summary but also all of the other pages that you submitted, that in your opening statement you did not mention your initiative on stock option expensing. Is that because you believe that it is simply not a small business issue? Small business representatives have told me that you and other FASB Board Members dismiss their concerns outright with respect to the issue. Does that mean that three or four letters have not come through?

Mr. HERZ. No. We have had more than three or four letters and many, many meetings. Would you like me to update you where we are in that project?

Senator ENZI. Yes, that would be great.

Mr. HERZ. As you know, we put that on our agenda last March, and as I noted in the roundtable that you organized in May on that topic, we had a plan and we were going to systematically, thoroughly go through all the issues with a view toward issuing a proposal by the end of this year. We have stuck to that plan. We have been going through many, many issues, not only on stock options, but also other equity-based awards. Over the summer, as you mentioned, we focused on valuation issues. I would say that the Option Valuation Group, all but one person, did agree on recommendations. So, I think there was a consensus as it applied, I will say, to large public businesses. The issue there is that it requires more data. Private companies, which obviously include small businesses, I think our valuation group thought that in many cases you could get a valuation. I think some of us are more skeptical as to whether you can in all cases get a robust valuation. Certainly it might be difficult, for example, determining the volatility for a very young company.

What we have tentatively—and this is very tentatively—decided, and it ain't over till it is over, is that companies that do not feel confident in their ability to get a grant date fair value would be able to, as a policy matter, adopt an alternative method which would basically measure the intrinsic value of options granted through exercise or expiration so that the total expense that they would accumulate in the income statement through the exercise date would be the same as the tax deduction that they take. That is tentative.

As you said, we are not meeting our original goal of getting an exposure draft out by the year end. One of the reasons is that we are going to do a number of field visits to large public companies, smaller public companies, and some private companies. We are trying to enlist private companies at the moment through accountants and anybody else that would like to do it. We have had some volunteers on that, but we are going out there to meet with them, go through how would they do this, could they gather the data, how do they overall feel about the proposal?

Right now our expectation would be that we would issue a proposal for public comment probably in February. It would be out for public comment for a lengthy period, and we would probably have some public roundtables, so there is still plenty of time for input.

Senator ENZI. I appreciate that, and you mentioned that this option value group did reach consensus except for one person?

Mr. HERZ. That is what I remember, yes. He was a supporter of minimum value, that individual.

Senator ENZI. Pardon?

Mr. HERZ. He was a minimum value supporter, what is called minimum value method.

Senator ENZI. Okay. But the valuation model potentially talked about by this group for the upcoming stock expensing proposal, currently it is my understanding that the option traders use physicists to calculate the pricing model for stock options, and most of the people that voluntarily started expensing stock options early on have gotten to me, saying that they had a lot of difficulty with Black-Scholes, so I am glad you are discounting the value of that,

and I do not know whether you are considering several pricing models or just this one pricing model that requires physicists.

Mr. HERZ. No. We are going to set out a framework, an objective, and explain how one would accomplish that objective. We would talk about the different models that would be available, but we would not mandate a particular model, and that is because it may be that for particular option grants, and given the number and materiality for a particular company, Black-Scholes may get you a result that is close enough. For use for a company that had more awards of lengthier periods, it probably would not be good enough.

Senator ENZI. But you will wind up with one formula or a multiple?

Mr. HERZ. No. We will describe objectives and how to get there.

Senator ENZI. You mentioned that you will be field testing the valuation models with business entities and accounting firms. Is a field test the same as a road test?

Mr. HERZ. It is a field visit.

Senator ENZI. Field visit.

Mr. HERZ. Visit, which means we go there, we have a detailed checklist, we send them information in advance, and then we hold meetings. We ask them to see how they would do it, whether they can do it, how they would do it, what data would be needed, as well as just general overall feelings about it.

Senator ENZI. I assume from some of your criteria that you would be talking about what the cost and the benefit is as well?

Mr. HERZ. Yes. That is a key aspect of those visits.

Senator ENZI. You will be including small businesses in those road tests?

Mr. HERZ. In fact, the more volunteers we can get, the better. We just do not show up on people's doorsteps.

Senator ENZI. I am hoping you will be prepared to help them with the calculations.

In your testimony you stated that FASB's open and thorough due process is also a fundamental to the mission. "Because the actions of FASB affect so many organizations, its decisionmaking process must be fair and as objective." That is a quote from you. It is my understanding that FASB has not issued FAS 123 for public comment, and will not do so until the spring of 2004. However, I did receive an unsolicited letter last week from the American Business Conference, stating that having met multiple times with the members of FASB on this issue, we recognize that the Board, as one of the members candidly told us last month, is set in concrete on the matter of expensing. If the matter is set in stone by FASB members, then where is this due process for small business, who have not even seen the proposal, let alone be able to comment on it yet?

Mr. HERZ. Well, I cannot comment on a secondhand comment.

Senator ENZI. I would hope that does not turn out to be a set-in-concrete situation for the Board. And I would hope that the Board members would not make those kind of comments, particularly to small businessmen who take all of that very seriously.

Mr. HERZ. Perhaps somebody made that, but I often get reports back from meetings I was at of what supposedly occurred, and I must have been at a different meeting.

Senator ENZI. I want to congratulate you on the number of speaking things that I did. I think that you probably do more speaking events than most of the Senators do.

Mr. HERZ. It seems to be a hot topic, and if you get the right group, an audience, I think it is important to do that, and also to hang around and talk with people.

Senator ENZI. Also in the paperwork that you submitted to me—I will find it here in a second. I apologize, I thought I had it. In your attachment on facts about FASB, 2003 and 2004, you mentioned the precepts in the conduct of your activities. I really appreciate those. I started with the fourth one and worked back in order of importance to me, but that was to bring needed changes in ways that minimize disruption to the continuity of the reporting practice, to promulgate standards only when the expected benefits exceed the perceived costs, to weigh carefully the views of its constituents, and to be objective in its decisionmaking, and of course, to review the effects of past decisions was the last one. I think that is an excellent statement of precepts. I am curious as to what point FASB reviews this compared to a FAS that they are putting out.

Mr. HERZ. I think the basic mission statement has stayed intact for a number of years, and it is something that is also discussed with our trustees of the Financial Accounting Foundation. I can tell you though that our detailed operating procedures to implement these, we regularly review them in kind of a continuous improvement mode. I know it is hard to believe, but we are not perfect, and you learn a lot.

Senator ENZI. We all do. I guess the reason that I listed that fourth one as the first one is under the explanation, the last sentence said, "The Board considers it desirable that change be evolutionary to the extent that it can be accommodated by the need for relevance, reliability, comparability, and consistency."

Mr. HERZ. I think that is right, and there are counter-tensions right now, as you know, as you expressed, in the wake of at least in the public company arena, given some of the revelations and the need to at least there to move fairly expeditiously to deal with some of the problems that were revealed.

Senator ENZI. Definitely, as part of the team that worked on Sarbanes-Oxley, we knew that something needed to be done and did provide some revolutionary, rather than evolutionary, legislation. The implementation of it will be very important because how revolutionary each of the steps of the implementation are will ensure the economy moving forward, but hopefully we will remember the engine of the small businesses that are 50 percent of the GDP and all of the jobs and things that we have up there.

Can you share any economic impact studies you have done on FAS 150, FIN 46, and FAS 123, or any of the other statements? Is there an economic impact statement that is done, referring back again to those four principles?

Mr. HERZ. We do an analysis of costs and benefits, and the benefits are in terms of better information, and sitting down with users and understanding how they would use it in their decisionmaking, and hopefully they are promoting better decisionmaking and resource allocation through the change in the information.

The costs we look at are the costs, the one-time cost to implement by preparers and auditors, the cost of retraining and ongoing systems changes and the like. I think it is well known, we do not have an office of economic analysis, per se, and the philosophy is that if you get better information into the system in a cost-effective way, that better information will enable better decisions and better resource allocation.

Senator ENZI. I do thank you for rearranging your time and being here, and the vote has started now, but I will not expect you to stay after, although I would hope that you would stay and hear the testimony from the next panel, and short of you being able to stay, would hope that some of your staff would stay and do it.

Mr. HERZ. Absolutely.

Senator ENZI. They have some excellent observations, which of course you can get through the testimony as well, but you will not be here for the questions, and I am told that four people will be joining me for the questions. They were hoping to be able to do that with you, but I will not hold you up for that.

When we sent out the notice for this hearing last Wednesday night, we did not have any idea how much attention it would receive. Since that time our phones have not stopped ringing, and it has been from small businesses and their representatives from across the country that have contacted the office to see if they could come and testify. Now, clearly, we could have had two or more additional panels. It should be noted that the small businesses did not want to come and talk about just these three accounting issues, FIN 46, FAS 123, and FAS 150, but other issues as well. So, obviously, there appears to be a lot of concern and interest on the part of small business.

Mr. HERZ. Can I make a comment on that?

Senator ENZI. Sure.

Mr. HERZ. And in my introductory remarks I talked about there is this big GAAP/little GAAP issue that every so often comes up, and it has been surveyed fairly regularly, and the surveys usually come back and say, well, the people who demand the financial statements want to keep it the way it is, maybe different disclosures, but if an asset is an asset or if you have a derivative transaction I want it accounted for the same way as a big company. If you got a special purpose entity, I want it accounted for the same way.

I think that is generally right, although you can probably tell from my New Jersey accent, I actually spent a number of years in my career in the UK. Over there they have developed a differential set of standards. Most of it is the same, but there are some shortcuts in some areas, and at least in their market it seems to work fairly well.

The real point I am making is that the issue is about satisfying the needs of the market, and that to me is where it is at. If the market were to want a credible, slightly different product, I think it will be somebody's responsibility to try and fill that need.

Senator ENZI. On the differential with the small businesses, they are just hoping of course that the cascading effect does not happen, and that is why we put some statements in Sarbanes-Oxley to indicate to States that they did not have to adopt Federal principles

to do it, and perhaps some wording in there that makes it clear that small businesses may not have the same capability to generate the information. As I mentioned, some small businesses think it takes a physicist to come up with valuations on stock options, and they do not have those.

Mr. HERZ. That is why we propose as an alternative a much simpler calculation. They may not like it because it potentially creates volatility.

Senator ENZI. Anything you can do to prevent that cascading effect from happening in instances where it is not necessary, where they are not affecting the outside individual investors who may not have the knowledge to interpret some things, but are rather working with professionals like their bankers, who do have the capability. They know the person. They know the business. In most cases with these small businesses, the audit and an exact inventory can be done particularly easily because they do not have anything.

Mr. HERZ. Yes. I have audited a lot of small businesses.

Senator ENZI. So, the requirements cannot be the same for them, one of the important things is for it to be clear that way, but I am also hoping that small businesses do not have to wage an 11th hour campaign in order to have FASB listen to their concerns.

Mr. HERZ. I would rather that not happen either.

Senator ENZI. I am very encouraged by your comments about the small business advisory committee or council or whatever, and I do applaud you on your recent decisions on FIN 46 and FAS 150 issues. I know there is still a lot of work to be done in that, and in addition these issues should be addressed much earlier in the process.

In your statement you readily acknowledge that you have a longstanding position recognizing that the cost of complying with financial accounting and reporting standards do fall disproportionately on small business.

With respect to the advisory committees that FASB has established, the FASAC, the Emerging Issues Task Force, and the Users Advisory Council, very good. However, small business representation is a very small proportion of the overall membership, and reading through the minutes of certain meetings, the concerns raised by small business sympathizers are given less weight as a result of having less weight on the committee, and in some instances are dismissed.

You have also submitted the list of speeches, which I already commented on, but I notice that you spend five times as much speaking as you do appearing to listen, and the listening is the part that comes through to me from the small business.

As FASB is an independent body there is an even higher standard for FASB to remain open and objective about the standard-setting process. In addition, the due process rights for small entities must be clearly delineated. I do have extreme concerns about that statement about "set in concrete" that I mentioned.

Again, I thank you for appearing here today.

Mr. HERZ. Thank you.

Senator ENZI. It has been most helpful, and we will be submitting some questions, and those who were not able to be here will be doing that, and I look forward to your answers on that.

Mr. HERZ. Thank you very much.

Senator ENZI. Thank you.

Senator ENZI. At this point, since we are past the halfway point on the vote, I will have a short recess while I go and vote, and there will be a second vote which should follow shortly after that, and then we will come back and reopen it with the second panel.

[Recess at 2:59 p.m.]

Senator ENZI. While I was over voting on the two measures, Senator Allard was here, left for the second one. He will be back. When he is back, we will allow him an opportunity to make some comments as well. And then, of course, following the panel we will have questions and an opportunity for comments again.

I appreciate everyone's patience during the vote. Two 15-minute votes around here can take an hour. But it is so that we make sure that everybody gets their opportunity to cast their vote and—so I was able to vote at the beginning of the next one and come back.

Today's second panel is a cross-section of the small business community with small business owners, financial experts, and a former small business that can describe what it is like to grow from small to large while trying to comply with the accounting standards.

In this second panel we have a very distinguished panel of witnesses. We have Peter Salg of Fort Collins, Colorado, who is the owner/president of a company that has five Wendy's restaurants. He is here representing tens of thousands of small franchisers and franchisees for the International Franchise Association, and has had some very personal effects on what has happened with FASB.

James Glassman, a Resident Fellow with the American Enterprise Institute and a syndicated columnist with *The Washington Post*. He has been closely following and writing about small business financing issues for quite some time.

We have Jeannine Kenney, who is with the National Cooperative Business Associations, here representing tens of thousands of small co-ops across the country.

Richard Forrestel is the CFO of a smaller-sized construction company in Akron, New York. I firmly believe that without his dogged perseverance on FAS 150 issue, FASB would not have arrived at its decision today to delay the implementation of FAS 150.

And finally, Walter Moore, who will be filling in for Lou Levine, as Mr. Levine is home with the flu. I remind everybody to get their flu shots. He will discuss how an entrepreneurial business started by two gentlemen grew into a multibillion-dollar corporation and how they managed to deal with the accounting standards while growing from a small business to a large business.

I thank all of the members of the panel for being here and for their comments.

Oh, yes, there is one more there than I introduced. I also thank Mark Heesen, the President of the National Venture Capital Association, for being here. And he deals with a lot of the start-ups of the small businesses that we have been talking about. I put him in as the clean-up batter there.

And I appreciate the testimony that all of you provided. I learned a lot from the testimony, and do know that we picked a significant panel here of solutions for FASB.

So with that, Mr. Salg, you may proceed.

STATEMENT OF PETER A. SALG
PRESIDENT, QSC RESTAURANTS, FORT COLLINS, COLORADO
ON BEHALF OF
THE INTERNATIONAL FRANCHISE ASSOCIATION

Mr. SALG. Thank you, Chairman Enzi, and thanks for the opportunity to testify at this important hearing.

I have worked in franchising since 1968, doing everything from running a restaurant to running a franchisor with 450 units. My company, QSC Restaurants, Inc., owns five Wendy's restaurants in Colorado. I will be testifying today on behalf of the International Franchise Association, which represents franchisees, franchisors, and others in the franchise community. I will be focusing my comments on the impact of FIN 46 as a small franchisee. But I also want to make sure that you know that the great majority of franchisors are small businesses, too.

The typical franchisor has less than 200 units and revenues of less than $5 million. If FIN 46 goes into effect as written, here is what it would mean to franchisees like me. We would have to have audited financial statements. This is not required currently, and would be very expensive. It is not required because it does not make sense, for two reasons. One, Wendy's has no contingent liability from my business; and two, I am not a public company.

We might be required to use the same outside auditor as our franchisor. This is not an explicit requirement of FIN 46, but if my franchisor's auditors say they will only be comfortable if my statements are prepared by their people, we are left with little choice. This requirement will hit single-unit franchisees the hardest. It is needless to say not every mom-and-pop business can afford PricewaterhouseCoopers.

We would also be required to adhere to the franchisor's internal accounting standards. Franchisees like me have made enormous investments in the way we have chosen to set up our financial statements. Wendy's P&L does not look like my P&L, and we both have good business reasons why they should not.

We would have to develop a system to provide internal control reports to franchisors and adhere to internal-control dictates of the franchisor's auditor. I can understand why the franchisor would want this, since the CEO and CFO are on the hook for criminal penalties in Sarbanes-Oxley. But why on earth should a privately held small operator have to institute an extensive internal control system? This unintended consequence of FIN 46 is, in my opinion, pure overkill.

Now let us look at the impact on small franchisors. If you have a successful small business and you are thinking of ways to expand it, franchising is a great method for a lot of people. But FIN 46 makes franchising much less appealing. First of all, it just got a lot more expensive to be a franchisee. As I described earlier, you have to have audited statements done by an expensive firm and acceptable internal control systems, et cetera. Second, your freedom to operate your franchise just got more limited. I have chosen to operate my restaurants the Wendy's way. The menu, the appearance of the store, the quality of the food—things like this must be standardized across the system so that you, the customer, know

what you are going to get when you walk into any Wendy's in the country.

But on the other hand, I am an independent businessman. I decide how to set up my business. I decide whether it is a partnership or an S corp. And I decide who my lawyer and accountant are. I decide on what capital expenditures I make, and I decide on product pricing. Furthermore, I decide who to hire and fire, what salaries and benefits to offer, and what pension plan to set up. I make decisions every day that directly affect my bottom line.

So in deciding whether franchising is the way to go, some prospective franchisees will find the level of intrusion called for in FIN 46 more than they can live with. This is, in my opinion, a very serious threat to franchising. If FIN 46 had been in effect when I made my decision to become a franchisee, I am not sure I would have made the leap.

There is another problem with FIN 46. When and if I want to sell my business one day, there will be fewer prospective buyers, and that will lower the value of my business.

I know the mission of the FASB is to improve financial reporting so that the public is protected. The entire franchise community supports that vital goal. But I cannot understand how FASB could come to the conclusion that hobbling franchising is an acceptable price to pay for preventing another Enron.

To make matters worse, I do not think FIN 46 accomplishes FASB's goal to improve financial reporting when it comes to franchising. If FIN 46 results in a franchisor consolidating the financial results of its franchisees, it may confuse investors who are not familiar with franchising. A franchisor's financial results just are not one and the same with its franchisees' results.

In other words, FIN 46 is going to make me and a lot of other people in the franchising world jump through a lot of hoops and pay a lot of money, with zero public benefit.

In conclusion, it is clear that FASB has not sufficiently understood the implication of their proposal. They apparently have not been listening to real business people like me. Frankly, I am surprised that FASB would consider doing something like this. FASB needs to better understand that the rules they set are not just academic exercises. These rules have real-life consequences, and FASB needs to understand what those consequences are and take them into account before they act.

In the case of FIN 46, FASB needs to listen carefully to the concerns of the franchising community before its implementation. Given what Chairman Herz said earlier, it appears FASB is moving in that direction. I like the idea of an advisory council, especially in light of the fact that I did not see franchisees on that big chart you had up here.

I would be happy to answer any questions that you might have.

Senator ENZI. Thank you. At this point, as I mentioned before, I will call on the Senator from Colorado for any opening comments that he might have.

COMMENTS OF SENATOR WAYNE ALLARD

Senator ALLARD. I would just like to take a moment to welcome and thank Mr. Salg for coming here and testifying before the committee. You know, when you are running your own business it is not easy to get away. And to come all the way to Washington from Fort Collins, Colorado, is not an easy task.

Mr. SALG. And on my wife's birthday.

Senator ALLARD. On your wife's birthday?

Mr. SALG. Yes, I have to go home and fix that tonight.

Senator ALLARD. Hey, I had better send her a birthday card.

Mr. SALG. I think that would be a good idea.

Senator ALLARD. Okay. Drop by the office here. We will take care of that. Do you want to sign it, too?

[Laughter.]

You know, Mr. Salg epitomizes entrepreneurship. He is a hard-working individual, puts in extra hours, and has an extensive record of involvement in the restaurant franchise business. Anybody that has been in the business of grocery stores and food, whether it is a restaurant or whatever, you put in long, hard hours, and you have rules and regulations you must adhere to. And one of the reasons I ran for the Senate is because as a small businessman, I was impacted by all these rules and regulations and high taxes, and it felt like I wanted to have some impact and certainly be a voice for small business. Mr. Salg being here, I think, is refreshing to hear what he has to say as a small businessman.

As he mentioned, he is testifying on behalf of the International Franchise Association, as an example of a successful franchisee and a business person, and it is a pleasure to have you hear before us. Thank you for your comments and your testimony before this Committee. They will become a part of the record and will have serious consideration by the Committee.

Thank you, Mr. Chairman.

Senator ENZI. Thank you, Senator.

Mr. Glassman.

STATEMENT OF JAMES K. GLASSMAN
RESIDENT FELLOW, AMERICAN ENTERPRISE INSTITUTE

Mr. GLASSMAN. Thank you, Mr. Chairman, Mr. Allard.

Mr. Chairman, you are to be congratulated for calling a hearing on this urgent subject. And it is an honor for me to be here on this panel with real-life practitioners rather than Washington policy wonks like me.

The determination of the Financial Accounting Standards Board to require mandatory expensing of stock options by U.S. firms, FAS 123, threatens small businesses and imperils the fragile economic recovery. The FASB states that its sole mission is,

> to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information.

In my view, the proposed expensing of options does not achieve this aim. But even if it did, you as policymakers, you Senators, have a more comprehensive mission than the FASB. Your concerns include improving the economy and increasing job opportunities in small businesses and elsewhere. The FASB's proposed action does

the opposite. Small business is the engine that drives the U.S. economy. Small businesses create 60 to 80 percent of net new jobs annually. And small businesses, moreover, grow into large businesses. For example, Microsoft started in Bill Gates's garage with two employees as a partnership in 1975. It now has 47,000 employees and $282 billion in stock market value.

Surveys show that three of the key ingredients in the success of small businesses are attracting a talented and motivated work force, limiting compensation outlays, and conserving cash during the early years of growth. I do not have to tell anyone on this panel about that. Lately, small businesses as well as large have increasingly turned to employee stock options to satisfy these needs and achieve success. And unfortunately, the FASB is moving quickly to change an accounting rule in order to require mandatory expensing of stock options on corporate income statements.

Such a change would cause a significant reduction in the issuance of stock options, especially to employees below the top five corporate officers. For example, America's best known venture capitalist, John Dorr, said in testimony that he thought, "broad-base employee stock ownership will disappear if expensing is mandated." And a review of the economic literature by Brian Hall and Kevin Murphy concluded that, "parties on both sides of the debate agree that such a change, expensing stock options, would result in granting fewer options, especially to rank-and-file workers."

Without the incentive tool of stock options, many of America's most innovative firms, small businesses and large, in technology and nontechnology, will suffer declining productivity with dangerous consequences for national competitiveness, growth, and employment. And one result is that talented workers in the United States will seek options elsewhere, mainly from our competitors in Asia. In an article in *Barron's* last summer, George Chamillard, the CEO of Teradyne, wrote that "while options are under attack in the United States, elsewhere the stock option as a recruiting tool is on the rise." Options are drawing scientists from the United States to Asia, to Taiwan in particular. As a result, he says, the United States is losing engineers educated at MIT, Stanford, and Caltech. Asian Nations understand the attraction of options, and they do not have the same taste for the fetish of expensing options as American regulators. In fact, the latest 5-year plan of the People's Republic of China specifically states that options should be used to motivate managers.

