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Stacey Sutay

Subject: FW: Position paper

----Original Message----

From: Sally Carter [mailto:sally.carter@visionael.com]

Sent: Monday, June 07, 2004 5:31 PM

To: Len Tatore

Cc: Karen Salmansohn; 'aburns@technet.org'

Subject: Position paper

Dear Sir or Madam,

I have previously had the opportunity to testify in front of the Senate Committee on Small Business and Entrepreneurship on this specific issue and I would like to contribute our thoughts as part of the roundtable meetings next month. As a former securities lawyer and investment banker, I can provide a variety of insights into how the proposed regulations will impact various stakeholders in this issue. I am submitting a copy of my Senate Committee testimony as my position paper. Once again, thank you in advance for your consideration.

Marc E. Jones
President and Chief Executive Officer
Visionael Corporation
410 Cambridge Avenue
Palo Alto, California 94306
(650) 470 - 8920 (o)
(650) 470 - 8921 (f)
mejones@visionael.com

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Testimony

Of

Marc Jones

President and CEO

Visionael Corporation

"Stock Options and Small Business: Fostering Innovation and Growth"

April 28th, 2004

Senate Committee on Small Business and Entrepreneurship SR-428A Russell Senate Office Building Washington, DC Senators Snowe, Enzi, and Kerry, and distinguished members of this Committee, my name is Marc Jones and I am the President and Chief Executive Officer of Visionael Corporation. I appreciate you giving me the opportunity to share my views on the recently released Financial Accounting Standards Board (FASB) exposure draft calling for the expensing of broad based employee stock option plans and the impact this proposal will have on small businesses like Visionael.

Our small business is a leading provider of network security and network management solutions designed for the largest and most complex corporate, government, and service provider networks. We have more than 60 large customers worldwide, including Sprint, Verizon, EDS, IBM Global Services, Kaiser Permanente, Fidelity Investments, the Pentagon, and the White House Communications Agency.

Visionael is a privately held company founded in 1997 with 20 employees. Since that time, Visionael has created 50 jobs, and we now have approximately 70 employees. All of our employees have been granted stock options in our Company. Stock options, and a belief in the market opportunity for our Company, have encouraged our employees to continue to work at Visionael, because the longer they stay, the more their stock options vest.

Stock options have allowed Visionael to recruit and retain the brightest and most talented employees and have given our employees a deep personal interest in seeing our company grow. Our dedicated employees recognize that their hard work, long hours, and commitment today will lead to improved sales, improved profits, and a much stronger company. Our employees eagerly anticipate the day when our company makes the leap from a small privately owned business to becoming a publicly held company. And they recognize that the success or failure of Visionael rests in their hands. Day in and day out, they pride themselves with doing things more efficiently and more productively, so that the company where they work – and which they own – can succeed.

We rely on rapid innovation and a dedicated work ethic to succeed in the marketplace. Our small business has been able to compete with corporations much larger than Visionael, primarily because of the relationships our people have developed with our customers. When America On-Line thinks of Visionael, they think of Pam, or George, or Ian; these are the people who are responsible for implementing our software. Our Company's success is predicated on having employees who spend long days and nights ensuring the successful deployment of our software. The extraordinary effort our employees provide to our customers is directly related to the pride they feel from being part owners of Visionael.

Today, a stock ownership system that works is threatened by FASB's current exposure draft. FASB is proposing to require all businesses, including small businesses like Visionael, to use a complex formula to calculate the value of stock options, and then to count that inaccurate cost as an expense. The FASB proposal also will curtail the ability of small business owners to offer our employees stock options and will likely lead to the elimination of popular discount employee stock purchase plans.

I am not one who spends a lot of time in Washington, DC or Norwalk, Connecticut, deciphering the minutia of accounting regulations. But what I do know – and the reason I am here today – is that this proposal gives absolutely no consideration to the real world operations of small businesses like Visionael, or to how this plan can be reasonably implemented. The FASB proposal provides small businesses with a completely unworkable approach to valuing stock options, and will lead to inaccurate income statement reporting, thereby making our businesses look less attractive to investors.

This is an extremely important point. In the current economy, the availability of capital is low, while the cost of capital is high. The FASB proposal is particularly punitive to small companies, especially those that rely on expensive, venture capital. Anything that adversely impacts the ability of small companies to address the broader capital markets is a significant problem.

People on both sides of the expensing debate have agreed that no accurate model for valuing employee stock options exists. So, while I support the goal of accurate, understandable financial statements, I don't understand the urgency in moving forward when no method has been developed to accurately value stock options and when current proposals will adversely impact small businesses.

The FASB proposal makes it extremely difficult for small companies to comply because the three "acceptable models" for deriving an expense number are unworkable. The first, the Black Scholes model, has been discredited as being inaccurate for valuing employee stock options. Indeed, one need only look at the language of the Exposure Draft to see that the FASB strongly discourages its use. The second, the lattice or binomial method, uses inputs similar to Black Scholes, but is even more complex because it requires literally thousands of assumptions by the company.

Using either the Black Scholes or the lattice model will require us to input assumptions about the volatility of our Company's stock. But as a privately held company, whose underlying shares have never been liquid and, in many instances, are not even issued and outstanding, it will be nearly impossible (and expensive) for us to come up with a volatility number since there is no historical reference upon which to base that number. This kind of "guessing" and "estimating" can result in significant distortion of the value of the stock option and, in turn, a company's income statement. FASB has long recognized the difficulty that private companies have in measuring volatility by allowing nonpublic entities in its current standard to omit expected volatility and instead use what is known as the *minimum value* method where volatility is set at zero.