The FASB, however, has made it clear that it will shortly require U.S. companies to adopt fair-value accounting under FAS 123. The problem of valuing the options, however, remains. The FASB acknowledged that its proposed standard on stock options "should not prescribe a particular option pricing model." And what is the model that would be applied? Well, either a Black-Scholes or a binomial model, it appears, and both of them seriously lack reliability and accuracy. And my complete testimony gives examples of the lack of reliability and accuracy, and critical quotes from very distinguished people.

In other words, the same deterrent that prevented the FASB's predecessor from requiring the expenses of options in 1972 still exists today. No one can place an accurate value on them. But 30

years of economic history have confirmed that options help improve the operations of small and large businesses and improve the economy. And for that reason, President Bush supported the current accounting treatment of options in an interview a year and a half ago. And in addition, leading Democratic presidential candidates—Representative Richard Gephardt, Howard Dean, Senator Joseph Lieberman—also oppose expensing of options.

The FASB is trying to find a single number, but one that can be derived by different means, to describe a highly complex situation. Such a perversion reminds us of the purpose of accounting conventions in the first place, which is to convey information about the health and prospects of a company for investors and potential investors. But some information cannot be reduced to a single number, nor should it be. The expensing proposal, nonetheless, as *The Wall Street Journal* said, "serves to satisfy an unquenchable fetish to see a contingent liability converted, however clumsily and unconvincingly, into a dollar amount that can be charged against earnings without caring in the slightest whether it is helpful or meaningful to do so."

And in this case, it is not helpful or meaningful to reduce all that information about options to a single number. It is confusing, misleading, and utterly unnecessary. In fact, for typical companies, the information that is provided on stock options today far exceeds information that is provided for far more important aspects of businesses, including intellectual property assets, cash compensation expenses, leases, and investments.

Finally, the case for stock options is built on a faulty premise, that investors do not understand, from the current data with which they are presented, the true status of the firm. In their article, Hall and Murphy write, "Several studies have shown that the cost of options are indeed reflected in stock prices." I noted earlier that Mr. Herz listed as a benefit of expensing options "better resource allocation," as though the managers did not understand themselves the importance of stock options in their own businesses. Managers understand, investors understand.

And if investors have the proper information currently, then why, at this critical time in the economic cycle, should we tamper with a system that provides incentives and conserves capital? There is no reason at all. The number one rule in public policy should be that of the Hippocratic Oath in medicine: First do no harm. Discourage stock options and you discourage a management tool that works for vast numbers of the best American companies, including the small businesses that have made the U.S. economy the envy of the world.

Thank you.

Senator ENZI. Thank you very much.

Mr. Forrestel.

STATEMENT OF RICHARD FORRESTEL, JR., TREASURER, COLD SPRING CONSTRUCTION COMPANY AKRON, NEW YORK ON BEHALF OF THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA

Mr. FORRESTEL. Good afternoon, Chairman Enzi, Mr. Allard. I am Richard Forrestel, Jr., a CPA and Treasurer of Cold Spring Construction Company based in Akron, New York. I am testifying on behalf of the Associate General Contractors of America, AGC, a national trade association and the voice of the construction industry. While AGC's membership is diverse, the majority of AGC firms are closely held businesses just like ours.

I would like to thank Chairman Enzi and the other Members of this distinguished Committee for the opportunity to discuss both a potentially devastating impact of FAS 150 on family-owned businesses as well as the general process of communication between American small businesses and FASB. Cold Spring Construction Company was founded by my grandpa in 1911. We are a closely held family-owned construction firm that specializes in highway and bridge construction.

The risk of FAS 150 to privately held firms like ours and the majority of AGC members cannot be overstated. As written, FAS 150 would have dramatically affected all privately held companies with mandatory redemption clauses in their buy-sell agreements. The result will be to take our companies' more than $10 million in net worth and make it zero through the imposition of this standard. I will briefly touch upon the ramifications of such an accounting bombshell.

Cold Spring builds only public works projects, and all require surety bonds. First, wiping out our equity would make us unable to obtain bonds. Second, we would be in violation of loan covenants. Third, many States, like Pennsylvania, have prequalification requirements in order to bid on public works projects. FAS 150 would have rendered us unqualified to bid on many projects in Pennsylvania. Finally—and this is strictly a psychological reason—this change would have dramatically altered the way our balance sheet looked. Dad first worked for Cold Spring the summer after the Japanese bombed Pearl Harbor. No way, not on my watch, will he be told that the company that he has worked to build for more than six decades, the equity just went to zero. No chance.

FAS 150 first came to my attention at an AGC Tax and Fiscal Affairs Committee meeting in June of this year. AGC wrote a letter to FASB with our concerns and requested a private meeting in Norwalk, Connecticut. This was set for October 30. After much thoughtful preparation, two ABC representatives and I met for 3 hours with two board members and five staff members of FASB. These people are, in my opinion, the best and the brightest people in the country in the accounting profession. The seven FASB representatives asked direct and penetrating questions. Honestly, it made the CPA exam seem awfully easy in comparison. They gave us a chance to tell our stories and listened well. They did not promise an outcome, but did thank us for our input.

My mindset walking out of the meeting was completely unexpected. Rather than a brick wall, I found an intelligent, thoughtful

group interested in hearing about my nonpublic company and how FASB standards affected me and my industry. I believed FASB heard us. Last week, FASB issued a change and indefinitely suspended a portion of the standard. In summary, there is no change to my financial statement.

But the other shoe has yet to drop, because it is FASB's apparent intention to address this issue again in the future. The uncertainty of not knowing what will happen, if anything, will undoubtedly continue to cause heartburn for lots of people currently contemplating buy-sell agreements.

While the process ultimately worked, it is unfortunate that the standard caused such turmoil. Large public companies are accustomed to lobbying for or against changes with FASB. We small companies are not. We often get caught up in changes that probably should be intended for public companies. I think this is exactly the case with FAS 150.

One possible solution is to consider a semiannual or annual meeting with FASB staff and representatives of small business. FASB would benefit from having small business representatives provide their point of view and at the same time share drafts of upcoming new standards.

I know that AGC is moving forward with FASB on a new working relationship. The AGC Tax and Fiscal Affairs Committee will meet in January, and we are inviting a representative from FASB to join us. We are going to work proactively and ensure we are staying abreast of the new standards, and will continue to work with FASB until 150 is finalized.

In conclusion, I would like to thank you for the chance to testify today and your willingness to listen and, potentially, address our concerns. As a fellow CPA, I agree with what I believe is Chairman Enzi's viewpoint. Congress should not be legislating accounting standards. I appreciate and agree with the many reasons FASB is an independent organization; nevertheless, this Committee's oversight is critical to ensuring all standards-setting agencies are responsive to both large and small entities.

Thank you, and I will gladly answer any questions you might have.

Senator ENZI. Thank you very much.

Mr. Moore.

STATEMENT OF WALTER K. MOORE

VICE PRESIDENT, GOVERNMENT AFFAIRS, GENENTECH, INC.

Mr. MOORE. Mr. Chairman, Senator Allard, I am Walter Moore, Vice President of Government Affairs at Genentech.

Today, Genentech has a market cap of over $40 billion. Why the heck, you might ask, is a company the size of Genentech even interested in the topic of FASB and small business growth? It is because Genentech is the classic American small business story.

The biotech industry was born 25 years ago when a UCSF biochemist and a young venture capitalist each agreed to contribute $500 to start Genentech. They fought convention. Researchers could publish their studies. Employees could dress as they liked. And all employees were given stock options. Among the young sci-

entists who came to Genentech in 1980 was Art Levinson, our current Chairman and CEO.

A primary factor that allowed Genentech to move from a startup biotech to where it is today was our ability to use broad-base employee stock options. Options make employees think and act like owners, not just employees who do their job, collect a paycheck, and go home. Genentech issued stock options to all employees when it was founded and still does so today.

Genentech actively competes for talent with at least 60 other biotechs in our ZIP Code. Our ability to remain competitive is directly related to our ability to offer options to all our employees. However, this is being directly threatened by FASB.

FASB's proposed stock option rules will impact all companies that use broad-base stock options without providing investors better financial information. Although we fundamentally disagree that employee options represent a corporate-level expense, we do believe that credible, transparent, and comparable financial information is essential. We also believe that all companies, not just small businesses, face the same valuation issues. Existing valuation models were designed to value freely tradable options, not employee stock options with all of their restrictions. If expensing is required based on these models, the integrity and comparability of financial reporting will be compromised.

A better approach is to require more disclosure. As you can see from our 10–K, which is Appendix 1 of my testimony, the dilutive effect that an investor could have from our stock options is readily apparent at any price point. Because we cannot accurately value options, expensing will create investor confusion and make income statements less reliable.

There are many areas of concern about valuation, but I will focus on only one in my talk today—volatility. Volatility at Genentech ranged, from 2000 to 2003, from 43 to 75 percent. Appendix 2 is our stock price over the last 3 years. Curiously, it ranges year-by-year 43 to 75, but I have drawn a line through right here—the 3-year average is zero.

What is concerning about that is the fact that we do not know what period to use for volatility. Do we use month, quarter, or year? Three years? Who knows? In our case, a 20 percent change in volatility prediction results in a 100 percent change in the option expense itself.

This should be of concern to you and to the SEC because it is very easy for us to make a knowledgeable estimate and to have it be way off. You will not be able to discern the difference between a knowledgeable estimate and manipulation. And that should be of concern to everybody involved in public companies.

If FASB really believes stock options are an expense, they have an obligation to get valuation right. FASB used to believe Black-Scholes could accurately predict option expense. They recently changed course and considered even prohibiting Black-Scholes, the method virtually every company has used in their footnotes since 1994. Because all current option pricing models suffer from the same flaws as Black-Scholes, all current models will reach the same ultimate wrong number.

Some believe that expensing any number, however wrong, is better than expensing nothing. We disagree. Under existing accounting rules both here and abroad, an expense is to be recognized only if it can be reliably measured. Unlike cash compensation or any other expense that results in an outflow of cash, employee stock options cannot be reliably measured. Mandatory expensing of broad-base stock options flies in the face of the most fundamental accounting rules. FASB must address the significant shortcomings of stock option pricing models and develop new models before mandating the expensing of all options.

Genentech has met with FASB to communicate the problems with existing valuation models, and our detailed presentation, we fear, has fallen on deaf ears. One prudent way to proceed is to road-test models through footnote disclosure and study how they actually work, rather than mandating the wholesale changes. Indeed, Genentech would welcome that and would volunteer to work with the FASB to road-test these.

Thank you.

Senator ENZI. Thank you very much.

Ms. Kenney.

STATEMENT OF JEANNINE KENNEY
VICE PRESIDENT, PUBLIC AFFAIRS AND MEMBER SERVICES
NATIONAL COOPERATIVE BUSINESS ASSOCIATION

Ms. KENNEY. Thank you, Mr. Chairman. I am Jeannine Kenney, Vice President of Public Affairs with the National Cooperative Business Association. On behalf of my members and the thousands of other co-ops that we represent through our national association members, we appreciate this opportunity to testify specifically on the impact of FAS 150 on cooperatives.

NCBA is the only National organization representing all types of cooperatives across all sectors, and it is a very diverse group. Our members include farmer-owned agricultural marketing and supply cooperatives, small parent-owned child care cooperatives, consumer-owned electricity, food, health care, housing, and telecommunications cooperatives, consumer-owned credit unions, and small business purchasing and shared services cooperatives, among others.

Purchasing cooperatives should be of particular interest to this Subcommittee because they help small businesses band together to procure inputs and services that make thousands of independent businesses more successful.

There are more than 40,000 co-ops in the United States, and they serve 120 million members. That is more than half of all adults. To put the size of the co-op sector into perspective, we outnumber publicly traded investor-owned firms by more than 2 to 1. The vast majority of co-ops are themselves small local businesses or are purchasing cooperatives that represent thousands of small local independents. They provide jobs, wealth, and opportunity for millions of Americans.

Of the many financial challenges confronting co-ops in recent years, few have generated the level of concern and uncertainty as FAS 150 has regarding co-op balance sheets. In its last comment period, FASB received more than 70 comments from cooperatives

out of the one-hundred-and-some comments on the extension of the implementation period for FAS 150. That is 70 percent of comments from co-ops.

By issuing comments and conducting personal meetings with FASB staff, co-ops and their representatives have participated in the lengthy consideration and comment processes leading up to FAS 150. However, until last Friday, it seemed as though these comments had fallen on deaf ears.

Cooperatives were initially told that to address their concerns regarding FAS 150's impact, they merely needed to educate their lenders about their equity structure. Over time, we have received the clear impression that FASB does not consider cooperatives to represent a significant business constituency.

It is absolutely critical that co-ops have the opportunity to participate in and be regarded as true stakeholders in FASB's standards development processes, including having representatives serve on the Advisory Council.

Mr. Chairman, NCBA supports your notion of a Small Business Advisory Committee for FASB and would hope that co-ops would be included on that committee. Even the establishment of a Small Business Advisory Committee, however, should not preclude the presence of co-ops and credit unions on the primary Advisory Council. I would note that there is a credit union representative on FASAC, and it is noted as a small business representative. It actually happens to be one of the larger credit unions in the country, with more than $1 billion in assets.

Notwithstanding these concerns, we are grateful to FASB for its recent decision to indefinitely defer the most concerning provisions of FAS 150 relating to mandatorily redeemable financial instruments. To understand why this is such a concern for co-ops requires a basic understanding of the co-op structure.

Co-ops are owned and governed by their members. Those are the people or the businesses that buy the goods and services of the co-op—also known as the patrons. Members make an equity investment in a cooperative when they join. It is risk capital. In the case of bankruptcy, it may never be returned to members. Debt holders are paid first; equity holders last, if at all.

Co-ops return profits to their members in the form of end-of-year dividends based on the amount of business that member did with the co-op. They receive these either in the form of cash or as equity held by the co-op and allocated to individual members known as allocated patronage capital, or in both forms. A member's equity rises or falls with the profitability of the business.

Because co-ops typically do not issue public debt, allocated patronage capital is how they accumulate equity. It typically represents most and, in many cases, all of a co-op's equity.

Co-ops redeem patronage capital in a variety of ways. Some may never redeem it, others repurchase the shares of members upon their withdrawal from the co-op, upon death, or upon reaching retirement or other age. Other co-ops revolve equity over a period of time when specific equity levels are reached and the financial condition of the co-op allows. Some purchasing cooperatives for small businesses have agreements with their members to redeem shares

upon their withdrawal of the business, raising concerns similar to those raised by Mr. Forrestel.

Redemption decisions are generally based in board policy or practice and are occasionally stipulated in the bylaws. But, generally, redemption decisions are at the board's discretion. They have no such discretion for repayment of debt.

FAS 150 requires the classification of mandatorily redeemable financial instruments as liabilities. On its face, cooperatives did not think FAS 150 applied to them. However, of principal concern to us is that the standard appears to include, under some circumstances, patronage capital in FASB's definition of mandatorily redeemable instruments.

Such instruments are defined as those for which the issuer had an obligation to redeem. Because of the vagueness of FAS 150 regarding what is considered an obligation, past cooperative discretionary practices to redeem shares could be construed as a constructive obligation in the future, requiring reclassification of the entirety of the co-op's capital as a liability. This uncertainty has resulted in different interpretations of FAS 150 by co-op accountants in identical fact situations.

Equally concerning is the lack of recognition that, in a cooperative, patronage capital as its primary asset is never redeemed all at once, except in the case of sale or dissolution of the business. It is completely implausible that all of a co-op's members would die, withdraw, or retire in a single year. It is equally nonsensical, then, to represent that possibility on the balance sheet.

FAS 150, in the absence of the indefinite deferral, and by requiring reclassification of equity as debt, would have created the appearance of insolvency for financially thriving businesses and badly misstated the financial health of thousands of small businesses across America. This would have put cooperatives in technical default of their loan agreements. It would also have made it more difficult for them to access new debt financing which, for cooperatives, is already a challenge because few conventional lenders truly understand the co-op structure. Co-ops would have just one more thing to explain to lenders.

Moreover—and this a particularly a concern for purchasing cooperatives for small business—having zero equity on your balance sheet would have damaged your credit worthiness in the eyes of suppliers, which is critical for purchasing cooperatives seeking to leverage the best deal from suppliers for their members. And, ultimately, this would have harmed the millions of Americans who are members of cooperatives.

Throughout this process, FASB either did not understand the co-op structure and the implications of FAS 150 on cooperatives or they chose to disregard them. We understand that the cooperative structure is unique, but FASB has an obligation to understand it. In any case, NCBA looks forward to working with FASB as stakeholders to ensure that what would have been a disastrous outcome for cooperatives will not occur as the board reevaluates the implementation and other issues associated with FAS 150.

Thank you.

Senator ENZI. Thank you.

Mr. Heesen, again, I apologize. I had meant in the opening to mention my regret that we are not in hearings to do slide shows. I really appreciate the slides that you gave us, which make a nice clear statement, and I will make sure that everybody takes a look at that as well.

Mr. Heesen.

STATEMENT OF MARK HEESEN
PRESIDENT, NATIONAL VENTURE CAPITAL ASSOCIATION

Mr. HEESEN. Very good. Thank you.

Cisco, Intel, Genentech, Home Depot, Outback Steakhouse, eBay, Dell, today, household names; once, all small venture-backed companies, and hopefully there will be a lot more coming down the pike. In fact, in the United States today, 11 percent of annual U.S. GDP comes from small venture-backed companies, and we employ 12 million people. This is why NVCA has a vital interest in this hearing.

While we recognize the pressure that has been placed on FASB to issue standards more quickly, we have a grave concern that this rush to regulate has needlessly burdened young companies in several ways.

My first example involves FIN 46, which has frankly created havoc within 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. This interpretation was extremely complicated, covered new ground, lacked adequate guidance, and allowed for no transition time.

To remain GAAP-compliant, private equity firms, and 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 have so convoluted those entities' financials that they would have had to maintain two sets of books—one to meet FASB's requirements and one to meet the investors' requirements. 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, CFO's of private equity firms and start-ups have spent hours and hours attempting to decipher FIN 46 and how it would apply to them with virtually no guidance from the FASB. FASB's aggressive time line 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 by this reversal of opinion, we believe that a process that solicited input up front would have averted this mess. And your suggestion, Senator, of a FASB Small Business Committee may have accomplished that. At this point, FASB is still determining to whom and how FIN 46 should apply, leaving

small business investors and the private equity firms in a state of uncertainty and confusion.

The second example is FASB's quest to mandate the expense 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 its current rule, FAS 123, in which specific provisions are 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 on two old models already discussed—Black-Scholes and binomial methods. Both of them, the Black-Scholes being tentatively rejected by the FASB themselves and the binomial methods being extremely complex and even more subjective than Black-Scholes.

Further, while FASB has acknowledge that it is impossible to measure the volatility of a company whose stock does not trade, its recent reversal will now require that volatility be determined by private companies. We, frankly, cannot comprehend FASB's sudden reversal on this issue, as there has been no material change in option pricing theory since 1994, and determining the volatility of a company whose stock does not trade has not become any easier.

We made these exact points before the FASB board in August. A copy of that FASB presentation is part of the record. FASB listened and quickly did exactly the opposite of what we were saying.

Both FIN 46 and stock option expensing will not only render a small company's financials meaningless, but will also require small companies who do not have large accounting staffs to hire costly outside experts.

Further, implementing ill-conceived regulation 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 company's underlying financials. Yet over 50 percent of Nasdaq companies and virtually all private companies do not have analyst coverage. Who is going to look through their numbers?

Today, we urge Congress to engage in the 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 field tests their proposals, and what the economic and practical impact of FASB pronouncements are on small businesses and the emerging business community as well.

Thank you very much for this opportunity to speak to you.

Senator ENZI. Thank you, and thank all of you for your excellent testimony and for summarizing your remarks. As I mentioned before, the full text will be in the record. And I have dog-eared all of the testimony and taken some quotes that I will be using fre-

quently to make the case among my colleagues and on the floor, and they are well-worded and very helpful. I learned a lot from it. I still have a few questions, though.

Mr. Forrestel, Mr. Salg, and Ms. Kenney, how did you first find out about FASB's initiatives that were going to affect the businesses you work with? How far down the road was FASB on these efforts, and did FASB make any attempt to reach out to your business or association prior to publishing the proposal for comment?

Mr. Salg, you may proceed.

Mr. SALG. Mr. Chairman, I found out about FASB 46 about 10 days ago at the Wendy's convention in Las Vegas from Mary Shell, who is in Government Relations, and 2 days later got an e-mail from IFA, sent to all members. But certainly I had heard nothing about it prior to that. Now, you might consult with Wendy's, the franchise, to see when they first heard about it, but it certainly was not on my radar screen. I was certainly horrified to hear about it.

Senator ENZI. Thank you.

Mr. FORRESTEL. As a CPA, I had heard a bit about FAS 150, but we really focused on it at our AGC tax and fiscal meeting in June, and it was at that point that we started the process of communicating with FASB, and we found them very responsive once we specifically asked for a private meeting with them.

Senator ENZI. Thank you.

Ms. Kenney.

Ms. KENNEY. In the case of cooperatives, there is a technical group within our sector, the National Society of Accountants for Cooperatives, who had been following this from the beginning and has been commenting. As it became clear that FAS 150 was moving forward despite co-op input, other groups within the cooperative sector got involved. Notably, the National Rural Electric Cooperative Association was actively involved in this, and they are one of our members. Additionally, NCBA became involved when it became clear that FASB was going to move forward with the rule.

Senator ENZI. Thank you.

Mr. Forrestel, your dad, who is a businessman like mine, was probably very proud when you became an accountant.

Mr. FORRESTEL. Probably not. He wanted me to be an engineer. [Laughter.]

Senator ENZI. There are some interesting parts to being in a business that your dad has some knowledge of. I know that from experience.

Mr. Glassman, how do you feel about FASB being required to take into consideration the economic effects of accounting standards on small business?

Mr. GLASSMAN. That is a good question. My position is I think that Congress should take those issues into effect. I am not sure whether FASB is competent to take economic issues into effect, but clearly there is an economic impact to what it does—not everything it does, but absolutely in FAS 123, and I think it is incumbent on the Senate and the House to exert its will here and should not be shy about it. I know there is all of this talk about the independence of FASB. I really think it is your responsibility because you have a much broader purview to say this is going to have an economic effect and do what you can.

Senator ENZI. As I mentioned before, I was pleased that in their precepts they listed that economic effect as one of the precepts that they are supposed to take a look at. As accountants, we are concerned about their independence, but it has occurred to me that independence is a lot like freedom. It has to be earned, and that is one of the reasons we are looking at this issue, to see how earned the independence is, but I appreciate your answer.

Ms. Kenney, how difficult is it for the small cooperative businesses to participate in the FASB drafting process for the accounting standards? Should FASB be required to do outreach to the small businesses prior to the draft proposal or interpretation that is put out for public comment? What is your feeling about the process for involving the cooperatives?

Ms. KENNEY. I think it is really critical that, in particular, cooperatives, but of course all small businesses, be a community that FASB actively reaches out to. As small businesses, in most cases, even the trade associations representing them do not have the resources at their disposal that a Fortune 500 company might have, say, to retain accountants who track everything that FASB does.

So, I would like to see FASB reach out actively and include cooperatives, credit unions, and other small businesses in their process for both identifying emerging issues and addressing them.

Senator ENZI. Did you feel that their statement here today about having a Small Business Advisory Committee might solve some of these problems?

Ms. KENNEY. Yes. I think that would be an excellent idea, and I look forward to working with them to include co-ops in it.

Senator ENZI. Thank you.

Mr. Moore, I do appreciate your being with us today and for filling in for Mr. Levine. Please give him our regards and hopes that he recovers from the flu very soon. I am sure that he is more concerned about that even than we are.

The question is, if FASB stock option expensing proposal were in place today, what effect would it have on Genentech and others like that? Would they have gotten off the ground?

Mr. MOORE. It would have a profound effect at Genentech, since we obviously give broad-based stock options. I am more concerned about the 60 small biotechs that surround Genentech who have been recruiting Genentech employees and other scientists from Stanford, UCSF, and the other local universities.

As Mr. Glassman said, they do not have much money, and one of the success traits is to hoard their money and give a piece of their company.

While Genentech will survive whatever happens on FAS 123, I do worry about companies like Tularik, Theravance, names that you have never heard of that are in South San Francisco near us, small businesses that without stock options are not going to be able to recruit either Genentech employees, with the kind of expertise that they need, or academics from our surrounding community.

Senator ENZI. Thank you.

With that lead-in, Mr. Heesen, what effect do you think the stock option expensing is having on initial public offering market right now? What effect particularly is it having on small businesses who are considering using options?

Mr. HEESEN. Right now, because you are still able to expense, I do not think that has been a direct impact on companies presently because you can either expense or you can elect to simply disclose, and so venture-backed companies are disclosing. They are not like Coca-Cola who have decided to go out and expense.

Having said that, the real concern we have is that if companies are forced to expense, it is going to take a much longer time for those companies to be able to be attractive in the public market, which will mean that venture capitalists will have to spend a lot more time with those companies, which means that they will have less time to put money and talent into new companies so that there will be fewer new venture-backed companies being created in the long-term, and those companies that are on the cusp of going public will not be able to do so because their financials will suddenly look very different than they were looking 2 days before.

Senator ENZI. Thank you.

Mr. Glassman and Mr. Heesen, can you give me a little bit of a feel for what the ramifications for U.S. small businesses will be when they are bound by more stringent accounting standards than businesses located overseas, what kind of a comparative—that is supposed to be under the precepts looked at as well, but what would be the effect as you see it?

Mr. GLASSMAN. Well, I think it should have a serious effect, and we are already beginning to see it. As I said in my testimony, and as I said further in my written testimony, there is a difference in the way that many Asian countries treat stock options, and there is not the political pressure against stock options that there is in this country. And as a result, there is at least anecdotal evidence that many American-trained scientists are going to countries in Asia because they are being recruited by companies that are offering them very lucrative stock options, which makes sense.

That is how Silicon Valley recruited engineers from Route 128 in Boston. It took them a long time in Boston to catch on to what was going on, and now the same thing is happening in Asia. So it would certainly get a lot worse if we began to expense stock options with the result that fewer companies in this country would issue stock options. That seems to be what almost everyone agrees with. And with other countries still offering them, you are going to get the best, the brightest, and the most motivated. These are the people who are attracted by stock options.

Senator ENZI. Mr. Heesen.

Mr. HEESEN. I think that FASB talks a lot about international harmonization and that we should have the same accounting standards as, and normally it is European accounting bodies, be it England or France. They do not talk about China and India. China and India are not going to suddenly say we are going to change our accounting for stock options if they see a powerful incentive to get Americans to start moving to China and India. There is no question in my mind about that.

Entrepreneurs are not jumping to go to France and England, frankly, but they will go to India and China to get those options and make a new life, and they are doing it actually right now.

Senator ENZI. Thank you. My time has expired.

Senator Allard.

Senator ALLARD. Thank you, Mr. Chairman.

Ms. Kenney, there are a number of accounting alternatives I think available to co-ops, perhaps more than just the average small business that might be out here. If, for some reason or another, you find options something that you cannot offer, what other incentives might you use in co-ops to attract good employees?

Ms. KENNEY. That is a very good question. Because co-ops are not publicly traded companies, they do not issue stock options, and frankly that is one of the characteristics I think that has helped keep co-ops relatively free of the Enron-related scandals. There are a couple of types of incentives stock options can produce.

I believe that for retention of co-op employees, obviously competitive salary compensation is critical. Co-ops also offer tremendous benefits, both in terms of health and retirement benefits. But retaining and recruiting employees to the cooperative sector is not a simple issue, and I think it is certainly one that the cooperative sector is working to address because we do not have some of the financial wherewithal that other companies might have to attract certain candidates.

However, employees of cooperatives I think are attracted to the community-based nature, the community commitment that co-ops embrace as part of the principles under which they do business.

Senator ALLARD. Now, in a co-op, everybody owns an interest in the business.

Ms. KENNEY. Correct.

Senator ALLARD. The way you use, for lack of a better word—call them options or that type of instrument—is that available to everybody, in a way, or is it just offered to your better employees—how is that handled?

Ms. KENNEY. Some co-ops are jointly owned by their members, that is, the people who use the goods or services of the co-op, and by their employees. That is relatively rare. Most co-ops are not able to issue options to their employees because there is no stock in the company that is publicly traded or valued in that way.

So the only beneficiaries of a co-op's value are the equity holders, which are the members of the cooperative themselves. And in the case of your State, certainly that includes many electric co-ops serving rural consumers.

Senator ALLARD. Mr. Salg, you have several restaurants that are incorporated, and then my understanding is that then that corporation is a member of a larger franchise; is that the way that works?

Mr. SALG. That is correct.

Senator ALLARD. In your restaurants, do you try and establish a value for each one of those restaurants and then bring that value into the corporation or the five Wendy restaurants that you have, do you consider them as one entity when you are doing your accounting?

Mr. SALG. When we do our accounting, we consolidate into one entity.

Senator ALLARD. Into one entity.

Mr. SALG. Yes.

Senator ALLARD. Do you and other members of the franchise, you have options that are available to just the officers in your corpora-

tion or are they available to the managers of the restaurants and the employees, also?

Mr. SALG. Well, since we are not a publicly traded corporation, the way we handle that aspect of our business is to have a profit-sharing plan for all of our employees, regardless of the level, into which we put 10 percent of our pretax budget and anything that we are over budget.

So stock options really are not going to affect my business, but I can tell you that Wendy's International, who also operate 1,200 restaurants of their own, have a program called We Share, where every employee, whether he is flipping burgers or carrying out the trash or the manager has a shot at getting options in Wendy's stock. And I am only guessing, because I am not an accountant, that this ruling could have a—those are the people, my guess is, that would get dropped out of the program first.

Senator ALLARD. I see.

Mr. SALG. It wouldn't the senior VP's.

Senator ALLARD. Now, the corporation that you have itself does not own options.

Mr. SALG. No.

Senator ALLARD. But each individual employee—so it is not an accounting problem, as far as your corporation is concerned.

Mr. SALG. If you are speaking of Wendy's International, I think it could be a problem.

Senator ALLARD. No, I am talking about your——

Mr. SALG. QSC Restaurants, Inc.?

Senator ALLARD. Yes.

Mr. SALG. No, it is not a problem.

Senator ALLARD. It is all individual.

Mr. SALG. Yes.

Senator ALLARD. So as far as the corporation being part of this whole franchise, you are comfortable with the type of disclosure and public information, and I assume that all of the franchisees understand the impact of options? I am also assuming they own stock, and if somebody exercises an option, it comes out of the profits on the stockholders' side, and I am sure they understand all of that, and your franchisees understand that aspect of it?

Mr. SALG. I think that they do. I happen to own some Wendy's stock, and my accountant tells me I have enough invested in Wendy's, but——

Senator ALLARD. Diversify.

[Laughter.]

Mr. SALG. But of course I know them, personally, and I trust them. I think they are good people. But I think somebody has to watch, and these guys know a lot more about stock options than I do because that is not the way I make my living.

What you have heard here from a lot of these people that concerns me, as a guy from out in the sticks, is why don't they talk to people like us before they draft this stuff? I mean, if somebody had—not me, somebody like me—come in and said, what kind of problem would you have consolidating your financial statement under FAS 46, consolidating your statement with Wendy's International, they would have gotten an earful real quick.

I mean, number one, from a timing standpoint, heck, my partner's wife and I do the accounting. It takes us 10–15 days to get a statement out at the end of the period, but now you want us to send it down to an auditor. I mean, how fast can that get done by over 500 individual Wendy's franchisees across the country, and get into Columbus, Ohio, and get put into some kind of a meaningful order in any kind of a timely fashion? Forget the fact that my franchise agreement with Wendy's International, which I have had for 20 years, does not require me to send my financial information, other than some verification of my sales, to Wendy's.

Believe it or not, there are going to be some guys out there who say, "Stick it in your ear," when they are asked for their financial information. You cannot require me to send it to you.

So, I mean, why didn't somebody talk to people prior to this happening and find out what the practical applications of this are? Just speaking as a guy from outside, you know, out in the "toolies."

Senator ALLARD. Thank you for your comments.

Mr. Moore, in the growth of your company, do you think that there would have been other options available than other than going with your options, I mean, other solutions? Let me put the question this way. Are there other solutions that you could have used to attract employees, other than just options that you think could have been as effectively?

Mr. MOORE. Certainly, there are other options to giving employees stock options. The question is, as a start-up biotech, what kind of people can we afford on a straight-pay basis? We certainly could not afford the kind of science we got out of the scientists we hired. The innovation that Genentech came up with, and continues to come up, I would submit is the basis of top scientific minds that, quite frankly, we could have never afforded 25 years ago, barely afforded 10 years ago, and are just beginning to afford today.

So what you have is a lot less innovation out of our firm, and multiply that 60 times by the small companies that surround us, and that is a lot of noninnovation in life sciences that I think we are all counting on in terms of serious unmet medical need today. And I do not see another way to generate it because there is not enough money except with options moving out.

Senator ENZI. Thank you.

I see my time has expired, Mr. Chairman.

Senator ENZI. Thank you.

I want to thank all of our witnesses for appearing before us today. You did an outstanding job. There does appear to be some significant communications and process problems in FASB reaching out to and the consideration of small business concerns in the establishment of accounting standards.

I applaud FASB's commitment today to establish a Small Firm Advisory Committee to work with FASB and FASAC on small business concerns. I think that will take care of quite a few of the problems at least early enough that small business can be a bigger voice in making sure that what works for big business also works for small business.

Small businesses should not have to initiate eleventh-hour campaigns to get their concerns heard.

I mentioned earlier that I received many calls from associations who had businesses who wanted to testify at this hearing. It is probably just as important to mention that every single one of those that called that wanted to be here all had the same approach that this panel did. There was not anyone from the other side, if there is another side.

I think that is very significant, that all of them were concerns very similar to what you have given today. It is only my regret that we were not able to get the details from everyone because, in each of the presentations, there were some parts that will be very significant that hopefully FASB will listen to and that all of us will be able to use.

I thank you very much for your time. The hearing record will be open for 10 days in order to accommodate Members' statements and also the opportunity to give you some additional questions in writing, which I hope you will respond to. While you are doing that, if you have any other thoughts that we should have, if you would submit those as well, I would appreciate it.

Today, America's community bankers, engineering, contracting, financial executives all submitted testimony as well, and I appreciate and will try to attribute the quotes from each of you as I use them over the next few days, weeks, and months.

Thank you all very much. The hearing is adjourned.

[Whereupon, at 4:41 p.m., the hearing was adjourned.]

[Prepared statements, response to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF SENATOR JIM BUNNING

Mr. Chairman, I would like to thank you for holding this hearing today. I would like to thank all of our witnesses for testifying.

I have been very concerned with the reports that I am hearing regarding the Financial Accounting Standards Board or FASB. We have many small businesses here today that will tell us that FASB does not listen to them or take their opinion into account. We also have many large corporations telling us the same thing.

This is very disturbing to me. If FASB is not going to follow their own procedures that call for public input and make a decision before the comment period has even begun, why have a comment period? Why even invite input from the industries and businesses affected if FASB's decision is a foregone conclusion? It is a waste of time for everyone involved if FASB is simply going to go through the motions on a comment period.

I certainly respect the independence of FASB. I want them to continue to be independent. I think it is a very bad idea if Congress gets involved in telling private boards what to do. I think it is an even worse idea to have Congress legislating accounting standards. But FASB is proposing things that may harm our economy. If Members of Congress think FASB is going to harm our economy, they will be forced to act. This a bad idea, and it sets a terrible precedent, but many may feel they will have to for the good of our Nation's economy. I am pleading with FASB, do NOT force Congress to act. Listen to the people affected, do not just go through the motions, and make arbitrary decisions. We do not want to get involved. And believe me, you do not want us to be involved, so do not force us to get involved.

A few years ago, there was a large controversy about the pooling accounting method and whether or not it should be done away with. This Committee held a roundtable with FASB and those affected. Both sides realized there was some common ground. They got together and worked out a solution that everyone could live with. I would respectfully suggest that FASB could solve a lot of the controversies they face right now by following the pooling example. Please sit down with an open mind with those who are affected by your rules and see if you can come up with a solution that both FASB and the industry can live with.

I am very happy that FASB has always taken its job of being the police for accounting standards seriously and I am glad they have renewed that commitment after Sarbanes-Oxley. But any cop on the beat will tell you, you are a much more effective policeman if you can work things out amongst disputing parties. The most effective cops do not feel the need to arrest everyone.

Testimony of
Robert H. Herz
Chairman
Financial Accounting Standards Board
Before the
Subcommittee on Securities and Investment of the Committee on Banking, Housing, and Urban Affairs
November 12, 2003

Full Text of Testimony

Chairman Enzi, Ranking Member Dodd, and Members of the Subcommittee:

I am pleased to appear before you today on behalf of the Financial Accounting Standards Board ("FASB" or "Board"). My testimony this afternoon includes a brief overview of the FASB, including the importance of our independence and due process to our mission of developing high-quality financial accounting and reporting standards for both public and private enterprises. My testimony also includes the FASB's past and ongoing efforts, consistent with our mission and Rules of Procedure, to solicit input from, and carefully consider the views of, our constituents that are users, auditors, and preparers of the financial reports of our nation's small businesses.

The FASB

The FASB is an independent private-sector organization.[1] Our independence from enterprises, auditors, and other constituents is fundamental to achieving our mission to establish and improve general-purpose standards of financial accounting and reporting for both public and private enterprises.[2] Those standards are essential to the efficient functioning of the United States ("US") economy because investors, creditors, and other users of financial reports rely heavily on credible, transparent, comparable, and unbiased financial information to make rational resource allocation decisions.

The FASB's independence, the importance of which was recently reaffirmed by the Sarbanes-Oxley Act of 2002 ("Act"),[3] is fundamental to our mission because our work is

[1] See Attachment 1 for additional information about the Financial Accounting Standards Board.
[2] See Attachment 2 for recent materials commenting on the importance of the FASB's independence.
[3] Sarbanes-Oxley Act of 2002, Public Law Number 107-204, Sections 108-109 (July 30, 2002).

technical in nature, designed to provide preparers the guidance necessary to report information about their economic activities. The guidance creates the yardstick to measure and report on the underlying economic transactions of business enterprises. Like investors and creditors, Congress and other policy makers need an independent FASB to maintain the integrity of a properly designed yardstick in order to obtain the financial information necessary to appropriately assess and implement the public policies they favor. While bending the yardstick to favor a particular outcome may seem attractive to some in the short run, in the long run an inaccurate yardstick (or a biased accounting standard) is harmful to investors, creditors, and the US economy.

The FASB's authority with respect to public enterprises comes from the US Securities and Exchange Commission ("SEC"). The SEC has the statutory authority to establish financial accounting and reporting standards for publicly held enterprises. For 30 years, the SEC has looked to the FASB for leadership in establishing and improving those standards. The SEC recently issued a Policy Statement reaffirming this longstanding relationship.[4]

The Policy Statement, consistent with the language and intent of the Act,[5] also reemphasizes the importance of the FASB's independence described earlier. It states:

> By virtue of today's Commission determination, the FASB will continue its role as the preeminent accounting standard setter in the private sector. In performing this

[4] Policy Statement: Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter, Exchange Act Release Nos. 33-8221; 34-47743; IC-26028; FR-70 (April 28, 2003).
[5] Sections 108-109; the legislative history of the Sarbanes-Oxley Act of 2002 ("Act") is clear that the provisions of the Act relating to the FASB were intended to "strengthen the independence of the FASB . . . from . . . companies whose financial statements must conform to FASB's rules." Senate Report 107-205, 107th Congress, 2d Session (July 3, 2002), page 13.

> role, the FASB must use independent judgment in setting standards and should not be constrained in its exploration and discussion of issues. This is necessary to ensure that the standards developed are free from bias and have the maximum credibility in the business and investing communities.[6]

The SEC, together with the private-sector Financial Accounting Foundation ("FAF"), is responsible for maintaining active oversight of the FASB's activities.[7]

The FASB has no power to enforce its standards. Responsibility for ensuring that financial reports comply with accounting standards rests with the officers and directors of the reporting enterprise, with the auditors of the financial statements, and for public enterprises, the Public Company Accounting Oversight Board, and ultimately the SEC.

What Process Does the FASB Follow in Developing Accounting Standards?

Because the actions of the FASB affect so many organizations, its decision-making process must be fair and as objective as possible. The FASB carefully considers the views of all interested parties, including users, auditors, and preparers of financial information. Our Rules of Procedure require an extensive due process. That process involves public meetings, public hearings or roundtables, field visits or field tests, liaison meetings and presentations to interested parties, and exposure of our proposed standards to external scrutiny and public comment. The FASB members and staff also regularly meet informally with interested constituents to obtain their input and better our understanding of their views.

---

[6] Page 5 of 8.
[7] See Attachment 1 for additional information about the Financial Accounting Foundation.

The Board makes final decisions only after carefully considering and analyzing the input of all parties. While our process is similar to the Administrative Procedure Act process used for federal agency rule making, it provides far greater opportunities for interaction with the Board by all interested parties. It is also focused on making technical, rather than policy or legal, judgments. In making those judgments, the FASB's mission and Rules of Procedure require that the Board must balance the often conflicting perspectives of our various constituents and make independent, objective decisions guided by the fundamental concepts and key qualitative characteristics of financial reporting set forth in our conceptual framework.

The FASB and the FAF, in consultation with the Board's constituents, periodically review the FASB's due process procedures to ensure that the process is working efficiently and effectively for all constituents. In recent months, the FASB and the FAF have undertaken a significant number of actions to improve the Board's due process procedures.[8] Some of those actions were intended to increase the quality and breadth of constituent input to our process. Those particular actions include the following:

- Establishing a User Advisory Council ("UAC") in order to obtain more active user involvement in our process.[9] The UAC consists of representatives of individual and institutional investors, investment and commercial banks, rating agencies, and other groups that represent investors and other key users. Several of the members of the UAC are primarily users of financial reports of small businesses.

- Making our public Board meeting announcements available to constituents more broadly through an email subscription service.

- Making our public Board meetings available to constituents for monitoring via the telephone.[10]

- Making our proposals for public comment and the full text of all of our standards available on our website.

Are Small Businesses Required to Comply with FASB Standards?

The US federal securities laws generally require that any enterprise, including any small business, that lists its shares on a national securities exchange or has $10 million or more in assets and 500 or more owners of any class of equity securities be deemed a "registrant."[11] All registrants generally are required to file periodic reports with the SEC.[12] As indicated above, the SEC has required, since the FASB's inception in 1973, that the preparation of the financial statements contained in the periodic reports comply with generally accepted accounting principles ("GAAP"), including FASB standards.[13] Also as indicated above, the SEC recently reevaluated and reaffirmed that requirement as a result of the provisions of the Act.[14]

---

[8] Full text of testimony of Robert H. Herz, Chairman, FASB, before the Subcommittee on Commerce, Trade and Consumer Protection of the Committee on Energy and Commerce, March 4, 2003, pages 18-32.
[9] See Attachment 3 for a listing of the members of the User Advisory Council.
[10] Constituents may monitor open Board meetings by telephone live or up to 48 hours following the meeting. The FASB charges $.75 per minute to recover the costs of the service.
[11] 15 U.S.C. Section 781(g).
[12] 17 C.F.R. Section 249.310.
[13] Policy Statement, page 2 of 8.
[14] *Id.*

Excluding those small businesses that are SEC registrants, there is generally no federal law requiring that small businesses file financial reports or comply with GAAP. Thus, for most small businesses, the use of FASB standards is a private choice.

Some small businesses may choose to comply with GAAP at the request or demand of current or potential lenders, suppliers, customers, or other contracting parties. The decision by one or more of those parties to require that the financial reports of a small business comply with GAAP instead of another basis of accounting, is, again, a private choice presumably dictated by the quality of FASB standards versus the other available alternatives.

How Does the FASB Identify the Concerns of Small Businesses about FASB Activities?

As indicated above, the FASB actively solicits the views of all of its various constituencies, including the views of those users, auditors, and preparers of financial reports of small businesses. Some of the ways in which the FASB currently attempts to identify the concerns of small businesses include the following:

- Including representatives of small businesses on the UAC, the Financial Accounting Standards Advisory Council ("FASAC"),[15] the Emerging Issues Task Force ("EITF"),[16] and other project task forces and working groups. Both the UAC and FASAC are formal parts of our independent structure and have

[15] See Attachment 1 for information about the Financial Accounting Standards Advisory Council and Attachment 4 for a listing of the members of the FASAC.
[16] See Attachment 1 for information about the Emerging Issues Task Force ("EITF") and Attachment 5 for a listing of the members of the EITF.

responsibility for consulting with the FASB as to technical issues on the Board's agenda, project priorities, and other matters as may be requested by the FASB. The mission of the EITF is to assist the Board in improving financial reporting through the timely identification, discussion, and resolution of financial accounting issues within the framework of existing authoritative literature. Several current members of the UAC, FASAC, and EITF are primarily users, auditors, or preparers of the financial reports of small businesses.

- Participating in liaison meetings with representatives of small businesses. Since January of this year, the FASB has held liaison meetings with several such organizations, including the Technical Issues Committee of the American Institute of Certified Public Accountants ("AICPA") Private Companies Practice Section, and the Accounting Practices Committee of the Risk Management Association.[17] FASB members or staff also frequently meet less formally with other organizations and individual constituents, including representatives of small businesses, upon request or at the initiation of the FASB members or staff.

- Participating at conferences and other speaking engagements that are sponsored by or primarily attended by representatives of small businesses. Examples include the Technical Issues Committee of the AICPA Private Companies

[17] See Attachment 6 for a listing of FASB liaison meetings since January 2003.

Practice Section and the various State CPA societies. Since January of this year, FASB members or staff has participated in over 20 such events.[18]

How Does the FASB Evaluate the Input from Small Businesses as Part of Its Due Process Procedures?

The FASB's conceptual framework guides the Board in its development of financial accounting and reporting standards. That framework states that the objectives of financial reporting are to provide information (1) that is useful to present and potential users, i.e., investors and creditors, in making investment and credit decisions; (2) to help the users to assess amounts, timing, and uncertainties of prospective cash flows from their investments; and (3) about the economic resources of and claims against enterprises, and the effects of transactions changing such resources and claims.[19]

The Board has long recognized that those objectives are not static and that since the reporting by nonpublic or small businesses caters to a different set of users, the same objectives, defined identically, may mean different things. For many small businesses, the relevant financial statement users include both current and potential lenders, suppliers, and customers. Some of those users may focus more heavily on an enterprise's ability to meet its debt or performance obligations. Their needs may vary in some respects from the needs of other users of financial reports.