Unfortunately, the FASB proposal does not allow continued use of the *minimum* value method. Instead, FASB calls on private companies to make a "policy choice" and use the same fair value accounting that public companies use, either the Black Scholes or the lattice models, or use the third option that FASB proposes, the *intrinsic value* method.

Under the *intrinsic value* method, the stock option expense is measured as the difference between the price of the underlying stock and the option exercise price at the date the option is granted. This calculation must be made each time we report financial results and the expense must be changed each time—this is costly, overly complex and will be confusing to the users of our financial statements.

It is not obvious which of these methods Visionael will use if the current FASB proposal is adopted. All of the methods will yield inaccurate results and all will be expensive to implement. In addition, to the extent a private company becomes an acquisition target, questions about the target's financial statements and how they comply with the acquirer's policies will inevitably negatively impact the target's valuation and the speed by which the transaction can be completed.

Another problem with the FASB proposal is the way that it treats Employee Stock Purchase Plans, or ESPPs. Many employees participate in ESPPs, which will also be severely curtailed, if not eliminated outright, under the FASB rule. Small businesses are not always able to offer 401k plans to their employees and ESPPs are a good way for our employees to bolster their savings for retirement. The FASB proposal will require companies to expense the discount that they offer to employees who buy company stock through their ESPP. If FASB gets its way, this important saving vehicle would be eliminated.

I am particularly confused by this proposal. The purpose behind ESPPs is to make it easier for employees to purchase company stock. The discount is related to eliminating the transaction cost associated with purchasing stock in the open market from stockbrokers. In addition, ESPPs provide a simple way for employees to save by taking money directly from their paychecks. This mechanism also protects employees from inadvertently running afoul of Securities and Exchange Commission laws against insider trading while still encouraging employee ownership of their companies. There is no compelling reason for changing the accounting treatment associated with ESPPs. After all, top company executives are not the major beneficiaries of ESPPs; employees are.

We can debate whether or not lawmakers should do something about curtailing executive compensation abuses at large corporations, but FASB's proposal does nothing to address that issue. Instead, it proposes to inject inaccurate and unreliable numbers into company financial statements.

This plan has serious consequences that create new hurdles that will severely hamper small businesses, the main sector of our economy where jobs are created. It will impose complex accounting rules in an already burdensome regulatory environment for small businesses. The worst-case scenario is that FASB's proposal will impede the creation and growth of a significant number of small businesses. In the best scenario, the few that are created and remain in business will see ownership shifted from broad-based employee ownership to a concentrated ownership in the hands of the top few leaders of the business.

Despite the fact that there is no consensus on how to accurately value stock options, small businesses like Visionael will be forced, in order to comply with the FASB mandate, to significantly alter our business plans. We will need to spend \$100,000 each year, perhaps more, to comply with the proposed regulations. Given the cost of capital, we will have to reduce other operational expenses to pay for regulatory compliance. As a practical matter, this means that we will not hire an additional engineer, or two more sales professionals. We may not invest in various marketing activities that could stimulate additional sales for our business. The value of a small business is often determined by its ability to move to be acquired or provide liquidity for investors through a public offering.

The current rules proposed by FASB will not help investors, yet these regulations will clearly negatively impact our small business and our business opportunity. Small business owners will be faced with two options: (1) do not offer stock options to employees, and run the risk of seeing those employees remain with larger multinational corporate competitors; or (2) reallocate precious funding and resources away from core business operations into new accounting regulatory compliance functions, and run the risk of layoffs and hiring freezes. A real consequence of these proposed regulations is that many small businesses will not get started as they won't be able to attract the talented employees necessary to have a successful enterprise.

Much is made of FASB's independence. But FASB has made clear that it cannot and will not consider the economic consequences of its standards. Given the state of our nation's economy, we don't have the luxury of ignoring the economic consequences of this proposal. This Committee is fully aware of the importance of small companies to our economy. As a result, it is Visionael's position that the FASB should formally submit its proposal to the newly formed Small Business Advisory Committee for that Committee's review, consideration and comment. Of course, for the Small Business Advisory Committee to truly have an active role, it would have been preferable for FASB to have obtained the review and comment of the Small Business Advisory Committee before actually issuing the exposure draft. Nonetheless, this problem could be mitigated were FASB to extend the comment period so that the Small Business Advisory Committee has sufficient time to analyze, review and comment upon the exposure draft.

An alternative we support is S. 1890, the "Stock Option Accounting Reform Act." S. 1890 deals with executive compensation problems at big corporations by requiring those companies to expense stock options granted to the top five executives. Most importantly, it requires an economic impact study to be conducted before any additional expensing could go into effect. This economic impact study is particularly important, as it will ensure that all of the possible job and economic implications are examined closely. I urge the Senate to pass S. 1890, which will allow small businesses to continue to offer stock options to employees, and will allow millions of Americans to continue to reap the benefits of ownership in the companies they work.

Small businesses have always been the driving force behind our nation's innovative and economic leadership, and talented and creative employees have always

driven the growth of small businesses. At Visionael, we recognize the value of our workforce, and we believe our employees should reap the fruits of their success as owners of our company. FASB's proposal to curtail stock option plans threatens broadbased employee ownership at Visionael and small businesses across this country. I urge you and your colleagues to send FASB back to the drawing board, pass S. 1890, and help protect and expand employee ownership in this country.

Thank you for giving me the opportunity to testify today. I will be happy to answer any questions.