---

[18] See Attachment 7 for a listing of FASB speaking engagements since January 2003.
[19] Statement of Financial Accounting Concepts No. 1, *Objectives of Financial Reporting by Business Enterprises*, November 1978, paragraphs 32-54.

The Board's conceptual framework also describes the qualitative characteristics of accounting information.[20] In the hierarchy of accounting qualities, the FASB conceptual framework rates "decision usefulness" as the most important quality, and "relevance" and reliability" as the two primary qualities necessary to provide such usefulness, subject always to the constraints of a cost-benefit evaluation.[21]

In applying the above concepts to the financial accounting and reporting of nonpublic or small businesses, the Board has generally differentiated between financial information appearing on the face of the financial statements and the additional, analytical, and collateral information appearing in the footnotes to those statements.[22] With respect to the former, the Board has generally concluded that all enterprises, including nonpublic and small businesses, should be subject to the same recognition and measurement

---

[20] Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information,* May 1980.

[21] *Id.* paragraphs 32-110, 133-44. The Board has long acknowledged that the cost of any accounting requirement falls disproportionately on small entities because of their limited accounting resources and need to rely on outside professionals. "FASB Analyzes Small Business Concerns about Accounting Standards," FASB *Status Report,* No. 181, November 3, 1986.

[22] See Statement of Financial Accounting Standards No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities*, December 1996, paragraph 10 (stating that in considering the costs and benefits of a new standard the Board has a commitment to consider potential *disclosure* differences between small and large companies on a case-by-case basis).

requirements.[23] That conclusion has been generally supported by the stated needs of users of financial reports of nonpublic or small businesses. The Board, however, has on a number of occasions provided deferred effective dates for nonpublic enterprises to alleviate the costs and other burdens that may be associated with the more rapid implementation of new requirements.[24] Examples include the Board's two most recent pronouncements FASB Interpretation No. 46, *Consolidation of Variable Interest Entities* ("FIN 46"), and Statement of Financial Accounting Standards No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity* ("Statement 150"), discussed later in more detail.

With respect to the latter information disclosed in the financial statement footnotes, the FASB has on a case-by-case basis decided in some circumstances to reduce[25] or

---

[23] FASB *Status Report,* No. 181, page 4. There have been some limited exceptions. For example, in our November 2002 Interpretation to improve the accounting and disclosure for guarantees, the Board provided a scope exception for the initial recognition and measurement of guarantees issued between parents and subsidiaries and certain other related parties (FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others,* November 2002, paragraph 7). One of the reasons given for the scope exception was to alleviate nonpublic entities' concerns about the cost of complying with the new requirement. *Id.* paragraph A29.

[24] See Statement of Financial Accounting Standards No. 107, *Disclosures about Fair Value of Financial Instruments,* December 1991, paragraph 79 (concluding that allowing smaller entities additional time to comply with the provisions of the Statement will reduce their costs of compliance). Compare Emerging Issues Task Force Topic No. D-1, "Implications and Implementation of an EITF Consensus," May 15, 2003, page 4965A, footnote 2 (establishing operating procedures that provide nonpublic entities a later effective date than public entities).

[25] See, e.g., Statement of Financial Accounting Standards No. 132, *Employers' Disclosures about Pensions and Other Retirement Benefits,* February 1998, paragraphs 57-59 (concluding that a reduced disclosure set would be appropriate for nonpublic entities as a result of comments by users of financial statements of nonpublic entities about the usefulness of the disclosures).

eliminate[26] the disclosure requirements for nonpublic or small businesses. Those decisions have generally been the result of input from users, auditors, or preparers of financial reports of nonpublic or small businesses indicating that the users of those reports did not need some or all of the disclosures[27] or that the cost of preparing the disclosures outweighed the usefulness of the information to those users.[28]

The FASB and its constituents have over the years periodically examined the issue of whether financial accounting and reporting standards should be different for small businesses.[29] Some of the reasons frequently cited in opposition to a so-called Big

---

[26] See Statement of Financial Accounting Standards No. 141, *Business Combinations*, June 2001, paragraph B201 (concluding that nonpublic entities should continue to be exempt from pro forma disclosure requirements because of arguments by preparers and auditors that costs of information exceed the benefits); Statement of Financial Accounting Standards No. 131, *Disclosures about Segments of an Enterprise and Related Information*, June 1997, paragraph 115 (concluding to continue to exempt nonpublic enterprises from the requirement to report segment information because few users of nonpublic enterprises' financial statements have requested that those enterprises provide segment information); Statement 126, paragraph 14 (concluding that certain nonpublic entities should be exempt from fair value disclosure requirements because of the likely limited utility of the disclosures to certain users).

[27] See, e.g., Statement 132, paragraphs 57-59.

[28] See Statement 141, paragraph B201; Statement 131, paragraph 115; and Statement 126, paragraph 14.

[29] See Status Report, No. 181, page 4 (concluding that the most constructive effort to alleviate the concerns of small business regarding GAAP is to ensure that the views of privately held companies and smaller CPA firms are adequately included in the Board's consideration of specific accounting issues); FASB Research Report, A. Rashad Abdel-khalik, *Financial Reporting by Private Companies: Analysis and Diagnosis*, August 1983, page 1 (stating that surveyed bankers that are users of the financial reports of private companies do not believe that a special set of GAAP would be beneficial for private companies considered to be small in size); FASB Invitation to Comment, *Financial Reporting by Private and Small Public Companies*, November 20, 1981 (soliciting input on several concerns about the existing financial reporting by private and small public companies); "Report of Task Force on GAAP Requirement of Concern to Small or Closely Held Businesses, to Small Business Advisory Committee, Financial Accounting Advisory Council," December 1978, page 3 (finding that most individuals surveyed reported that there were no areas of particular concern to them with respect to current reporting requirements of small or closely held businesses); See also Abraham M. Stanger & Samuel P. Gunther, Article, "'Big GAAP—Little GAAP'": Should There Be Different Financial Reporting For Small Business? N.Y.U. L. Rev. 1209 (Nov. – Dec. 1981) (concluding that different disclosure requirements, but not recognition and measurement standards, should apply to small businesses, but that there should remain a unitary system of GAAP); Compare Eric P. Wallace & Richard E. Wortmann (summarizing the arguments for and against an alternative to GAAP for nonregistrants).

GAAP/Little GAAP approach to financial accounting and reporting include:

- Similar economic transactions and events should be reported consistently regardless of the size of the reporting enterprise.
- Differential standards for enterprises of different sizes would reduce the benefits to users of financial reports by impairing comparability more than they would reduce the costs of financial statement preparation.
- It would be virtually impossible for an accounting standards-setting body to decide which economic transactions and events should be permitted to be recognized and measured differently by large versus small businesses.
- Dual standards would represent additional costs to preparers, accountants, advisors, and others in the areas of continuing education, authoritative resources, and quality control systems.[30]

Significantly, the users of small business financial reports have historically been generally supportive of uniform accounting standards for both nonpublic or small businesses and larger public enterprises.[31]

---

[30] See Eric P. Wallace & Richard E. Wortmann; J. E. McCahey & A. L. Ramsay, "Differential Reporting: Nature of the Accounting Standards Overload Problem and a Proposal for its Resolution," Australian Accounting Research Foundation, June 26, 1989, 10-11, 12-13.

[31] See, e.g., A. Rashad Abdel-khalik, page 1. Of note, the FASB's counterpart internationally, the International Accounting Standards Board ("IASB") recently added a project to its agenda to develop IASB accounting standards for small or medium-sized entities ("SME"). Under the IASB planned approach there would be a rebuttable presumption that no modifications would be made to the recognition and measurement principles of International Financial Reporting Standards for SME standards. Similar to the general approach taken by the FASB, the IASB approach would generally be limited to disclosure modifications. As part of its international convergence efforts, the FASB will be closely monitoring the IASB project.

The FASB's two most recent pronouncements, FIN 46 and Statement 150 illustrate the Board's solicitation and consideration of the input of users, auditors, and preparers of the financial reports of small businesses. The following is a brief description of our due process with respect to those two standards.

FIN 46

The project that resulted in FIN 46 began in early 2002 in response to concerns raised by a broad range of constituents about the need to improve the application of consolidation policies. Many of those constituents believed that the existing accounting requirements governing consolidations impeded the quality and comparability of financial reports of enterprises engaged in similar activities when some of those activities were conducted through certain off-balance-sheet or variable interest entities ("VIEs").

After several months of Board deliberations at public meetings, the Board issued a proposed Interpretation, *Consolidation of Certain Special-Purpose Entities*, in June 2002. The Board received over 140 letters of comment from a broad range of constituents.

On September 30, 2002, the Board held 2 public roundtable meetings at which approximately 40 respondents and other interested parties discussed the provisions of the proposed Interpretation with the Board. FIN 46, issued in January 2003, was the result of the Board's public redeliberations of all of the issues raised in light of the comments received on the proposal.

The objective of FIN 46 was not to restrict the use of VIEs but to improve financial reporting by all enterprises involved with those entities. Consistent with that objective,

FIN 46 establishes a general principle that if control over another enterprise cannot be determined through an analysis of who holds the majority voting interest of the enterprise, a further analysis is required. That further analysis provides that if an enterprise absorbs a majority of the expected losses, a majority of the expected returns, or both, as result of holding financial interests in VIEs, the assets, liabilities, and results of the activities of VIEs are required to be included in the financial statements of the controlling enterprise.

Given the broad concern with the financial accounting and reporting in this area, the Board concluded that the requirements of FIN 46 should be made effective as soon as reasonably possible. The Board, however, also recognized that some enterprises were involved with a large numbers of VIEs and that their analysis of those entities would require significant data gathering and qualitative and quantitative analysis. The Board, therefore, deferred the required application date of FIN 46 to existing VIEs to three months later than originally proposed.

The Board found no basis for providing different recognition, measurement, or disclosure requirements for nonpublic or small businesses. Users of the financial reports of those enterprises, including creditors who raised concerns about the off-balance-sheet activities of small business debtors, generally supported the Board's decision. In recognition, however, of the disproportionate cost incurred by some nonpublic or small businesses in implementing the new requirements as compared to some public enterprises, the Board provided that nonpublic enterprises would not be required to apply the requirements of

FIN 46 to existing VIEs until more than 12 months after the provisions would be applicable to public enterprises.

Since the issuance of FIN 46, the FASB has received input from many constituents, including users, auditors, and preparers of the financial reports of small businesses, about implementation issues relating to the application of the provisions of FIN 46. In response to that input the FASB has issued nine FASB Staff Positions[32] and a proposed modification to FIN 46 to address certain technical corrections and implementation

[32] FASB Staff Position No. FIN 46-1, "Applicability of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, to Entities Subject to the AICPA Audit and Accounting Guide, *Health Care Organizations*," July 24, 2003; FASB Staff Position No. FIN 46-2, "Reporting Variable Interests in Specified Assets of Variable Interest Entities as Separate Variable Interest Entities under Paragraph 13 of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*," July 24, 2003; FASB Staff Position No. FIN 46-3, "Application of Paragraph 5 of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, When Variable Interests in Specified Assets of a Variable Interest Entity Are Not Considered Interests in the Entity under Paragraph 12 of Interpretation 46," July 24, 2003; FASB Staff Position No. FIN 46-4, "Transition Requirements for Initial Application of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*," July 24, 2003; FASB Staff Position No. FIN 46-5, "Calculation of Expected Losses under FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*," July 24, 2003; Proposed FASB Staff Position No. FIN 46-b, "Effective Date of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, for Certain Decision Makers"; Proposed FASB Staff Position No. FIN 46-c, "Impact of Kick-Out Rights Associated with the Decision Maker on the Computation of Expected Residual Returns under Paragraph 8(c) of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*"; Proposed FASB Staff Position No. 46-d, "Treatment of Fees Paid to Decision Makers and Guarantors as Described in Paragraph 8 in Determining Expected Losses and Expected Residual Returns of a Variable Interest Entity under FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*."

issues that have been raised.[33] The FASB continues to monitor the application of FIN 46 and will consider the issuance of additional guidance to assist constituents, including small businesses, in implementing the requirements of the Interpretation.

Statement 150

Statement 150 was the result of the Board's broad project on financial instruments that was added to the Board's agenda in 1986. The purpose of the project was to address financial reporting issues that were arising, or were given a new sense of urgency, as a result of financial innovation. In 1990, the Board issued a Discussion Memorandum for public comment that elicited views on issues about the distinction between liabilities and equity. The Board received 104 comment letters in response to the Discussion Memorandum.

The Board held 2 days of public hearings on the 1990 Discussion Memorandum in March 1991, at which representatives from 13 organizations testified. In 1992, after two public meetings to discuss the issues raised, the Board decided to suspend work on the liabilities and equity project to devote its resources to financial instrument issues that were deemed more urgent. The project was inactive until 1996, at which time the Board's Financial Instruments Task Force discussed it. Based on the discussion at that task force meeting, work on the project began anew.

After discussing issues related to the project at 30 public Board meetings, as well as additional task force meetings, the Board issued on October 27, 2000, an Exposure Draft

[33] FASB Proposed Interpretation, *Consolidations of Variable Interest Entities*, October 21, 2003.

of a proposed Statement of Accounting Standards, *Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both.* On the same day, the Board issued another related Exposure Draft, *Proposed Amendment to FASB Concepts Statement No. 6 to Revise the Definition of Liabilities.* The Board received 71 letters commenting on those Exposure Drafts.

During May, June, and July 2001, Board members and staff met with 7 different companies that volunteered to participate in field visits pertaining to the Exposure Drafts. Board members and staff also met in field visits in November 2001 with various users of financial statements to discuss, from their perspective, the usefulness of the reporting that would result from the proposed change to the definition of liabilities.

On October 16, 2001, 18 constituents participated in a roundtable discussion focusing on several issues raised in comment letters on the Exposure Drafts. At 16 public meetings during 2001 and 2002, the Board redeliberated the issues raised in the Exposure Drafts, comment letters, field visits, and the roundtable discussion. During four further meetings during 2003, the Board decided that issuance of a limited-scope Statement, even though issues effecting certain instruments within the scope of the project had not yet been resolved, was needed to provide timely and necessary guidance for certain troublesome instruments for which the practice problems were both clear and resolvable without necessarily addressing more complex separation and conceptual issues. The Board is currently in the process of redeliberating those and other remaining issues raised and plans to issue another proposal for public comment at a future date.

The objective of Statement 150 is to improve the usefulness, relevance, and reliability of financial reports by providing a more complete depiction of an enterprise's liabilities and equity. Statement 150 establishes a general principle that an enterprise's obligations to transfer cash or other assets or issue shares to settle an obligation should generally be accounted for as liabilities. That principle is generally consistent with the FASB's conceptual framework and international accounting standards.

Statement 150 describes three types of instruments and concludes that, consistent with the general principle, those types of instruments should be classified, measured, and reported as liabilities. One of those three types is an instrument issued in the form of shares that is mandatorily redeemable—that embodies an unconditional obligation requiring the issuer to redeem it by transferring its assets at a specified or determinable date (or dates) or upon an event that is certain to occur. Under the general principle, those shares are liabilities. Constituents, including lenders to small businesses, supported that conclusion.

The proposal that resulted in Statement 150 indicated that shares issued by some privately held enterprises that must be sold back to the enterprise, for example, upon the holder's termination of his or her employment, are liabilities because they are mandatorily redeemable upon an event certain to occur. Accounting for those financial instruments in the legal form of shares as liabilities would reduce or eliminate the equity of those companies with mandatory buy-back arrangements. Some small business commentators to the proposal suggested that an exception be made to allow such arrangements to continue to be reported as equity. Others suggested that while those

instruments were appropriately classified as liabilities, some sort of special reporting was merited, that disclosure about those arrangements was necessary for other investors and creditors, and that affected companies needed more time to revise debt covenants or make other changes in response to the change in classification.

The Board initially concluded that those kinds of arrangements met the definition of mandatorily redeemable financial instruments, that the definition should not be changed to classify them differently from other mandatorily redeemable financial instruments, and that there was no adequate basis for any exception. However, the Board acknowledged the need for special reporting in the most often cited circumstance in which no equity would be reported. Therefore, the Board concluded in Statement 150 that entities that have no equity instruments outstanding but have financial instruments in the form of shares, all of which are mandatorily redeemable financial instruments required to be classified as liabilities, should describe those instruments as *shares subject to mandatory redemption* to distinguish them from other liabilities and should separately present payments to and interest due to creditors in statements of cash flows and income.

For entities that have financial instruments in the form of shares that are all mandatorily redeemable, the Board also decided that, in addition to separate presentation, a related disclosure was needed that displays the nature and composition of the mandatorily redeemable instruments. For example, such an entity would disclose the event triggering the redemption, the number of shares issued and outstanding, the value associated with those financial instruments, and any retained earnings or accumulated other comprehensive income that would be distributed on redemption (the items that those

entities have previously displayed in equity). The Board concluded that for those entities that have financial instruments in the form of shares that are all mandatorily redeemable, disclosure would assist financial statement users in assessing the amount and timing of redemptions.

In addition, the Board concluded that private companies needed more time to adapt to liability classification, in part because many of them are affected significantly by the requirements on mandatorily redeemable shares, and decided to delay the effective date for mandatorily redeemable instruments of a nonpublic enterprises until fiscal periods beginning after December 15, 2003.

Following the issuance of Statement 150, the Board received additional input from some nonpublic and small businesses expressing concerns about the implications of applying the mandatorily redeemable provisions of Statement 150 and requesting that the provisions be either changed or delayed to allow enterprises to adapt to those provisions and educate financial statement users.

At its August 27, 2003 public meeting, the Board directed the FASB staff to issue a proposed FASB Staff Position for public comment deferring the effective date of Statement 150 for mandatorily redeemable financial instruments of certain nonpublic entities until fiscal periods beginning after December 15, 2004. In comments in response to the proposal and in several meetings with representatives of small businesses, the

FASB obtained additional input about implementation issues related to the mandatorily redeemable provisions of Statement 150 that had not been previously raised.[34]

At its November 5, 2003 public meeting, the Board discussed the input received and decided to direct the FASB staff to issue a final FASB Staff Position that defers indefinitely the effective date for applying the provisions of Statement 150 for mandatorily redeemable instruments of nonpublic enterprises pending further Board action.[35] During that indefinite deferral, the Board plans to reconsider implementation issues and, perhaps, classification or measurement guidance for those instruments in conjunction with the Board's ongoing project on liabilities and equity.[36]

---

[34] The additional input included information from small businesses in the construction and engineering industry about certain issues relating to the mandatorily redeemable provisions of Statement 150 that will require additional time and efforts to communicate with and educate the relevant parties.
[35] FASB Staff Position No. FAS 150-3, "Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests under FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity,*" November 7, 2003.
[36] *Id.* at page 2.

The FASB also has issued three additional FASB Staff Positions to address certain technical implementation issues that have been raised by constituents in connection with the provisions of Statement 150.[37] The FASB continues to monitor the application of Statement 150 and will consider the issuance of additional guidance to assist constituents, including small businesses, in the application of the requirements of the standard.

In addition, the Board has begun embarking on Phase 2 of the liabilities and equity project. The objectives of Phase 2 include:

1. To improve the accounting and reporting by issuers for financial instruments that contains characteristics of equity and liabilities, assets, or both.

2. Amend and improve on the definitions of liability, equity, and perhaps assets in the FASB's conceptual framework, such that decisions made in Statement 150 and in Phase 2 are consistent with those definitions.

[37] FASB Staff Position No. FAS 150-1, "Issuer's Accounting for Freestanding Financial Instruments Composed of More Than One Option or Forward Embodying Obligations under FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*," October 16, 2003; FASB Staff Position No. FAS 150-2, "Accounting for Mandatorily Redeemable Shares Requiring Redemption by Payment of an Amount That Differs from the Book Value of Those Shares, under FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*," October 16, 2003; FASB Staff Position No. FAS 150-4, "Issuers' Accounting for Employee Stock Ownership Plans under FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*," November 7, 2003.

In conclusion, we are aware of the significant focus over the past year on the financial accounting and reporting of public enterprises, in part because of the many activities relating to the Act and the increased attention on the movement toward convergence of international accounting standards. We, however, remain committed to serving all of our constituents including private companies, small businesses, and not-for-profit enterprises.

Accordingly, we appreciate the opportunity that this hearing presents to publicly encourage representatives of private companies, small businesses and not-for-profits to more actively participate in our activities. Greater participation by those constituents will be welcomed and will help ensure that, consistent with the FASB's mission and Rules of Procedure, the various perspectives of those constituents are effectively communicated to the Board and receive the careful consideration they deserve.

That concludes my testimony. Thank you, Mr. Chairman. I would be happy to respond to any questions.

PREPARED STATEMENT OF PETER A. SALG

PRESIDENT, QSC RESTAURANTS, FORT COLLINS, COLORADO
ON BEHALF OF THE INTERNATIONAL FRANCHISE ASSOCIATION

NOVEMBER 12, 2003

Chairman Enzi, Senator Dodd, Senator Allard, other Members of the Subcommittee, thank you for opportunity to testify before you on the impact the Financial Accounting Standards Board (FASB) has on small business growth.

As you know, my name is Pete Salg. I have worked in franchising since 1968, doing everything from running a restaurant, to running a franchisor with 450 units. Today, I am a small franchisee. My company, QSC Restaurants, Inc. owns five Wendy's restaurants in Colorado.

I will be testifying today on behalf of the International Franchise Association (IFA), which represents franchisees, franchisors, and others in the franchise community. In the 44-year history of the organization, there has been a clear and constant effort to promote entrepreneurship for all sectors of American society.

I will be focusing my comments on the impact of FASB FIN 46 on the small franchisee, but I also want to make sure you know that the great majority of franchisors are small businesses too. The typical franchisor has less than 200 units and revenues of less than $5 million. I will mention some of the hardships they face as a result of FIN 46 as well.

If FIN 46 goes into effect as written, here is what it could mean to franchisees like me:

- We would have to have audited financial statements. This is not required currently and would be very expensive. It is not required currently because it does not make sense to require it for two reasons: one, Wendy's has no contingent liability, and two, mine is not a public company!
- We might be required to use the same outside auditor as their franchisor. This is not an explicit requirement of FIN 46, but if my franchisor's auditors say they will only be comfortable if my statements are prepared by their own people, Wendy's is left with little choice and neither am I. This requirement will hit the single-unit franchisees the hardest. Needless to say, not every mom and pop small business can afford PriceWaterhouseCoopers or KPMG.
- We would also be required to adhere to the franchisor's internal accounting standards. Franchisees like me have made enormous investments—enormous at least in relation to my business—in the way they have decided how best to create their financials. Wendy's P&L Statement does not look like my P&L. We both have good business reasons why they look the way they do and there is no reason they should look the same.
- We would have to develop a system to provide internal control reports to franchisors and adhere to internal control dictates of the franchisor's auditor. I can understand why the franchisor would want this since the CEO and CFO are on the hook for criminal penalties provided for in Sarbanes-Oxley, but why on earth should a small operator have to institute an extensive internal control system? An individual Subway sandwich shop that probably grosses under $400,000 is not the same as IBM and should not be treated as such. This unintended consequence of FIN 46 is pure overkill.

Now let us look at the impact on small franchisors.

Typically, franchisors generate all of their revenue from royalties paid by the franchisee and that royalty is usually around 5 percent of sales. When you read about a franchise company you often see reports in the media about their system-wide sales figures. For example, if a franchisor with 100 percent franchises has system-wide sales of $100 million dollars, that sounds impressive. But what it means is that the franchisor probably has an annual income of around $5 million—5 percent of $100 million. Of the 1,500 franchisors in the United States, probably half have annual incomes of $5 million or less. So it is important to remember that not just franchisee—but also most franchisors—are very small businesses.

This hearing is about the impact on small business growth and it is hard to think of something more stifling to growth than FIN 46.

If you have a successful small business and you are thinking of ways to expand, franchising is a great method for a lot of people. You share your brand and operating plan with others willing to invest their money to start a franchise and you both can profit while your brand takes off.

FIN 46 makes franchising much less appealing. First of all, it just got a lot more expensive to be a franchisee. As I described earlier, you have to have audited statements done by an expensive firm, acceptable internal controls systems, etc. etc.

Second, your freedom to operate your franchise just got more limited. I have chosen to operate my restaurants the Wendy's way—the menu, the appearance of the store, the quality of the food—things like this must be standardized across the system so that you the customer knows what you are going to get when you walk into any Wendy's in the country. This consistency is critical to my success.

On the other hand, I am an independent businessman. I decide how to set up my business. I decide whether it is a company, a partnership, or an S Corp, and I decide who my lawyer and accountant are. I decide on what capital expenditures I make and I decide on product pricing. Furthermore, I decide who to hire and fire, what salaries and benefits to offer, and what pension plan to set up. I make decisions that directly affect the bottom line. There are reasons that some franchises within a system fail and others succeed and the biggest one is the abilities of the franchisee.

So, in deciding whether franchising is the way to go, some prospective franchisees will find the level of intrusion called for in FIN 46 more than they can live with.

This is a very serious threat to franchising. I was an employee of a franchisor for decades, but I chose to become a franchisee because of the freedom to be an independent businessman and to build my family's future security through owning my own business. My restaurants do better than other restaurants because they are mine. My success is the direct result of my ability to run my operation as I see fit. If FIN 46 had been in effect when I made my decision to become a franchisee, I do not think I would have made the leap. That is another problem with FIN 46. When and if I want to sell my business one day, there will be fewer prospective buyers and that will lower the value of my business.

Looking at another example, suppose you are a publicly traded company with hundreds of units. First of all, you have the flip side of all the problems facing franchisees I mentioned earlier. For example, you have to convince hundreds of independent business people to hire expensive firms to audit your financials and develop internal controls, and you have to convince them to give you a lot of financial information they have not had to. You also have the Sarbanes-Oxley problem I mentioned earlier. You may want to sell out just to avoid the headaches.

I know that the mission of FASB is to improve financial reporting so that the public is protected and I know that FIN 46 is supposed to prevent shady Enron-style arrangements. The entire franchise community supports this vital goal.

But I can not understand how FASB could come to the conclusion that the only way to prevent another Enron is to hobble a way of doing business so important to our economy and job creation. To make matters worse, I do not think FIN 46 even accomplishes FASB's goal of improved financial reporting when it comes to franchising. If FIN 46 results in a franchisor consolidating the financial results of its franchisees, FIN 46 may reduce financial statement transparency and clarity, as well as confuse investors who are not familiar with how franchisors and franchisees work together and how real it is that a franchisor's financial results are not one and the same with its franchisee's results.

For example, for the income statement, this means no longer including franchise royalty revenue, but instead essentially grossing-up the franchisor's income statement for the franchisee's results of operations and then eliminating their combined impact on the franchisor's income statement through an adjustment to "minority interest."

For the balance sheet, this means consolidating a franchisee's assets and liabilities, including, as an example, the franchisees' debt, even though the franchisor has no legal obligations associated with the debt. Amounts owed to the franchisor would be eliminated in consolidation.

Additional disclosure would be needed to explain the consolidated financial results—disclosure necessary not only to provide better information, but also necessary to provide clarity to allow financial statement users to understand the consolidated financial statements presented and distinguish between the economic benefits and risks inuring to the franchisor and those not.

Due to the different business models of franchisors and franchisees, the transparency of the franchisor's financial position and results of operations often can be dramatically altered. Consider the example of a 100 percent franchised system that collects a 5 percent royalty from franchisees. If the franchisees were to be consolidated, the franchisor would report a twenty-fold increase in sales (net of eliminated royalty income) materially distorting the franchisor's revenues, gross margin and expenses. Further, note that while the franchisor would gross up the income statement revenue and expenses by a factor of twenty, the franchisee net income would be entirely eliminated as minority interest such that the franchisor's net income would be the same before and after consolidation. A reader of the financial statements might ask whether this results in greater clarity and understanding of the operations of the franchisor.

In fact, there has been a longstanding concern expressed by the Securities and Exchange Commission (SEC) staff, about the use of "system wide sales" information (for example, combining franchisee sales with franchisor company sales) in "selected financial data" and "management's discussion and analysis" as being potentially misleading.

In other words, FIN 46 is going to make me and a lot of other people in the franchising world jump through a lot of hoops and pay a lot of money with zero benefit to the public.

Clearly, FASB has not sufficiently understood the implication of their proposal. They apparently have not been listening to small business concerns, or to big business concerns for that matter.

I was surprised to see FASB acknowledge in the October 31 exposure draft that, "[t]he Board's assessment of the benefits and costs of clarifying and modifying Interpretation 46 was based on discussions with preparers and auditors of financial statements and on consideration of the needs of users for more consistent application of that Interpretation."

It does not seem that real business people like me were consulted on the costs as well.

In conclusion, thank you for holding this hearing. This experience has been a real eye opener for me. I am certain there are not very many small franchisees like me that would ever have thought that FASB could do something like this that could have such a devastating impact on our businesses. I consider myself to be a pretty sophisticated franchisee, but I do not think I would have heard of FIN 46 in time had it not been for the International Franchise Association.

FASB needs to better understand that the rules they set are not just academic exercises. Those rules have real life consequences and FASB needs to understand what those consequences are and take them into account before they act.

IFA and its 30,000 members stand steadfast in their opposition to the current iteration of FIN 46 and urge the Subcommittee to take appropriate action.

I would be happy to answer any questions you have.

Thank You.

PREPARED STATEMENT OF JAMES K. GLASSMAN

RESIDENT FELLOW, AMERICAN ENTERPRISE INSTITUTE

NOVEMBER 12, 2003

Introduction

The determination of the Financial Accounting Standards Board to require mandatory expensing of stock options by U.S. firms threatens to harm small businesses and imperils the fragile economic recovery. The FASB's self-stated mission is to improve accounting standards. I do not believe that its proposed expensing of options achieves this aim, but, even if it did, you as policymakers have a more comprehensive mission than the FASB. Your concerns include improving the economy and increasing job opportunities.

In the testimony that follows, I review the importance of small business, the key role played by stock options, and the potential damage that the expensing of options will do to businesses, jobs, and the economy. One inevitable result will be to send U.S. jobs offshore. I urge you to rein the FASB in by acting immediately to delay implementation of new standards on options.

Accounting rules may seem arcane and boring, but they are far too important to be left in their entirety to an unelected board in Norwalk, Connecticut.

Small Business and Stock Options

Small business is the engine that drives the U.S. economy. Businesses with fewer than 500 employees represent 99.7 percent of all American firms, employ more than half of private-sector employees, create more than half of private gross domestic product and, perhaps most important at a time of economy recovery, create 60 percent to 80 percent of net new jobs annually.[1] According to the most recent data, in 1999–2000, "small businesses created three-quarters of U.S. net new jobs (2.5 million of the 3.4 million total)."[2]

---

[1] Small Business Administration, "Small Business by the Numbers," online publication updated May 2003: *http://www.sba.gov/advo/stats/sbfaq.pdf.*

[2] Ibid.

Small businesses, moreover, grow to large businesses. For example, Microsoft, started in Bill Gates' garage, began with two employees as a partnership in 1975 and now has 47,000 employees, 118,000 shareholders, and $282 billion in stock market value.[3]

Three of the key ingredients in the success of small businesses are attracting a talented and motivated workforce, limiting compensation outlays, and conserving cash during their early years of growth.[4] Over the past 10 to 15 years, small businesses, as well as large, have turned to employee stock options as a reasonable means to achieve success:

Stock option plans give executives a greater incentive to act in the interests of shareholders by providing a direct link between realized compensation and company stock price performance. In addition, offering employee stock options in lieu of cash compensation allows companies to attract highly motivated and entrepreneurial employees and also lets companies obtain employment services without (directly) expending cash. Options are typically structured so that only employees who remain with the firm can benefit from them, thus also providing retention incentives.[5]

It is evident that the use of options is critical to smaller, early-stage businesses and that the use of options has broadened and deepened.[6] For example, top managers and employees below the top five executive officers in 2002 received more than 90 percent of the total value of options granted—up from less than 85 percent in the mid-1990's. Both "Old Economy" and "New Economy" firms issue options. For Old Economy firms, the average grant-date value of options per employee (below the top five executives) went from $522 in 2001 to $2,856; for financial firms, from $1,007 to $5,562; for New Economy firms, from $1,684 to $18,882. (All of these figures are adjusted for inflation, using 2002 constant dollars).[7]

High-tech companies are not alone in relying on stock options to motivate their workforces. One of the great options success stories, for instance, comes from Staples, Inc., the office supply chain, which was launched in 1986 with a single store in Brighton, Mass., and now has 1,500 stores worldwide and employs 58,000.[8]

Expensing Options Would Reduce Issuance of Options to Lower-Level Workers

Unfortunately, the FASB is moving quickly to change an accounting rule in order to require mandatory expensing of stock options on corporate income statements issued under generally accepted accounting principles (GAAP).

Such a change, it is widely agreed, would cause a significant reduction in the issuance of stock options, especially to employees below the top five corporate officers. For example, America's best-known venture capitalist, John Doerr, said in testimony he that thought "broad-based employee stock ownership . . . will disappear if expensing is mandated."[9] A study by consultants at Mellon's Human Resources & Investor Solutions also found that companies intend to cut back significantly on options programs for employees below the top executive level if expensing is enacted.[10] A review of the economic literature by Brian J. Hall and Kevin J. Murphy concluded that "parties on both sides of the debate agree that such a change [expensing stock options] would result in granting fewer options, especially to rank-and-file workers."[11] Dozens of chief executive officers have publicly stated that their firms will reduce or eliminate options if expensing is enacted. Typical is the CEO of Advanced Fiber Communications, which stated in a letter to the FASB: "The ex-

[3] Value Line Investment Survey, Aug. 29, 2003, p. 2207; Yahoo Finance; Microsoft Corp. annual report, 2003, Form 10–K, p. 17.

[4] A survey by the National Federation of Independent Business asked respondents to list problems in order of importance. Ranking third (after health insurance and Federal taxes) was "locating qualified employees." Ranking seventh, out of more than 70 listed problems, was "workers' compensation costs." Ninth was "cashflow." See *http://www.nfib.com/cgi-bin/NFIB.dll/Public/SiteNavigation/home.jsp.*

[5] Brian J. Hall and Kevin J. Murphy, "The Trouble With Stock Options," Journal of Economic Perspectives, vol. 17, no. 3, Summer 2003, p. 49.

[6] For a good overview of the subject, see Josph Blasi, Douglas Kruse and Aaron Bernstein, *In the Company of Owners* (Basic Books, 2003).

[7] Hall and Murphy, op. cit., pp. 51-52.

[8] Value Line Investment Survey, Oct. 17, 2003, p. 1151; *www.staples.com.*

[9] Committee on Banking, Housing, and Urban Affairs, U.S. Senate, May 8, 2003; transcript at p. 55. Mr. Doerr has been a partner in the firm of Kleiner, Perkins, Caulfield & Byers since 1980. The firm has sponsored investments in such companies as Compaq, Cypress, Intuit, Macromedia, Lotus, Netscape, Sun Microsystems, and Symantec, which have led to the creation of over 30,000 jobs.

[10] Mellon, "SFAS 123: Responding to Mandatory Option Expensing," September 2003 survey, p. 9.

[11] Hall and Murphy. op. cit., p. 68.

pensing of stock options would likely require AFC to discontinue its broad-based stock option plan that helps us to retain and motivate our employees."[12]

It is reasonable to predict that, without the incentive tool of stock options, many of America's most innovative firms—small businesses and large, in technology and nontechnology industries—will suffer declining productivity, with dangerous consequences for national competitiveness, growth, and employment.

Talented Workers Will Move from United States to Asia

Already, the consequences are becoming apparent. In an article in *Barron's* last summer, George Chamillard, the CEO of Teradyne, a Boston-based maker of automatic test equipment for the electronics industries, wrote that one major factor in the "flight of the semiconductor industry from Route 128 [in Massachusetts] to Silicon Valley" was "stock options." Bay Area start-ups "were romancing East Coast talent with the opportunity to strike it rich through options . . . Stock options were a low-cost way to draw talent away from mature companies and into start-ups. In return for assuming higher risk, the options-givers offered the recruit the chance for high rewards through equity ownership and a piece of the action. Best of all, the cost did not hit the P&L—an important point, since there usually were little or no profits in the early years of a start-up . . . Other industries learned the lesson well, using options to drive new companies and inject excitement into older ones."[13]

Now, writes Chamillard, the next cycle of "Go West, Young Man" has begun. "While options are under attack in the United States, elsewhere the stock option as a recruiting tool is on the rise." Options are drawing scientists from the United States to Asia—Taiwan in particular. As a result, says Chamillard, the United States is losing "engineers educated at MIT and Stanford and CalTech."[14] Asian nations understand the attraction of options, and they do not have the same taste for the fetish of expensing options as American regulators. In its 2001–2005 5-year plan, China officially encourages the use of stock options to motivate managers.[15] A recent study by the consulting firm Towers Perrin found that, with the exception of Singapore, "stock options still remain companies' most popular long-term incentive for their executives."[16] So, where did the fetish for expensing options—which, at a critical time, imperils U.S. small businesses and the economy as whole—come from?

Background

An option is literally a choice. The owner of a fixed stock option has the choice of purchasing shares at a fixed time in the future at a price that was fixed at the date it was granted. Often, that price is the market price at the date of the option grant. Therefore, if, by the time of the exercise date, the stock rises above the price at which it was granted, the owner of the option will exercise the option, purchase the stock, then either sell the stock at a profit or hold it for a longer period. It is easy to see how such options help align the interests of managers with those of shareholders, whose main concern is that the value of their stock increase.

Encouraging management to adopt a shareholder-orientation became a major concern in the 1970's when managers, who typically owned little stock, were criticized for using corporate assets for their own benefit and paying scant attention to the interests of institutions and individuals who were the actual owners of their companies. Options helped change that situation, and they played a key role in the economic revival in the United States that began in the early 1980's and has lasted, on an unprecedented scale, for two decades. "Options," as two distinguished economists recently wrote, "are needed to ensure compatibility of the interests of stockholders and management, whose divergence has recently been so dramatically demonstrated."[17]

The controversy over the accounting treatment for stock options goes back more than 30 years. In 1972, the Accounting Principles Board issued Opinion No. 25, which stated clearly that no compensation expense need be recognized for fixed

---

[12] FASB Comment Letter No. 185. See also many others (Staples, Altera, Genentech, etc.), including, poignantly, FASB Comment Letter No. 29 from Vermont Teddy Bear Company: "If options are expensed, I can tell you that a small company like the Vermont Teddy Bear Company will no longer grant them."

[13] "Go West Again? Lured by Stock Options, Techland's Best and Brightest Moved to California; Next Stop, Asia?" *Barron's,* July 21, 2003.

[14] Ibid.

[15] Five-Year Plan of the People's Republic of China. (2001–2005)

[16] Agence France Presse, Sept. 24, 2003. *http://asia.news.yahoo.com/030924/5/singapore49820.html*

[17] "A false cure for the ills of stock options," by William Baumol and Burton Malkiel, *Financial Times (London),* April 3, 2003.

stock options granted to employees "because of the concern that stock options could not be reliably valued at the exercise date."[18] As the use of such options increased, the FASB in 1984 began to reconsider the earlier ruling by its predecessor.[19]

As a result, companies today have two choices. They can adopt the "fair-value" method of treating options and record them as an expense against earnings in the year in the which the grant is made, or they can use the "intrinsic-value" method, which discloses the impact on net income in footnotes but not as a charge against reported earnings; if shares are issued to accommodate the exercise of options, then a dilution will occur on that date. Most public companies use the second method.

The FASB, however, has made it clear that it will shortly require U.S. companies to adopt "fair-value" accounting under FAS 123. The problem of valuing the options, however, remains. The FASB acknowledged that its proposed standard on stock options "should not prescribe a particular option-pricing model. Rather the objective would be to use the option-pricing model that produces the best estimate of fair value given all the facts and circumstances."[20] And what is that model? Either a Black-Scholes or a binomial model, it appears—both of which seriously lack reliability and accuracy.[21] In other words, the same deterrent that prevented the FASB's predecessor from requiring the expensing of options in 1972 still exists today: No one can place an accurate value on them.

But there is another reason that the past 30 years of economic history have confirmed: Options help improve the operations of small and large businesses and improve the economy. For that reason, President Bush supported the current accounting treatment of options in an interview a year and a half ago, saying that "they should be dilutive in [a company's] earnings per share calculations"[22]—the situation that currently prevails. In addition, leading Democratic presidential candidates also oppose expensing of options. Rep. Richard Gephardt (D-Mo.), for example, supported the current accounting treatment, saying in June that "stock options are a very important way to get employees to think like owners."[23] Howard Dean said he would "not favor expensing stock options if at least 65 percent of the options were distributed widely throughout a company"[24]—a description of the majority of businesses today.

Why, then, has intense pressure developed to expense options?

There is little doubt that the campaign for expensing originated in the wake of the corporate scandals involving such firms as Enron and WorldCom—although in no case did options play a role in the fraud and deception at the root of the scandals. There is, as well, an earnest desire by policymakers to provide investors with accurate information about the companies in which they invest. But it is my belief that expensing options will confuse such investors, not enlighten them.

Expensing of Options Will Confuse and Mislead Investors

Stocks options issued by companies to their employees cannot be accurately valued at the time they are issued. They do not comprise a cash cost, and they have no market price since they cannot be sold. The Black-Scholes method of valuation, the "gold standard" for determining the value today of options subject for future contingencies, applies to options that are tradable—not to options whose ownership is restricted to specific individuals. Consider just one contingency: Many employees will quit before they options can be exercised and lose all their rights to the value of the options. That cannot happen with conventional options purchased in open markets.

"Mark Rubenstein, a finance professor at the University of California at Berkeley, found that some models used to value options require as many as 16 separate variables." Adjusting only a few of those variables, he found, could produce "huge dif-

---

[18] Dechow, P., Hutton, A., and Sloan, R., "Economic Consequences of Accounting for Stock-Based Compensation," *Journal of Accounting Research,* 1996, 1:2, p.2–3.

[19] Ibid, p. 3.

[20] Financial Accounting Standards Board User Advisory Council Meeting, Attachment 2, Memorandum on "Equity Based Compensation," FASB User Advisory Council, Oct. 7, 2003, p.1.

[21] Many statements attest to this fact. See, for example, criticism of Black-Scholes ("it is crazy to use Black-Scholes") by Warren Buffett, the Chairman of Berkshire Hathaway, Inc., in Andrew Hill, "Buffett and Munger—In Their Own Words," *Financial Times,* May 2003. Also, the investment firm Warburg Pincus advised the FASB, "We feel very strongly that these models [Black-Scholes and binomial] do not recognize the fact that employee options are nontransferable [and] are not liquid" (FASB Comment Letter No. 194).

[22] "Bush Supports Businesses in Debate Over Changing Options Accounting," by Michael Schroeder, *Wall Street Journal*, April 10, 2002.

[23] "Gephardt Backs Foes of Options Expensing," by Laura Kurtzman, *San Jose Mercury News,* June 18, 2003.

[24] "Dean Castigates Bush During Visit to San Jose," by Dana Hull, *San Jose Mercury News,* Sept. 8, 2003.

ferences in costs." For example, in one test, Rubenstein discovered that the value an option for a theoretical $100 stock could range from under $20 to over $300.[25] How valuable is such information to investors? Not very. Can such information be easily manipulated by firms to meet earnings targets? Of course.

Think about how an employee stock option works. If a company issues an option today, when the price of its stock is $50 per share, allowing an employee to buy stock at the same $50 in 5 years time, how can the firm accurately value the option today if it does not know the price 5 years from today? It cannot, so it has to guess the value using those multiple variables, including interest rates, volatility, earnings, likelihood of job retention, and on and on.

For that guess to have any usefulness to investors, it needs to be updated frequently. Imagine that the firm originally estimates its stock price at $120 5 years from now and that, after 1 year, the stock drops to $15. Is it reasonable to believe that in 4 years, the price will rise to $120? Probably not. So the company should then reduce its estimate for the value of the options issued the previous year. Such a reduction would create increased earnings! So as the firm's stock price drops, its earnings increase.

Such a perversion reminds us of the purpose of accounting conventions in the first place—to convey information about the health and prospects of a company for investors and potential investors. But some information cannot be reduced to a single number. Nor should it be. The expensing proposal, nevertheless, "serves to satisfy an unquenchable fetish to see a contingent liability converted, however clumsily and unconvincingly, into a dollar amount that can be charged against earnings—without (and here's the fetish element) caring in the slightest whether it is helpful or meaningful to do so."[26]

In this case, it is not helpful or meaningful to reduce all the information about options to one number. It is confusing and misleading—and utterly unnecessary.

The current regime gives firms a choice: Expense options at the time they are granted or provide information about the options in the footnotes and record a dilution when the options are exercised. The information provided today by companies is highly detailed. Consider, for example, the Form 10–K of Gilead Sciences, Inc., a biopharmaceutical company based in Foster City, California. The footnote on stock options extends for four pages. It shows the number of options outstanding, forfeited, exercised, and outstanding for the preceding 3 years, the weighted average exercise price of those options and the weighted average fair value of options granted. It then breaks down, by four price categories, the number of options and their average price and contractual life. And it presents a table that shows what net income would be if the company had chosen the alternative method, "fair value" accounting, under FAS 123. There is more information as well.[27]

In fact, for typical companies, the information provided on stock options far exceeds information provided for far more important aspects of the business, including intellectual-property assets, cash compensation expenses, leases, and investments.

Under the current regime, investors who require information on stock options can get it—and get it in spades. They can use it—not as a single number—but as a mass of detail more important than a single number—to make their decisions. Perhaps there could be even more transparency. Perhaps the disclosures could be made in a more uniform way. H.R. 1372 addresses such improvements.

Since 1993, I have written a regular financial column for *The Washington Post,* which is syndicated into many other newspapers, including the *International Herald Tribune* and the *New York Daily News.* I have written about investing for many other publications as well, including *The Wall Street Journal, Los Angeles Times, The New Republic, The Weekly Standard, Forbes,* and *Worth* magazine. I have devoted much of my professional life to educating small investors, so I have a keen interest in ensuring that investors get all the information they need to make good decisions.

Do current accounting rules give them such information? Absolutely. Will expensing help them make better choices? Not at all. Will it confuse them and actually increase the fog surrounding investment decisions? That is highly likely.

---

[25] "The Imperfect Science of Valuing Options," by Howard Gleckman, *Business Week,* Oct. 28, 2002.

[26] "Much Ado About Stock Options: The Epilogue," editorial, *Wall Street Journal*, April 23, 2003.

[27] Gilead Sciences, Inc., Form 10–K, submitted to the Securities and Exchange Commission, March 11, 2003.

Investors Understand the Cost of Options

The case for expensing stock options is built on a faulty premise: That investors do not understand, from the current data with which they are presented, the true status of the firm. In their article, Hall and Murphy write, "Several studies have shown that the costs of options are indeed reflected in stock prices."

That leads to two further questions:

First, if investors already can figure out the cost of options without an accounting change, then why make the change to expensing and jeopardize small businesses and the economy as a whole? And

Second, if options are already reflected in stock prices, then why should small businesses fear the change to expensing? If the costs are known already, then stock prices should not change.

Let me take the second question first and let Hall and Murphy answer it: "The fact that financial markets see through the 'veil of accounting' does not imply that accounting considerations are irrelevant since accounting rules affect—and sometimes distort—managerial decisions." In other words, whatever economists think, managers fear that a change in the rules will indeed hurt their companies in the stock market and raise their costs of capital. Such managers—and we have heard from dozens of them—will cut back their options programs, with an adverse effect on the economy. My guess, as well, is that stock prices will fall in the short-term and the cost of capital will rise. Stock prices may rebound, but the damage will be done. Why, at this critical time in the economic cycle, should we tamper with a system that provides incentives and conserves capital?

Which brings me back to the first question: Why make a change if the change threatens to harm the economy and produce no benefit? There is no reason at all. The number one rule in public policy should be that of the Hippocratic Oath in medicine: First, do no harm.

So why is the FASB, an unelected group of accounting mavens, bent on making such a dangerous change?

The FASB's Mission

The answer lies in FASB's sole mission, which it states this way:

"... to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information."[28]

But Federal policymakers have a far broader mission.

For example, they are responsible for encouraging—or at least not discouraging—economic growth, for preserving and increasing jobs, innovation, and U.S. competitiveness. Even if the FASB expensing proposal were cogent from an accounting viewpoint (and it is not), it would be the duty of Congress and the executive branch to consider its economic impact. I do not have to remind you. That is your job. You cannot abdicate it. You cannot farm it out to a group of accountants, however well-meaning.

Some issues, quite literally, are beyond the FASB.

As a result of expensing options, many firms—among them some of America's most successful and innovative—will be forced to take massive charges against earnings. "Accounting for [options'] cost by the usual method (the Black-Scholes options-pricing model) would cut tech firms' reported profits by 70 percent, on some estimates."[29] Although they will not alter the firms' cashflow or actual business prospects from what they are today without mandatory expensing of options, the reduced reported earnings are almost certain to lead, at least in the short-term, to lower stock prices and a higher cost of capital for the firms. Companies, in addition, will be discouraged from issuing options in the future. The effect will be to reduce economic growth, U.S. competitiveness, and job creation.

While some critics have made wild claims about the uselessness of stock options,[30] the truth is that firms issue options because they work. They represent an efficient

[28] On the home page of the FASB website: *www.fasb.org.*

[29] "Now for Plan B: Expensing Share Options," *The Economist,* March 15, 2003.

[30] Typical is Charles Munger, Vice Chairman of Berkshire Hathaway, Inc., who has said, "In 90 percent of the cases, the handing out of options is excessive." Quoted in "Options Vigilantes," by Robert Lenzner, *Forbes,* Dec. 23, 2002, p. 67. In addition, the U.S. Secretary of the Treasury, John Snow, derided stock options in an Oct. 15, 2003, speech as a "freebie," claiming that, "in many cases [options] shortened the time horizon of management and accentuated the 'short-term-it-is' that addicted the markets in the 1990's." There is, no surprisingly, no economic evidence for this view. In fact, the problem in the 1990's was that investors took too long a view, not too short. They thought that companies that were losing money would make money somewhere in the future—lots of money—and bid up stock prices accordingly. Since stock-option use

Continued

method, especially for companies that have limited cash and depend on innovation to prosper, to spur employees at all levels to work harder and accomplish more—and thus to increase the value of the corporation and ultimately its stock price.

Conclusion

Are other incentives, such as cash or perks or the awarding of restricted stock, better incentives than options? Perhaps for some companies, and nearly all firms diversify their incentives beyond cash. But academic research shows that "incentive-intensive" firms favor the use of stock options.[31] No one knows more about incentives at an individual company than the shareholders, the board, and the top managers of that firm. When they choose stock options, it is hubristic and foolish for outsiders to second-guess them. Discourage stock options and you discourage a management tool that works for vast numbers of the best American companies—including the small businesses that have made the U.S. economy the envy of the world.

Thank you.

PREPARED STATEMENT OF RICHARD FORRESTEL, JR.

TREASURER, COLD SPRING CONSTRUCTION COMPANY, AKRON, NEW YORK
ON BEHALF OF THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA

NOVEMBER 12, 2003

The Associated General Contractors of America (AGC) is the largest and oldest national construction trade association in the United States. AGC represents more than 35,000 firms, including 7,500 of America's leading general contractors, and over 12,000 specialty-contracting firms. Over 14,000 service providers and suppliers are associated with AGC through a nationwide network of chapters. These contractors are engaged in the construction of the Nation's commercial buildings, shopping centers, factories, warehouses, highways, bridges, tunnels, airports, waterworks facilities, waste treatment facilities, dams, water conservation projects, defense facilities, multifamily housing projects, and site preparation/utilities installation for housing development.

I am Richard Forrestel, Jr., a CPA and Treasurer of Cold Spring Construction Company, based in Akron, NY. I am testifying on behalf of the Associated General Contractors of America (AGC), a national trade association representing more than 33,000 firms, including 7,200 of America's leading general contractors, and 12,000 specialty-contracting firms. AGC is the voice of the construction industry.

While AGC's membership is diverse, the majority of AGC firms are closely-held businesses like ours. AGC member firms are 94 percent closely held, 81 percent are owned by fewer than four people.

I serve as the Chair of AGC's Tax and Fiscal Affairs Committee. It is this subgroup of small business CFO's and construction accounting professionals who have spent the last few months trying to understand why the Financial Accounting Standards Board (FASB) would inflict Financial Accounting Standard 150 (FAS 150) on the industry. This FASB standard has hit our industry and my committee like an earthquake. Its has the potential to undermine the fiscal stature of tens of thousands of construction companies, like mine.

I would like to thank Chairman Enzi and the other Members of this distinguished Committee for the opportunity to discuss both the potentially devastating impact of FAS 150 on family-owned businesses as well as the general process of communication between American small businesses and FASB.

Cold Spring Construction Company was founded by my grandpa in 1911. We are a closely held, family-owned construction firm that specializes in highway and bridge construction. Our projects range in size from $1 million to $40 million. Dad and his brother, Uncle Tom, both entered the business after serving our country in WWII and worked together until Uncle Tom died in 1977. As Dad, our Chairman, approaches his 79th birthday, he still remains very active in the business. In addition, my brothers, Steve, President and CEO, and Andrew, Vice President, are actively involved in managing our business today. We have eight siblings who have chosen other career paths; however, each worked for the company every summer to pay for college, as did 12 of my first cousins.

---

started to accelerate, the United States has enjoyed a period of enormous prosperity, with only two brief and shallow recessions.

[31] Bryan, S., op. cit.

You get the picture, we, like thousands of other businesses in this industry, are privately held and intend to remain so. It was with this backdrop that we faced the potential onslaught of FAS 150. Through our involvement with AGC, I was able to visit FASB in Norwalk, CT, along with two other representatives of AGC on October 30, 2003.

The risks of FAS 150 to privately held firms like ours, and the majority of AGC members, cannot be overstated. As written, FAS 150 would have dramatically affected all privately held companies with mandatory redemption clauses in their buy-sell agreements. That is, if your "buy-sell"[1] agreement is written so that the company must buy your stock back at some point in the future (for example at death or retirement), then the contingent future liability must be booked or accounted for today. For my family's company, this is all our shares. The result will be to take our company's more than $10 million net worth and make it zero through the imposition of this standard.

I will briefly touch upon the ramifications of such an accounting bombshell. Cold Spring builds only public works projects, all of which require surety bonds.[2] First, wiping out our equity would make us unable to obtain bonds. Second, we would be in violation of loan covenants.[3] Third, many States like Pennsylvania have prequalification requirements[4] in order to bid on public works projects. FAS 150 would have rendered us unqualified to bid on most projects in Pennsylvania, because the State requires the contractor to show net worth in order to bid. Finally—and this is strictly a psychological reason—this change would have dramatically altered the way our balance sheet looked. Dad first worked for Cold Spring the summer after the Japanese attacked Pearl Harbor. He has worked his tail off for more than six decades. No way, not on my watch, will he be told that the company just lost all it is net worth, even if it is only on paper.

FAS 150 first came to my attention at an AGC Tax and Fiscal Affairs committee meeting in June of this year. During our two-day meeting, we discussed the implications of the standard—which at that point was effective in December 2003—and decided our best course of action was to put together a task force to contact FASB with our concerns. At the end of August, AGC sent our four-page letter. This letter was timed to arrive at FASB the day before their board meeting addressing FAS 150. Because of our letter, and the letters of other associations of nonpublic companies, FASB delayed extension of FAS 150 for an additional year.

While we appreciated the delay, FAS 150 still needed to be permanently amended for nonpublic companies. During the AGC Midyear Convention in Washington DC in September, contractors began to educate Members of Congress about this issue. The Tax and Fiscal Affairs Committee met at the same time, and decided to request a personal meeting with FASB in Norwalk. FASB responded and began the process of putting a meeting together. Schedules being what they are, the meeting was set for October 30, 2003.

Walking into this meeting, I was unwilling to accept any other outcome other than a complete change by FASB regarding 150. There is absolutely no way I would have followed through with this standard—and I told FASB this. I was frustrated that this standard was in place, which seemed like such an obvious mistake to me, and I believed this was my best, and possibly only, chance to make myself heard. I could not let this standard be enacted. At the same time, as a contingency effort, AGC continued educating Congress about the devastating impact of this standard.

After much thoughtful preparation, on October 30, two AGC representatives and I met for three hours with two Board members and five staff members of FASB. These people are, in my opinion, the best and the brightest people in the country in the accounting profession. I found them engaging and concerned with the way FAS 150 would affect my company, Cold Spring, and the rest of the industry. The seven FASB representatives asked direct and penetrating questions—honestly, it made the CPA exam seem easy in comparison. They gave us a chance to tell our stories and listened well. They did not promise an outcome but did thank us for our input. We could have asked for nothing more. My mindset walking out of that meeting was completely unexpected to me. Rather than a brick wall, I found an intel-

---

[1] Buy-sell agreements are an agreement between shareholders, and possibly the corporation, for the transition of ownership.

[2] Surety bonds are guarantees that the contract will be completed and that workers, suppliers, and subcontractors will be paid. Virtually all public contracts require surety bonds.

[3] Loan covenants often require a target net worth.

[4] Prequalification: In order to bid on public projects, contractors are required to submit information to the agency. The agency evaluates the contractor's financial ability to complete the contract.

ligent, thoughtful room interested in hearing about my nonpublic company and how FASB standards affected me and my industry.

I believe FASB heard us. Last week, FASB issued a change and indefinitely suspended the portion of the standard that would have forced companies like ours, who have mandatory redemption clauses with an uncertain date and value of redemption, to book it. In summary, there is no change to my financial statement. But, the other shoe has yet to drop because it is FASB's apparent intention to address this issue again in the future. The uncertainty of not knowing what will happen, if anything, will undoubtedly continue to cause heartburn for lots of people currently contemplating buy-sell agreements.

I intend to remain available to FASB if I can be of further assistance. Having been through this process now, I know I will find the doors of FASB wide open to the concerns of my company and to small businesses in general as they move forward. It appears to me that FASB board members and staff are incredibly interested in how their standard will affect all the users of the financial statement, and willing to hear from everyone.

So, FASB's process worked, but it is unfortunate that it came down to the eleventh hour. The small business community is certainly partly to blame for our late involvement in this issue. However, I believe that this experience can be instructive for others. A better, more public, mechanism could be put in place to ensure useful communication between FASB and the American small business community at large.

Large, public companies are accustomed to lobbying for or against changes with FASB. We small companies are not. We often get caught up in changes that probably should be, at least in my opinion, intended for public companies. I think this is exactly the case with FAS 150. Great idea for the public companies, disastrous for us. Our small construction company perspective is necessary to ensure they have evaluated all of the potential wrinkles in their standard.

One possible effort to consider is a biannual or annual meeting with FASB staff and representatives of small businesses. Just as the IRS, the Small Business Administration, and other entities have meetings just with small businesses, this would be an opportunity for all sides to meet and talk. FASB would benefit from having small business representatives provide their point of view, and at the same time, share drafts of upcoming new standards. In this way, both small business and FASB are "on the hook" and working together.

I know that AGC is moving forward with FASB on a new working relationship. The AGC Tax and Fiscal Affairs committee will meet in January, and we are inviting a representative from FASB to join us. We are going to work proactively and ensure we are staying abreast of new draft standards. We also will continue to provide information on FAS 150 until this standard is finalized. Our intention is to keep the lines of communication open and make sure our voice is heard.

In conclusion, I would like to thank you for the chance to testify today, and your willingness to listen to and potentially address our concerns. As a fellow CPA, I agree with what I believe is Chairman Enzi's viewpoint—Congress should not be legislating accounting standards. I appreciate and agree with the many reasons FASB is an independent organization. Nevertheless, this Committee's oversight is critical to ensuring all standard-setting agencies are responsive to the industry.

I would also like to thank the members of the FASB and their staff. Having now had the opportunity to work with them directly, I have found them to be smart, dedicated, and responsive. I would also like to suggest that a better communication mechanism between the FASB and American small business would benefit the entire economy and its 285 million participants. Thank you and I will gladly answer any questions you might have.

PREPARED STATEMENT OF WALTER K. MOORE

VICE PRESIDENT, GOVERNMENT AFFAIRS, GENENTECH, INC.

NOVEMBER 12, 2003

Good afternoon. I am Walter Moore, Vice President for Government Affairs with Genentech. Unfortunately, Lou Lavigne, Genentech's Chief Financial Officer, is unable to be here today and sends his regrets. As you are probably aware, Genentech is the founder of the biotechnology industry and is still among the world's leading biotech companies, with 12 protein-based products on the market for serious life-threatening medical conditions and 20 drug candidates in the pipeline. Our strength is in all areas of the drug development process—from research and development to

manufacturing and commercialization. Genentech continues to transform the possibilities of biotechnology into improved outcomes for patients.

Today, Genentech has a market capitalization of over $40 billion. Why, you might ask, is a company the size of Genentech testifying today or even interested in the topic of FASB and Small Business Growth? Because Genentech has a classic small business story to tell.

Genentech was founded over 25 years ago by a UCSF Biochemist and young venture capitalist. The biotechnology industry was born when they agreed to each contribute $500 to start the company. They fought convention in their business practices. Researchers could publish their findings of their studies, casual dress for all employees, and all employees were given stock options when the company went public in 1980. Among the young scientists who came to Genentech in 1980 to enjoy this atmosphere was Art Levinson, our current Chairman and CEO. Genentech issued stock options to all employees when it was founded, and still does today.

One of the primary factors that allowed Genentech to move from a small start up biotech company to where it is today was its ability to use broad-based employee stock options. Employee stock options make employees think and act like owners, not just employees who do their job, collect a pay check, and go home. Genentech actively competes for talent with at least 60 other biotechnology companies located within our zip code, let alone throughout California and the rest of the country. Our ability to remain competitive is directly related to our ability to offer and provide robust and broad-based options to our employees at all levels. This has clearly helped Genentech build and maintain a dynamic team of people that discover, develop, and market life-saving therapies to patients all over the world. However, the ability for new Genentechs or other success stories to be created is being directly threatened by the Financial Accounting Standards Board (FASB).

FASB's proposed new rules on how to account for employee stock options will greatly impact all companies that use broad-based employee stock options—without providing investors with consistent, comparable, and reliable financial information. In the current accounting standard for employee stock options, FAS 123, companies are allowed, but not required, to expense employee stock options. Private companies that choose to expense their stock options are allowed to do so under rules that are different than those applicable to all other companies. The reason for the different treatment is that it simply is too difficult to value stock options for a company whose stock either does not trade, or trades infrequently. FASB, without any justification, has decided that this distinction should be eliminated.

We disagree and also believe that all companies, and not just small businesses and private companies, face the same valuation problems. In fact, we at Genentech fundamentally disagree with those who believe that employee stock options represent a corporate level expense. That said, we do believe that credible, transparent, consistent, comparable, and unbiased financial information is essential.

As I mentioned earlier, there are 60 biotech companies in South San Francisco. The vast majority of these companies are small businesses and their recruitment strategy is to provide broad-based options to employees to compete with Genentech and other mature biotechs in our area. Expensing stock options will be a burden on companies of Genentech's size, but it will be a much heavier impediment to recruitment of scientists by these small businesses. These small businesses operate in a global marketplace. One of small neighbors has recently begun construction of a manufacturing facility in Korea. If the FASB mandates stock option expensing in the United States and the EU mandates it Europe, some companies will relocate to countries without mandated stock options expensing.

My testimony today will focus on mandated stock options expensing while highlighting myriad problems with existing valuation methods. Existing models fail to adequately incorporate factors unique to employee stock options and, if used to establish a corporate expense, will compromise the integrity and comparability of financial reporting. Proponents of mandatory stock option expensing have held that expensing options will provide investors a more clear understanding of the financial state of the company. I believe, however, that the current footnote disclosure method provides more clarity. As you can see from Genentech's 10–K disclosure, an investor with a target price can determine the exact dilution in the stock price he or she can expect. Conversely, expensing options will take the focus away from the real cost of options, dilution. Instead, companies will report a seemingly "precise" number in the income statement, which, in fact, is totally subjective, unreliable, and cannot account for scientific and technological breakthroughs or failures.

From Genentech's perspective, the major areas of concern on valuation relate to FASB's view that any option pricing model used to compute a corporate expense must take into account volatility, expected holding periods, and the risk free rate of return. Moreover, all of the existing models assume that the options being valued

are freely transferable and, to date, FASB has not allowed companies to factor in this difference between employee stock options and the options that the models were designed to value. In addition, FASB has not allowed companies to factor in other significant restrictions that impact employee stock options, such as black out periods. Trading black out periods can also have a significant impact on the "value" of an employee stock option. Blackouts, time periods when options cannot be exercised, are frequently the equivalent of 5 months or more in any given year. For some employees, blackout periods can extend for up to 8 months in any given year. To date, FASB has not permitted this significant restriction to be taken into account in determining the supposed "fair value" of employee stock options.

One might think that the risk free rate of return should be consistent across companies and industries. This, however, is not the case. Even in our own industry segment, the risk free rates used in the footnote disclosures of Genentech and three of our chief competitors ranged from 3.9 percent to 5.5 percent in 2001.

When you move on to the issue of volatility, the differences are even greater. At any point in time the volatility of companies even within the same industry can be radically different. For example, in our industry in 2001, four companies used volatility assumptions in their 2001 footnote disclosures that ranged from 44 percent to 63 percent. What is the correct volatility to use? Who knows? Biotech is a stunningly risky business: Clinical trials of promising therapies fail more often than they succeed.

To make matters worse, FASB's rules require that companies predict their future volatility. Even if one were to use past volatility as a predictor of future volatility, which is a dubious proposition to begin with, you can derive significantly different answers depending upon the number of data points you use. For example, you will get entirely different answers if you use an average of the prior 3 years' stock volatility as compared to an average of the quarterly, monthly, or daily volatility over the same period. At Genentech, our stock experienced a curious volatility over the last 3 years. Our volatility for calculating stock option disclosure was 75 percent in 2000, 63 percent in 2001 and 43 percent for 2002. We estimate expected stock volatility for 2003 to be 45 percent. However, our actual volatility over 3 years is near zero. For growth companies, estimating future stock volatility is highly subjective and the impact of inaccuracies can be material both to reported earnings and potentially to the stock price. If an expected volatility of 60 percent turns out to be 40 percent in practice, estimated options expense is skewed by almost 100 percent, or $119 million versus $62 million.

No specific number is right or wrong. Virtually any number is a possible answer, and each can be supported, but you will get a different stock option value depending on which you use. These differences can be significant, and it will be impossible to discern the difference between a knowledgeable projection that is wrong and one that is manipulative.

For small companies whose stock either does not trade at all or trades infrequently it is virtually impossible to compute "volatility." Yet, that is precisely what FASB is proposing. How can it be that something that is no more than a mere guess can result in more meaningful, comparable, and consistent financial statements?

FASB's desire to finish its stock option project quickly should not overtake the need to determine whether, and if so how, employee stock options can be accurately valued. When FASB promulgated FAS 123, it was believed that the Black-Scholes method could be used to determine an accurate value for employee stock options. Time showed that FASB's determination was wrong. Indeed, FASB recently considered prohibiting the use of this method because they determined that it simply does not work. Instead, FASB is now advocating that companies be allowed to use whatever method they want, with at least some preference for the use of what is known as a binomial model.

Binomial models require the use of "binomial trees." These are analogous to a series of decision trees that are used to predict possible future events. As a result, binomial models permit the modeling of behavior over time, thereby allowing the inputs used in the model to change during the life of the option. Black-Scholes, on the other hand, uses a specific and constant number throughout the life of the options. For example, under Black-Scholes, once an assumption is made about volatility, that assumed number remains constant over the term of the option. Under a binomial model, multiple assumptions could be made about volatility, so that the volatility estimate could change over the term of the option. Unfortunately, the volatility estimate, whether it changes or not, is still a guess. A binomial model, while more complicated than Black-Scholes, still suffers from the same problems.

Moreover, a binomial model can produce any answer you want, depending on how many binomial trees, or iterations, are performed. The following is a chart that

shows just how different the answers will be depending on how many binomial iterations are performed.*

According to binomial theory, the more decision trees that are used, the more precise the answer. The problem is that the more trees that are used, the closer the binomial estimate becomes to the Black-Scholes estimate. As a result, although the answer derived from a binomial model at any given point in time will likely differ from the answer derived under Black-Scholes, it will not be a "better" number, it will just be different. And if you follow binomial theory and use a significant number of binomial trees, you are back to the Black-Scholes number that FASB has already determined is inaccurate in virtually every circumstance.

Another model being considered as acceptable by FASB is known as "Crystal Ball." This model, like a binomial model, is more "flexible" than Black-Scholes. There are no set parameters. This means that one can use an unlimited number of variables, and that one can set each variable to a constant number or model the variable using what is called "Monte Carlo" simulation. As is the case with binomial methods, the more "sophisticated" the analysis—that is, the more variables and inputs used—the more the "Crystal Ball" number will converge to the Black-Scholes number.

In the end, all of the option pricing models that exist today were designed to value something else—freely tradable options—that are fundamentally different than employee stock options. Black-Scholes, binomial models, and Crystal Ball are identical in one key respect—they all require companies to predict the future, including future stock price and volatility. The only difference is that binomial models and Crystal Ball use more inputs to try to predict the future. One does not need to be a mathematician to know, however, that whether one is using 5 variables or 500 variables, the future remains impossible to predict accurately. Thus, if one agrees that continued use of Black-Scholes is not warranted, so, too, should one conclude that the use of binomial models or Crystal Ball is not warranted—they both lead inexorably to the wrong answer.

As I said in the beginning, this is a problem for companies, large and small. The problems for small companies are even worse because they frequently do not have staff qualified to run the models and make determinations as to what assumptions to use. This all translates to added cost. Any added cost uses precious resources needed my small companies to grow and add jobs.

I recognize that there are many who believe that expensing some number in the financial statements is better than expensing nothing. I, however, disagree. Under existing accounting rules, both here and abroad, an expense is to be recognized only if it can be reliably measured.

It is beyond doubt that current stock option pricing models cannot accurately value employee stock options in the hands of an employee let alone estimate a cost of those options to the company. Mandatory recognition of an expense that cannot be reliably measured flies in the face of the most fundamental accounting rules.

Some have also argued that there are lots of estimates in financial statements and that employee stock options are no different. This is false. Some estimates that are included in the financial statements, like deprecation, only present timing issues. A company knows how much it spent to buy, for example, a machine. But under the accounting rules, it is not allowed to expense the entire amount paid in the year of acquisition. Instead, the company must estimate the useful life of the machine and expense a prorata portion each year. While the company has to estimate the useful life, it still knows exactly how much it paid so, over time, the correct amount will ultimately be expensed. With stock options, the company not only has no reliable way to measure the anticipated "cost" of the options, but it also has no idea when, or even if, a single option will ever be exercised. Yet, under a mandatory expensing scheme, it would be required to determine the expense up front and recognize an expense. Even if you believe that options should be expensed, how can it be that an option that is never exercised can result in any expense?

For other types of estimates, like pension costs, companies are required to estimate their total out-of-pocket costs and expense these anticipated costs over time. To the extent the company's estimates prove incorrect, however, the company is allowed to "true-up" its expenses to equal what it actually ended up paying. Again, stock options are different. First and foremost, there never is any out-of-pocket cost for stock options. Further, while, like pension costs, a company must estimate its costs up front, unlike with pension costs, the company is never allowed to true up those costs.

There are other areas where estimates are so imprecise that no expense is recognized as in the contingent liability area. For example, assume a company is in liti-

* Held in Committee files.

gation. Unless a loss is probable, it is not permitted to recognize an expense. However, even if the company knows it will end up paying something to either settle the case or as part of a judgment, unless the company can reliably estimate what that amount will be, which is virtually never the case, the company cannot recognize an expense until that expense actually materializes. It must, however, report the contingency in its financial statement footnotes. Stock options should not be treated differently. In the end, mandatory expensing of employee stock options is bad accounting and is in direct conflict with fundamental accounting principles.

In conclusion, Genentech strongly urges that neither FASB nor the Congress rush to judgment on this complicated yet important issue. Rather, we must attempt to address the significant shortcomings of existing option pricing models or develop new models before mandating their inclusion on the face of financial statements. One prudent way of moving forward would be to "road test" models through footnote disclosure to discern whether they actually work, rather than mandating wholescale change and risking what we believe would be severe consequences for small businesses and their employees.

We look forward to working with this Committee and with FASB on this issue. Thank you for the opportunity to testify.

STATEMENT OF JEANNINE KENNEY

VICE PRESIDENT, PUBLIC AFFAIRS AND MEMBER SERVICES
NATIONAL COOPERATIVE BUSINESS ASSOCIATION

NOVEMBER 12, 2003

Senator Enzi and Members of this subcommittee, on behalf of the National Cooperative Business Association and the thousands of U.S. cooperative businesses that we represent, thank you for the opportunity to testify on the need for clarity on, and resolution of, issues raised by Financial Accounting Standard No. 150.

Introduction

The National Cooperative Business Association is the only national organization representing cooperatives across all sectors of our economy including agriculture, childcare, electricity, finance, food retailing and distribution, healthcare, housing, insurance, purchasing and shared services, telecommunications and many others. Our mission is to develop, advance and protect cooperative enterprise.

Of the many financial challenges confronting cooperatives in recent years, few have generated as much concern and uncertainty as FAS 150. How and whether these concerns are resolved will have enormous impact on the balance sheets of cooperatives, and equally important, on the individual members those cooperatives serve, many of whom are small business people themselves—farmers and ranchers, and the independent owners of local hardware stores, pharmacies, hotels, restaurants, office supply stores, newspapers, and the many other independents served by purchasing cooperatives.

For this reason, NCBA and its members are extremely grateful to FASB for its decision last Friday to indefinitely defer FAS 150 for mandatorily redeemable instruments, other than those that are redeemable on fixed dates. We hope to work with FASB as it reconsiders and evaluates the implementation issues associated with FAS 150. Our comments below reiterate and build upon the comments submitted to FASB in past comment periods for FAS 150.

Co-op Basics: 40,000 Strong With 120 Million Members

To understand why FAS 150 has been so troubling to co-ops first requires an introduction to co-op structure.

The more than 40,000 co-ops in this country are, by definition, businesses that are owned and democratically controlled by their members—the people who buy the goods or services provided by the cooperative, rather than by outside investors. About 120 million Americans are members of a cooperative—or more than half of all adults. To put the importance of the cooperative sector into perspective, note that cooperatives outnumber investor-owned firms by more than two-to-one.

Though many cooperatives are large and well-known businesses—some are included in the Fortune 500—the vast majority of cooperatives are small, community-based businesses such as food cooperatives, electric cooperatives, agricultural marketing and supply co-ops, worker-owned cooperatives, and purchasing and shared services cooperatives that serve tens of thousands of independently owned businesses across America's towns and cities. These cooperatives and their members generate millions in economic activity, creating jobs, wealth, and opportunity.

Cooperatives Fall Into Four Categories:

- Producer-owned cooperatives—These are cooperatives owned by farmers or craftsmen who form a co-op to jointly market, process or produce a like-product. There are 1,600 farmer- or rancher-owned marketing or processing cooperatives in the United States, most of which are local co-ops. The growth of new generation co-operatives-small co-ops that specialize in value-added agricultural processing has been spurred by programs and incentives, such as USDA's Value-added Producer Grants program, that have originated in the U.S. Senate. Renewable fuels co-operatives—those that process ethanol, biodiesel, and wind power—are a growing segment of this category.
- Consumer-owned cooperatives—Representing the largest category of co-ops, these cooperatives are owned by the consumers who buy the goods or services of the business. They are largely small and local in nature and include food co-ops, credit unions, rural electric and telecommunications cooperatives, housing co-ops, parent-owned childcare co-ops, and consumer-owned HMO's.
- Worker-owned cooperatives—These are cooperatives that are owned and controlled by their employees. They are similar to companies with Employee Stock Ownership Plans (or ESOP's) in that the workers own the company. However, in a worker cooperative, the employees benefit from the profitability of the company earlier than ESOP employees. Members of worker-owned co-ops receive annual taxable dividends on the company's earnings, rather than waiting for retirement to cash in their stock.
- Purchasing and shared services—These are cooperatives that are owned by individuals or small businesses that band together to jointly buy goods or services as a group, thereby lowering their input costs. Unlike buying clubs, the members of purchasing cooperatives actually own the company, ensuring that it is acting only in their best interests in procuring inputs and services. This is a growing segment of the co-op sector, as more and more small businesses see purchasing co-ops as the key to their survival. We estimate that, nationwide, more than 50,000 independent businesses are members of purchasing co-ops. The Nation's 1,600 local farm supply and service co-ops fall into this category, since they are effectively purchasing co-ops for farmers and ranchers.

Co-op Patronage Equity

Because co-ops are member-owned businesses, their equity is provided by their members. Generally speaking, co-ops do not issue public debt, though there are a few exceptions to this rule. Co-op equity, in most cases, consists largely of, or in many cases, solely of member equity.

A co-op member will make an equity investment, usually in nominal amounts, in a cooperative upon becoming a member. This investment represents a member's ownership interest in the cooperative. This equity stake grows or declines depending on the co-op's profitability.

It is important to understand that, unlike investors, co-op members join a cooperative in order to benefit from the goods and services it offers, not to make a substantial return on their initial investment. That is, consumers join food co-ops or credit unions in order to shop at a particular grocery store and enjoy discounted prices to members or better rates and lower fees. Farmers join an agricultural marketing co-op to benefit from the improved leverage that cooperative has in negotiating prices for their crop or the premium enjoyed through the co-op's branding of products. Small businesses join a purchasing co-op to reduce their costs of doing business, and workers join a worker-owned co-op to better enjoy the profitability of that company through annual dividends.

All co-ops operate as not-for-profit businesses in that they return any profits they earn to their members in the form of end-of-year dividends based on the amount of business a member did with the co-op—these are referred to as patronage dividends. Members receive dividends either in the form of cash, or as equity held by the co-op and allocated to individual members-often known as allocated patronage capital or capital credits or both. Cooperative patronage capital therefore is the accumulation of capital from revenues in excess of expenses over time.

Allocated patronage capital is how a cooperative, and often the only way, builds up equity in the company. It is recognized by members as risk capital. In the unfortunate incidence of a bankruptcy, co-ops may never return equity to members. Debt holders are paid first. Patronage capital is an asset that can be called in by lenders. Holders of equity are paid last, if at all.

By FASB's own definition, allocated patronage equity is true equity. FASB Statement of Financial Accounting Concepts Statement No. 6, defines equity as the ownership interest in the business. In a co-op, the equity shares of members—the owners—is their ownership interest. Further, Concepts Statement No. 6 states,

"equity distributions to owners are at the discretion and volition of the owners or their representatives after satisfying restrictions imposed by law, regulation, or agreements with other entities."

In the case of cooperatives, the representatives of the owners are the members of the co-op board of directors. Co-op boards of directors, which are elected by members, retain the ultimate discretion as to how or whether to return allocated equity to members. Co-ops have a variety of arrangements regarding redemption of members' shares.

Some co-ops repurchase the shares of members upon their withdrawal from the co-op, upon death, or upon reaching retirement or a certain age. Other cooperatives have a policy of revolving equity of the cooperative over a period of time once specific equity levels are achieved and the financial condition of the co-op allows.

Redemption decisions may be based in board policy, practice, or in the co-op's bylaws. However, most co-ops have no provisions in their bylaws, but have a past practice of repurchasing members' shares upon withdrawal, death, retirement, or on some revolving basis. And some co-ops may never redeem member equity. Co-op boards make such discretionary redemption decisions based on the financial and other needs of the cooperative. Boards have no such discretion with respect to repayment of true debt obligations.

It is important to note that cooperative boards are elected by the members and change over time. There can be no assumption, then, that the practices and policies of past boards will be adopted by future boards.

Finally, in instances when the discretion of a co-op board to redeem equity has been challenged, courts have consistently affirmed that the board of a cooperative has discretion with respect to redemptions.

Therefore, regardless of redemption policies, co-op patronage capital retains all the characteristics, as defined by FASB, of equity.

FAS 150

FAS 150, in the form approved by FASB in May, raises serious and unanswered questions for cooperatives that affect their financial solvency, their ability to meet loan agreements and ultimately, the ability of the co-op board of directors to exercise its authority over redemption of equity.

Again, we are grateful to FASB for its decision to indefinitely defer FAS 150's provisions regarding mandatorily redeemable shares of nonpublic entities—the provision of greatest concern to co-ops—pending further board action. This will provide time for cooperatives to work with FASB on unresolved issues raised by any new accounting standard.

Cooperatives and their membership organizations have been following FASB's work that culminated in FAS 150 for several years and have actively participated in the comment periods throughout FASB's process. The recent comment period on FAS FSP 105–c, the staff position regarding delay of the effective date, drew more than 70 comments from cooperatives, or roughly 70 percent of all comments FASB received on this staff position.

However, we are troubled that the concerns and substantive arguments of cooperatives, expressed through the series of FASB comment periods and personal meetings, were not heard until the eleventh hour. These concerns are similar to those raised by other professions that actively participated in this process, architectural, engineering and construction-related firms.

Key Issues Regarding Mandatorily Redeemable Financial Instruments

At the heart of co-op concern regarding FAS 150 is how the accounting profession will interpret the new rule with respect to cooperative patronage capital and whether it will be considered a "mandatorily redeemable financial instrument" under the varying conditions for redemption. Fundamentally, we believe that co-op patronage capital should be classified as equity, rather than as liabilities, until such time as it will be redeemed.

FAS 150 stipulates that mandatorily redeemable financial instruments shall be classified as liabilities unless redemption is required to occur only upon the liquidation or termination of the reporting entity. FASB defines "mandatorily redeemable" to include instruments that embody "an unconditional obligation requiring the issuer to redeem the instrument by transferring its assets at a specified or determinable date, or upon an event certain to occur." [Emphasis added.]

FASB defines "obligation" as a "conditional or unconditional duty or responsibility to transfer assets or to issue equity shares." Meanwhile, in the Statement of Financial Accounting Concepts No. 6, FASB notes that an obligation is broader than a "legal" obligation. Concepts No. 6 states that FASB uses "obligation" with "its usual

general meaning to refer to duties imposed legally or socially; to that which one is bound to do by contract, promise, moral responsibility, and so forth."

This very broad definition of "obligation" has raised significant questions about what an "unconditional obligation" within the context of FAS 150 will actually mean in practice and how it will be interpreted by the accounting profession.

Cooperatives and their accountants have questioned whether the absence of an unconditional legal obligation with respect to co-op equity redemptions is sufficient to exclude co-op patronage capital from reclassification as "mandatorily redeemable instruments." Though most co-op boards retain discretion on equity redemptions as noted above, past discretionary practices to redeem such equity under different situations could constitute a constructive duty or obligation, even though there is no legal obligation to redeem.

Unofficial conversations between cooperative representatives and FASB staff made clear that this could indeed be an outcome of FAS 150. A history of certain discretionary redemption practices could therefore require reclassification of all member equity as liabilities even if there is no obligation to continue those practices in the future.

Without such clarification, co-ops with a practice of redeeming capital to heirs of deceased members, to retiring members, or of revolving capital run the risk of having all of their equity reclassified as debt even though only a fraction or no capital may be redeemed in a given year. Co-op equity is never redeemed all at once, except upon the sale or dissolution of the cooperative. This would be a nonsensical outcome.

In addition, cooperatives are concerned that FASB has failed to recognize the similarities between co-op patronage capital redemption and similar instruments issued by for-profit companies that are not considered by FASB to be mandatorily redeemable.

For example, allocated patronage capital in a cooperative is analogous to retained earnings in a for-profit firm. Just as for-profit companies may distribute retained earning to owners by paying dividends, cooperatives may return patronage capital to owners by retiring patronage capital. In both instances, the payments are made at the discretion of the board of directors. The decision to return capital to owners in a co-op is made using the same decision process as that used by for-profit companies regarding dividend payouts for preferred or nonredeemable common stock—by managing the entities' capital structure and cashflow and examining income tax ramifications.

FAS 150 clearly states that for companies issuing nonredeemable common or preferred stock, "Declaration of dividends is at the discretion of the issuer, as is a decision to reacquire shares." It therefore concludes, "Nonredeemable outstanding shares of both common and preferred stock lack an essential characteristic of a liability." This is also clearly the case with co-op patronage capital—in most cases, the co-op has no obligation to redeem member shares. But FAS 150 provides no clarification on this matter for cooperatives.

We are concerned by what will be, without further clarification, disparate treatment of cooperatives relative to for-profit companies exercising similar discretion. If a for-profit company with continuing dividend payouts is not considered by FAS 150 to have mandatorily redeemable retained earnings, it follows that a cooperative that has regular redemptions of patronage capital must not be considered to have mandatorily redeemable patronage capital.

For this reason, cooperatives are seeking greater clarification by FASB that just as companies issuing nonredeemable common stock have no obligation to pay dividends or reacquire shares despite a past practice of doing so, cooperatives likewise have no obligation to redeem member shares, although they may have in the past.

In some cooperatives, the agreement between a member and the co-op does include redemption upon termination of membership. However, since it is unclear when or if such termination will occur, equity associated with such agreements should not be considered mandatorily redeemable. It is important to underscore, here, that regardless of such agreements, a member may never receive equity redemption, depending on the financial state of the business—this is because such equity represents a true ownership interest.

Moreover, we seek clarification that patronage capital shall not be classified as debt until such time as a co-op makes a decision to redeem it and then only that portion of capital would be classified as a liability. Any other outcome seriously mistakes the nature of the relationship between a cooperative and its owners.

Events Certain to Occur

Also unclear in FAS 150 is what constitutes an "event certain to occur." While death falls into this category, it is unclear what other events might be captured.

For example, some cooperatives, such as purchasing cooperatives for small businesses, may have an obligation to redeem a member's equity when that member leaves the co-op. However, in cases where the member is a small business corporation—as is the case for many small business purchasing cooperatives—there can be no certainty that the membership of that corporation in the purchasing cooperative will ever be terminated. In many cases, membership is maintained by the successor owners of the small business. Such obligations to redeem equity should not be reclassified as mandatorily redeemable since the event triggering the redemption is not certain to occur.

Moreover, FASB should reevaluate whether it is appropriate to reclassify equity as debt even for some events that are certain to occur, such as the death of a member. In this example, it is preposterous that all member-owners of a cooperative would die in a given year, bringing into question why the equity of all members should be reclassified as debt, even if there were a mandatory obligation to redeem.

In summary, NCBA and its cooperative members seek greater clarification from FASB on the following:

- Co-op patronage capital represents a true ownership interest of the members of a cooperative and is properly classified as equity.
- Co-op patronage capital shall not be considered a mandatorily redeemable financial instrument until a decision is made or action taken to redeem a portion of that capital, and that only that portion scheduled for redemption is properly classified as a liability.
- For the purposes of FAS 150, unconditional obligations shall include only legal obligations rather than those perceived as "constructive obligations," a "socially imposed duty" or "moral responsibility." Uncertainty in this area could be disastrous for many small businesses around the country.
- That "events certain to occur" be narrowly defined so as not to include events that may or may not occur depending on the nature, type and structure of a business.

Potential Impact of FAS 150 on Cooperatives

The uncertainties associated with the application of FAS 150 to cooperative patronage capital generated significant concern among cooperatives because for many of them, patronage capital makes up the entirety of the business's equity. The new standard, if implemented as originally proposed and without further clarification, could have required many cooperatives to reclassify all of their equity as debt, creating the appearance of insolvency. It is hard to overstate the negative consequences of that outcome.

Other Impacts Include:

- Debt Financing—The impact of a dramatic increase in liabilities on co-op balance sheets would put many cooperatives in technical default of their loan agreements that require certain levels of equity. Moreover, a balance sheet that reflected zero equity would make it difficult for co-ops to secure new debt financing agreements.
- Relationships with Suppliers—Vendors and suppliers to cooperatives also frequently rely on the business's balance sheet to assess credit worthiness. An increase in a co-op's liabilities could adversely affect its relationships with its suppliers.
- Impact on Members—If FAS 150 would have required co-ops to discontinue discretionary redemptions, co-op members and their heirs would be adversely affected by the standard. For purchasing cooperatives, FAS 150 could jeopardize the financial solvency of the co-op, adversely impacting its ability to serve its small business owners. And to the extent the reclassification would jeopardize the financial solvency of the business, all member-owners of a cooperative would be harmed.
- Reduced board discretion on equity redemptions—If FAS 150 had required reclassification of all member equity, it would have effectively converted what had been discretionary redemptions into mandatory redemptions. That is, the standard could have reduced the discretion of the board in managing the overall financial health of the cooperative by eliminating its ability to determine when and whether equity would be redeemed. This outcome would imperil many cooperatives.

FAS 150 Does Not Improve Transparency of Financial Statements

Though one intent of FAS 150's provision on mandatorily redeemable shares was to improve the transparency and accuracy of financial statements, for cooperatives it would have had the opposite effect. It would have seriously misstated the financial health of financially sound and thriving businesses.

FAS 150 addressed this situation by allowing a business with only mandatorily redeemable shares to include them under liabilities listed separately as "shares sub-

ject to mandatory redemption," in order to distinguish them from other liabilities. But this allowance tacitly suggests that, in fact, there is something about these instruments that is different from standard liabilities that should not give lenders pause. What is different, of course, is that for cooperatives, the instrument is truly equity.

FASB staff also suggested that the issues raised by cooperatives could be addressed by educating lenders and suppliers regarding the nature of co-op patronage capital. However, changes to accounting standards that require more, not less, explanation cannot represent an improvement in transparency.

Conclusion

NCBA hopes to work with FASB over the coming months to clarify that co-op patronage capital remains properly classified as equity. Moreover, discretionary redemptions in the past should not result in constructive obligation for redemptions in the future.

The satisfactory resolution of these accounting standard questions is critical to the continued health and growth of community-based cooperatives across the United States, and their ability to serve their members, including the many small businesses that belong to cooperatives.

Mr. Chairman, we thank you for opportunity to testify on this important issue.

PREPARED STATEMENT OF MARK HEESEN

PRESIDENT, NATIONAL VENTURE CAPITAL ASSOCIATION

NOVEMBER 12, 2003

Introduction

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 United States 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 United States 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 percent 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 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 (VIE's). 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 (SPE's) 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 VIE's 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 VIE's 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 thshould 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 the costs imposed to meet that standard, as compared with other alternatives, are justified in relation to the overall benefits from improvements in financial reporting. . . The Board has long acknowledged that the cost of any accounting requirement falls disproportionately on small entities 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 do not have analysts to make this interpretation? Over 50 percent of the Nasdaq companies do not have analyst coverage. With only 50 percent 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 percent. 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 percent 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 2 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.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR ENZI FROM ROBERT H. HERZ

Q.1. In your written testimony you referred both to "field visits" and "field testing" that FASB occasionally conducts. Please elaborate on the difference between the two. Please list all companies currently involved in the testing process and denote which are small businesses. Please list all small companies that will be included in any future testing.

A.1. A "field visit" generally involves Financial Accounting Standards Board (FASB or Board) members or staff meeting with representatives of individual enterprises or firms that volunteer to engage in an in-depth discussion of a proposed approach or a proposed standard. In contrast, a "field test" generally involves the volunteer representatives engaging in the actual application of a proposed accounting approach or standard to certain past or current transactions.

Field visits or field tests are not required by the FASB's Rules of Procedure. They are supplemental to the Board's open, extensive, and public due process procedures. The Board, on occasion, has chosen to conduct field visits or field tests when, in the judgment of the Board, those procedures might provide the Board with new information that may assist in obtaining a better understanding of the types of incremental costs and benefits that various parties may incur or realize in gathering, processing, understanding, and using the information that results from a proposed approach or standard.[1]

Field visit participants may request that their participation and the information they provide to the FASB receive confidential treatment. Consistent with the FASB's Rules of Procedure, those requests are routinely granted.

Below is the current list of enterprises that have, to-date, volunteered to participate in the field visits in connection with the project to improve the accounting for equity-based compensation. As noted, some participants have requested confidential treatment.

Your question does not include a definition of "small businesses." As I indicated in my testimony, it has been our experience that users, auditors, and preparers of financial reports have very different notions of what constitutes a small business. The list, therefore, denotes three objective categories of field visit participants: (1) public enterprises (those companies that are registrants under the Federal securities laws); (2) nonpublic enterprises (those enterprises that are not registrants under the Federal securities laws); and (3) compensation consulting firms (those firms having both public and nonpublic enterprises as clients).

Public Enterprises

Aetrium Incorporated
Baxter International Inc.
CVS Corporation
EMC Corporation

[1] The FASB recently revised its internal procedures to provide that field visits be undertaken prior to the issuance of a proposal for public comment for projects that are expected to introduce significant change or cost to users, auditors, and preparers of financial reports.

J.P. Morgan Chase & Co.
Siebel Systems, Inc.
6 additional enterprises requesting confidential treatment

Nonpublic Enterprises

Cargill, Incorporated
Google, Inc.
3 to 5 additional enterprises to be identified by Grant Thornton LLP[2]

Compensation Consultants

Aon Consulting
Mercer Inc.
Mellon Consulting

Q.2. Will the field visits and/or road testing include testing of the valuation models to be set forth in the upcoming draft proposal for FAS 123? Will the testing look at the degree of sophistication that is necessary by small companies to implement a valuation model to be set forth in the upcoming draft?

A.2. As indicated above, the FASB's ongoing field visits in connection with the project on improving the accounting for equity-based compensation are designed to provide additional supplemental input to the Board. That input is intended to further assist the Board in assessing and understanding the nature of the costs that some enterprises would incur as a result of applying the major tentative decisions made by the Board at public meetings since March 2003.[3]

More specifically, the Board's field visits are designed to solicit a broad range of information from participants about the Board's tentative decisions. That information is expected to include input on costs that participants would expect to occur in training or educating personnel or employees about the requirements to estimate the fair value of equity-based compensation as described in the Board's tentative decisions. Participants will be encouraged to comment on all aspects of the changes to reporting that are contemplated in those decisions.

As indicated in my testimony, the Board's tentative decisions would not require that a nonpublic enterprise, including a small business, use an option-pricing model to determine the fair value of equity-based compensation. The Board has tentatively decided that nonpublic enterprises would be permitted to account for equity-based compensation using the intrinsic value method through exercise date. That method, defined as the difference between the exercise price of the award and the underlying stock price, is relatively simple, is well understood, and will result in a total expense for financial reporting purposes equal to the amount of expense that the enterprise would currently report for income tax purposes.

[2] Grant Thornton LLP (GT) is a national accounting, auditing, and business advisor whose clients are largely nonpublic enterprises. GT has agreed to assist the FASB in conducting the field visits for some nonpublic enterprises. GT is currently in the process of identifying three to five nonpublic enterprises to volunteer to participate in the field visits.

[3] All of the Board's major tentative decisions in connection with the project to improve the accounting for Equity-Based Compensation, and other FASB projects, are publicly available on the FASB's website at *www.fasb.org.*

Q.3. What does the FASB intend to pursue in connection with its equity based compensation project?

A.3. The Board plans to continue its public deliberations on the project to improve the accounting for equity-based compensation. Those public meetings will include deliberations about the results of the field visits and other miscellaneous issues that have not yet been deliberated at public meetings. Announcements of those public meetings, the minutes of previous meetings, a detailed summary of the Board's tentative decisions to-date, and other materials relating to the project are publicly available on the FASB's website.

The Board currently plans to be in a position to issue a proposed standard for public comment in the first quarter of 2004. The Board, at public meetings, will carefully consider all input received in response to any proposal before any final decisions are made. The Board's current plan is to be in a position to complete its public redeliberations of the proposal and issue a final standard in the second half of 2004.

Q.4. Will the Option Value Group's final recommendation be made publicly available?

A.4. The FASB established the Option Valuation Group (OVG) to provide the Board with an additional source of input on how best to develop a standard to measure the fair value of equity-based compensation. The OVG is composed of individuals who are leading experts on issues relating to equity pricing.[4]

Like other FASB task forces and advisory groups, the OVG is purely advisory. Thus, the OVG has not, and will not, be requested by the Board to develop a proposal or form a collective view or recommendation on any specific issue. Rather, individual members of the OVG are solicited by the Board and FASB staff on an ongoing basis to obtain their individual views, comments, and recommendations on specific issues that are within their areas of expertise and relevant to the Board's deliberations.

As was indicated above, those individual views, comments, and recommendations are only one source of input to the Board in considering how best to measure the fair value of equity-based compensation. All decisions of the Board, including all measurement decisions, are deliberated at public meetings after carefully considering the views, comments, and recommendations of all interested parties, including users, auditors, and preparers of the financial reports of public and nonpublic enterprises.

Q.5. In your testimony, you refer to the precepts that FASB adheres to when establishing an accounting standard. One of those precepts is a "cost-benefit" analysis that FASB conducts on each proposal. Please elaborate on the "cost-benefit" you intend to conduct in connection with your equity-based compensation project, and please indicate whether or not such a "cost-benefit" analysis includes an economic impact study assessing the consequences of a mandatory expensing standard.

Please elaborate on findings of the cost-benefit analysis that was done on the proposal for FAS 150. Was a cost-benefit analysis done

[4] The FASB's website includes the minutes from the Board's July 8, 2003, public meeting with the Option Valuation Group.

for FIN 46. If so, please elaborate on how the analysis was done and the findings of the analysis.

A.5. As indicated in my testimony, assessing the benefits and costs of a new or different method of accounting is integral to the Board's decision-making process. Every issue in an FASB project has its own mix of incremental improvement and incremental cost for the Board to consider.

The principal benefit of any new accounting standard is to provide information that is useful in making business and economic decisions. Secondary benefits include:

- Maintaining and increasing the credibility of financial statements, which is critical to investor confidence.
- Lowering the cost of capital.
- Increasing the utility that users gain from the new accounting information, including the ability to select better among various investment options.
- Increasing the knowledge that a preparer gains about the financial position and results of the enterprise.

The Board's assessment of a standard's benefit to preparers, auditors, creditors, investors, and other users is unavoidably subjective. In making that assessment, the Board also considers the costs of not issuing a standard (for example, shareholder losses associated with nontransparent accounting), which is inherent in the benefits indicated above.

As with the benefits associated with a new standard, a standard's incremental costs are borne by preparers of financial reports as well as by auditors and users of those reports. The types of costs associated with a new accounting standard are varied; some are one-time costs, while others are ongoing costs. The FASB' s conceptual framework identifies a number of costs that are relevant for the Board to consider as part of its assessment. Those costs include:

- Costs to the preparer of analyzing, developing, collecting, and processing the information,
- Costs to the preparer and the auditor of understanding the new requirements, and
- Costs to the users of analyzing and interpreting the new information.[5]

Those costs do not include potential "economic impact" costs. As indicated in my testimony, the mission of the FASB is to develop and improve financial accounting and reporting standards that result in transparent, credible, and unbiased financial information. Our mission is premised on the long and widely held belief that unbiased and objective financial information enhances economic and policy decisions, comparisons between enterprises, capital allocation, investor trust and confidence in financial reporting and the capital markets, and the growth and stability of the U.S. economy. Slanting an accounting standard to favor a particular transaction, industry, or special interest group, because of some potential "economic impact," thwarts the attainment of those objectives.

[5] Statement of Financial Accounting Concepts No. 2, Qualitative Characteristics of Accounting Information, May 1980, paragraph 137.

There will always be many different business, economic, and social objectives that many may agree are worthy of encouraging, promoting, or otherwise subsidizing in some manner. Most users, auditors, and preparers of financial reports, however, agree that permitting or creating distortions through accounting standards and the resulting financial information is not the way to achieve those objectives.

The purpose of financial accounting and reporting is to facilitate and promote sound, fair, and credible information to enable informed economic decisions. Diverging from that purpose to fulfill some other objective severely impairs the benefits and utility of accounting standards, weakening the fabric of the capital market system.[6]

In addition to undertaking the field visits, described above, the Board's assessment of the costs and benefits resulting from the project to improve the accounting for equity-based compensation will include the following additional procedures:

- Continuous dialogue with users, auditors, and preparers of financial reports throughout the deliberations and redeliberations about the types of benefits they expect to realize and the costs they expect to incur as a result of any new requirements,
- An explicit request in any proposal for public comment for input on how the Board could further reduce the related costs without reducing the benefits of the proposed requirements, and
- Discussions at public Board meetings about the results of the steps the Board has taken or will take to further consider and balance the costs and benefits of applying any new requirements and the relative costs and benefits associated with alternative approaches that were considered and rejected.

The Board will not issue a final standard in connection with the project on equity-based compensation unless it can conclude, after deliberations at public meetings, that the issuance of any new requirements is a sufficient improvement to financial reporting to justify the perceived costs.

With respect to Statement of Financial Accounting Standards No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity (Statement 150), and FASB Interpretation No. 46, Consolidation of Variable Interest Entities (FIN 46), both standards address certain financial accounting and reporting issues that were brought into the spotlight following the Enron Corp. bankruptcy.[7] Those issues include the accounting for certain debt obligations that were classified as equity and the accounting for certain off-balance-sheet entities, respectively. Many preparers, auditors, and users of financial reports, including the U.S. Securities and Exchange Commission and many Members of

[6] Testimony of Paul A. Volcker before the U.S. House of Representatives, Committee on Financial Services, June 3, 2003, page 2.

[7] "Rebuilding Investor Confidence, Protecting U.S. Capital Markets—The Sarbanes-Oxley Act: The First Year," *House Committee on Financial Services,* pages 3 and 4; Olaf de Senerpont Dornis, "Consolidating Options," *Daily Deal,* June 2, 2003; "Accounting Rulemakers Tighten Rules on Liabilities," *Reuters News,* May 15, 2003; "In Quick Compromise, FASB Issues Tighter Rules on SPE's," *Accounting Today,* March 2003; "New Rule to Curb Accounting Abuse," *The Seattle Times,* January 17, 2003; Jackie Spinner, "FASB Tightens Rules on Special Purpose Entities," *Washingtonpost.com,* January 17, 2003; Deepa Babington, "Tougher Rules on Enron-Type Deals Approved," *Reuters,* January 15, 2003.

Congress, requested that the FASB promptly address those issues. The Board worked as expeditiously as practicable to establish improved requirements in those areas while at the same time fully complying with our open, extensive, and public due process procedures.

In connection with both Statement 150 and FIN 46 the Board concluded, in large part because of the broad and heightened level of concern about certain of the issues addressed in those standards, that issuance of the new requirements resulted in a sufficient improvement to financial reporting to justify the perceived costs. The Board, however, provided for special transition provisions, and special deferred effective dates for nonpublic entities in both standards to minimize the costs of the new requirements.[8] Statement 150 included the following summary description of the Board's assessment of the costs and benefits of that standard:

> The mission of the FASB is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including preparers, auditors, and users of financial information. In fulfilling that mission, the Board endeavors to determine that a proposed standard will fill a significant need and that the costs imposed to meet that standard, as compared with other alternatives, are justified in relation to the overall benefits of the resulting information. Although the costs to implement a new standard may not be borne evenly, investors and creditors—both present and potential—and other users of financial information benefit from improvements in financial reporting, thereby facilitating the functioning of markets for capital and credit and the efficient allocation of resources in the economy.
>
> The Board determined that the requirements in this Statement would result in improved financial reporting. In this Statement, certain obligations that require a transfer of assets and that meet the definition of liabilities in Concepts Statement 6 will be reported as liabilities rather than as equity or between the liability and equity sections of the statement of financial position. Also, certain obligations that can be settled by issuance of an entity's equity shares but lack other characteristics of equity will be reported as liabilities, rather than as equity as previously required under Issue 00–19. Those changes result in financial statements that are more representationally faithful and present a more complete depiction of an entity's liabilities that will assist users in assessing the future cash flows and equity share issuances of an entity.
>
> The Board believes that the incremental costs of implementing this Statement have been minimized principally by (a) requiring cumulative-effect transition instead of restatement of financial statements and (b) providing a delayed effective date for mandatorily redeemable financial instruments of nonpublic companies. Although the one-time costs for changes needed to apply the accounting requirements of this Statement may be significant, the benefits from more representationally faithful information will outweigh those one-time implementation costs and will be ongoing.[9]

As indicated in my testimony, since the issuance of Statement 150 and FIN 46, the FASB has received input from many users, auditors, and preparers of financial reports, including representatives of small businesses, about implementation issues relating to the application of certain provisions of those standards. In response to that input, the FASB has issued over a dozen FASB Staff Posi-

[8] Statement 150, May 2003, paragraphs 29 and 30; FIN 46, January 2003, paragraphs 27–29.

[9] Statement 150, paragraphs B82–B84.

tions,[10] and a proposed modification to FIN 46,[11] to address certain of the technical and implementation issues that have been raised.

The FASB continues to monitor the application of Statement 150 and FIN 46. The FASB will consider the issuance of additional guidance, if necessary, to assist users, auditors, and preparers, including representatives of small businesses, in implementing the provisions of those standards in a cost-effective manner.

Q.6. With respect to FAS 150, you stated that while this accounting standard has been postponed indefinitely with respect to closely held companies there is still more to be accomplished. How will the FASB reach out to small entities to ensure that they are part of the discussion process for the remaining elements?

A.6. As indicated in my testimony, the Board has begun embarking on Phase 2 of its project to improve the accounting for Financial Instruments: Liabilities and Equity. The objectives of Phase 2 include:

- To improve the accounting and reporting by issuers for financial instruments that contain characteristics of equity, liabilities, or assets, and
- To amend and improve on the definitions of liability, equity, and, perhaps, assets in the FASB's conceptual framework, such that decisions made in Statement 150 and in Phase 2 are consistent with those definitions.

Phase 2 also will include a reconsideration of implementation issues, and, perhaps, classification or measurement guidance, for mandatorily redeemable instruments of nonpublic enterprises. As

---

[10] FASB Staff Position No. 150–1, "Issuer's Accounting for Freestanding Financial Instruments Composed of More Than One Option or Forward Contract Embodying Obligations under FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity,"* October 16, 2003; FASB Staff Position No. 150–2, "Accounting for Mandatorily Redeemable Shares Requiring Redemption by Payment of an Amount that Differs from the Book Value of Those Shares, under FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity,"* October 16, 2003; FASB Staff Position No. 150–3, "Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests under FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity,"* November 7, 2003; FASB Staff Position No. 150–4, "Issuers' Accounting for Employee Stock Ownership Plans under FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity,"* November 7, 2003; FASB Staff Position No. 46–1, "Applicability of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities,* to Entities Subject to the AICPA Audit and Accounting Guide, *Health Care Organizations,"* July 24, 2003; FASB Staff Position No. 46–2, "Reporting Variable Interests in Specified Assets of Variable Interest Entities as Separate Variable Interest Entities under Paragraph 13 of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities,"* July 24, 2003; FASB Staff Position No. 46–3, "Application of Paragraph 5 of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities,* When Variable Interests in Specified Assets of a Variable Interest Entity Are Not Considered Interests in the Entity under Paragraph 12 ofInterpretation 46," July 24, 2003; FASB Staff Position No. 46–4, "Transition Requirements for Initial Application of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities,"* July 24, 2003; FASB Staff Position No. 46–5, "Calculation of Expected Losses under FASB Interpretation No. 46, *Consolidation of Variable Interest Entities,"* July 24, 2003; FASB Staff Position No. 46–6, "Effective Date of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities,"* October 9, 2003; FASB Staff Position No. 46–7, "Exclusion of Certain Decision Maker Fees from Paragraph 8(c) of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities,"* November 26, 2003; Proposed FASB Staff Position No. 46–d, "Treatment of Fees Paid to Decision Makers and Guarantors as Described in Paragraph 8 in Determining Expected Losses and Expected Residual Returns of a Variable Interest Entity under FASB Interpretation No. 46, *Consolidation of Variable Interest Entities;"* Proposed FASB Staff Position No. 46–f, "Evaluating Whether as a Group the Holders of the Equity Investment at Risk Lack the Direct or Indirect Ability to Make Decisions about an Entity's Activities through Voting Rights or Similar Rights under FASB Interpretation No. 46, *Consolidation of Variable Interest Entities."*

[11] FASB Proposed Interpretation, *Consolidation of Variable Interest Entities,* October 31, 2003.

part of that consideration the Board plans to again actively solicit the views of users, auditors, and preparers of the financial reports of nonpublic enterprises, including representatives of small businesses, in several ways, including:

- Seeking participation by representatives of small businesses on an FASB small business advisory committee,
- Seeking participation by representatives of small businesses on an FASB Financial Instruments: Liabilities and Equity resource group,
- Scheduling regular public liaison meetings and less-formal meetings with representatives of small businesses, and
- Participating in conferences and other speaking engagements sponsored by or attended by representatives of small businesses, which provide opportunities for having a dialogue with a broad range of users, auditors, and preparers of the financial reports of small businesses.

The Board presently expects to issue a proposal for public comment in connection with Phase 2 of the project on Financial Instruments: Liabilities and Equity in the second half of 2004.

As indicated in my testimony, the Board is aware of the significant focus over the past year on the financial accounting and reporting of public enterprises, in part, because of the many activities relating to the Sarbanes-Oxley Act of 2002. We, however, remain committed to serving the needs of all users, auditors, and preparers of financial reports, including those representing small businesses.

STATEMENT OF DAVID A. RAYMOND

PRESIDENT, AMERICAN COUNCIL OF ENGINEERING COMPANIES

NOVEMBER 12, 2003

Mr. Chainnan, on behalf of the American Council of Engineering Companies (ACEC), I am pleased to submit this testimony today before the Subcommittee on Securities and Investment hearing on the Financial Accounting Standards Board and Small Business Growth.

ACEC is the business association of America's engineering industry, representing 6,000 independent engineering companies throughout the United States engaged in the development of America's transportation, environmental, industrial, and other infrastructure. ACEC member firms represent the broad spectrum of the engineering industry, from very large firms to small, family-owned businesses. More than 60 percent of ACEC's membership, about 4,000 firms, are small businesses with fewer than 30 employees each. Overall, our members employ approximately 500,000 people throughout the 50 States. Founded in 1910 and headquartered in Washington, DC, ACEC is a national federation of 51 State and regional organizations.

ACEC is very appreciative of your leadership, Mr. Chairman, and that of the Ranking Member, Senator Dodd, in focusing the Subcommittee's attention on the Financial Accounting Standards Board (FASB) and the impact of FASB's actions on our members, particularly smaller engineering firms. The Statement of Financial Accounting Standards 150 (FAS 150), which was originally released last May, has generated considerable concern in the engineering industry. While it appears that FASB has made modifications to the statement in response to industry comments, we remain concerned over what the future may hold should FASB decide to proceed with implementation.

ACEC remains strongly opposed to FAS 150 as it was originally released. If implemented, FAS 150 will artificially and unfairly eliminate the net worth of many nonpublic engineering firms throughout the country. The statement will distort the true economic value of these firms and present a false picture to the readers of their financial statements, leading to errors, misunderstandings, and possibly the wrong conclusions.

As you know, Mr. Chairman, FAS 150 requires non-public companies to classify as liabilities any financial instrument issued in the form of equity that is "mandatorily redeemable." A financial instrument is "mandatorily redeemable" if it requires the company or entity to buy back the assets of a shareholder at a specific date or time, such as the death of the shareholder, retirement, or termination.

Since many firms have such arrangements in place where shares are automatically repurchased when a shareholder retires, resigns, or dies, the new standard is expected to affect most non-public engineering firms. Repurchasing arrangements are typically put in place in order to keep ownership within a family or small group of key management employees. Stock ownership in small companies is needed to fuel the entrepreneurial spirit; where an individual's efforts will reap future rewards based on such efforts. The obligation today is on the individual to perform; the firm's obligation to redeem the shares sometime in the future is affected by events that may or may not happen. More importantly, the value of this obligation varies based on a variety of internal and external factors, such as profitability (or lack thereof), industry or market conditions, and even gross national product (as it may relate to the availability of funding for Federal and State projects.). All of these factors, I am sure you will agree, are largely volatile, yet FASB apparently believes a specific and accurate valuation can be assigned. Worse still, any change in the valuation is to be reflected in the income statement of the entity.

Firms must follow FASB's standards to comply with generally accepted accounting principles and receive an unqualified audit opinion from their certified public accountant (CPA). Unfortunately, by classifying as debt equities held by company shareholders, the affect of the new standard would significantly reduce, or even eliminate, the net worth of non-public engineering firms. The revisions to financial statements as required by FAS 150 will not reflect an engineering firm's real financial condition, yet they will have dire consequences on its ability to obtain new clients, loans, bonding and insurance.

For example, under the requirements of FAS 150, an engineering firm seeking prequalification with a State department of transportation will present the agency with a financial statement characterized by an artificially high debt load that could effectively shut them out from competing for the design work on a road or bridge project.

The accounting required by FAS 150 recognizes only the eventual re-purchase obligation. It does not recognize the increase in assets that will result from the "re-

cycling" of such re-purchased shares for sale to other owners. When such re-cycling is recognized, there is no need for FAS 150.

Mr. Chairman, ACEC strongly recommends that FASB take steps to ensure that the new standard does not apply to non-public, non-SEC registered firms. We believe very strongly that more time and study is needed to carefully and completely assess the impact this standard will have on privately held engineering firms and others in the business community. We applaud FASB's efforts to bring more truth into financial reporting and believe that disclosure is important, but requiring the recording of redeemable stock as a liability when no date for redemption is known and where the valuation is questionable is wrong.

Today's hearing is a necessary and important first step in the education process. Once again, Mr. Chairman, on behalf of ACEC and the Nation's engineering industry, we thank you and Senator Dodd for your leadership on this important issue. We look forward to working with you in coming months. Thank you.

BIOTECHNOLOGY
INDUSTRY
ORGANIZATION

News Release

1225 Eye Street, NW • Suite 400 • Washington, DC 20005-5958 • (202) 962-9200 • Fax: (202) 962-9201

Stock Option Expensing Will Harm Small Biotech Companies

For Immediate Release
www.bio.org

Contact: Kathy Stover
(202) 962-9200

WASHINGTON, D.C. (November 12, 2003) — During testimony today before the Senate Subcommittee on Securities and Investment, Walter K. Moore, vice president for government affairs at Genentech Inc., said that proposed accounting rules mandating that companies expense employee stock options will be detrimental to biotechnology firms — particularly small, biotech start-up companies, which often use stock options as an enticement for employee recruitment.

Under current accounting standards, companies are permitted but are not required to expense employee stock options. The Financial Accounting Standards Board (FASB), however, is considering a proposal that would require all companies to expense the options.

Such a proposal would "greatly impact all companies that use broad-based employee stock options without providing investors with consistent, comparable and reliable financial information," Moore stated in testimony submitted to the Senate panel.

Proponents of the proposed changes in the FASB accounting standards argue that stock option expensing will provide investors with a clearer understanding of a company's financial health. However, the proposal would seriously hinder small, start-up biotechnology companies, which frequently offer stock options as part of an employee's overall compensation package

Moore told Senate panel members that existing problems with current option valuation methods applied by the FASB must be addressed or new models must be developed before wide scale accounting changes are implemented.

BIO represents more than 1,000 biotechnology companies, academic institutions, state biotechnology centers and related organizations in all 50 U.S. states and 33 other nations. BIO members are involved in the research and development of health-care, agricultural, industrial and environmental biotechnology products.