June 30, 2004

Director of Major Projects - File Reference No. 1102-100
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Dear Director:

On April 28, 2004, the Senate Committee on Small Business and Entrepreneurship held a hearing titled, The Impact of Stock Option Expensing on Small Business. The first panel of this hearing included Chairman Robert H. Herz and Mr. George J. Batavick, both members of the Financial Accounting Standards Board (FASB). The second panel included small business owners and representatives many of whom testified concerning the severe negative impact the proposed changes to FAS 123 and FAS 95 would have on their businesses and on the small business sector in general. I respectfully request that their written statements be included in the public docket and be considered by FASB when its seeks to finalize the Exposure Draft on Share-Based Payment.

The submitted testimonies include: Dr. Keith Carron, President of CC Technology, Inc. in Laramie, Wyoming and a former SBIR/STTR outreach coordinator; Mr. Jere Glover, Executive Director of the Small Business Technology Coalition, former Chief Counsel for Advocacy of the U.S. Small Business Administration, and attorney with the firm Brand & Frulla; Mr. Marc Jones, President and CEO of Visionael Corporation; Mr. John Kavazanjian, CEO of UltraLife Batteries Inc.; Mr. Roberto Mendoza, founder and Chairman of Integrated Finance Limited; and Mr. Chris Schnittker, CFO of Cytogen Corporation.

Since the release of the Exposure Draft, I have had the opportunity to discuss the proposal with many small business owners. One of the biggest concerns of the small business owners is, that even though they may not be technically bound by FASB’s Accounting Statement on stock option expensing, the small companies will be subject to it as required by financial institutions and institutional investors. This cascading effect of the proposal may have significant unintended consequences on small companies.
In addition, the small business owners strongly believe that the proposed valuation models as set forth in the Exposure Draft (binomial and intrinsic value models) would not accurately represent any stock options granted by their companies. For example, Mr. Jones at the Senate hearing testified that his company may face upwards of $100,000 in additional accounting/auditing costs to procure the necessary valuation for his company’s stock options. He stated that this additional cost would add nothing to the company’s bottom line and would not present any additional benefit to his institutional investors. However, the $100,000 cost would prevent him from hiring two additional engineers to help grow and expand his business. Accordingly, I respectfully request that FASB consider exempting small businesses from the proposed Accounting Statement. To better determine the effects of the proposal on small companies, I strongly believe that FASB should conduct field tests to determine the accuracy of the valuation models for stock options granted by small companies.

It is my understanding that FASB’s Small Business Advisory Committee has taken an initial look at the Exposure Draft. I fully support FASB’s efforts in this area as well as inviting a couple of small companies to participate in the recent roundtables in California and Connecticut. While these initial outreach efforts will be beneficial to the process, there are thousands of small companies in the country that may be unaware of the Exposure Draft and its potential ramifications for the companies. I urge FASB to continue the review of the proposal for the potential effects on small companies and to continue its outreach efforts.

If there is any additional information that you would like to have from the Senate hearing please do not hesitate to contact me or Greg Dean of my staff. I look forward to working with FASB throughout this process.

Sincerely,

Michael B. Enzi
United States Senator

cc: Robert H. Herz, Chair, FASB
    George J. Batavick, Chair, Small Business Advisory Committee, FASB
Statement of
Christopher P. Schnittker, CPA
Senior Vice President and Chief Financial Officer, Cytogen Corporation

Senate Committee on Small Business & Entrepreneurship
Hearing on “The Impact of Stock Option Expensing on Small Businesses”
April 28, 2004

Madam Chair Snowe, Ranking Member Kerry, and Members of the Committee:

My name is Chris Schnittker and I am the Senior Vice President and Chief Financial Officer of Cytogen Corporation.

Thank you for the opportunity to participate in this hearing on the impact of stock options expensing on small businesses. The following is my written statement, which I respectfully request to be entered into the public record.

I am here today on behalf of my company and millions of other public and private small businesses that stand to be seriously impacted by the proposed accounting rules set forth by the Financial Accounting Standards Board in their recent exposure draft on “Share-Based Payment”, better known as the accounting standard which will require stock option expensing.

First, allow me to provide a brief description of my company and how it relates to this hearing. Cytogen Corporation is a small, publicly-held biopharmaceutical company located in Princeton, New Jersey, the heart of the East Coast pharmaceutical corridor. We currently have about 65 employees most of whom are dedicated to selling and marketing our two lead oncology products, Quadramet™, a therapeutic radiopharmaceutical to palliate metastatic cancer pain, and ProstaScint®, a monoclonal antibody-based molecular imaging agent used to image the extent and spread of prostate cancer. We are also developing Combidex®, a molecular imaging agent which is currently under review by the FDA, and we support a research and development joint venture to develop prostate cancer therapies based on our prostate-specific membrane antigen, or PSMA, technology. Clearly, each addresses serious and substantial unmet medical needs of cancer patients and the physicians who serve them.

Cytogen relies on the dedication and drive of our Board of Directors, officers and employees to advance its reach on our currently-marketed products and to progress its other product candidates through the long and expensive process of drug research and development. To this end, we have chosen a compensation program for our employees which includes stock option grants and participation in an employee stock purchase program. Our stock option program is a broad-based one, granting stock options to every employee of the company – from our CEO, to my department’s staff accountants, to each
of the company's administrative assistants. We believe such a program best aligns the interests of all employees with that of the company and its outside shareholders – improving shareholder value – boosts productivity, and allows each and every employee to own a part of our success. I would suggest it also allows them to feel some of the pain of an unsuccessful business or a market downturn, with underwater stock options plaguing our industry during the past few years. At the company level, stock-based compensation allow us to attract, retain and motivate highly qualified personnel – many of whom are courted by the larger pharmaceutical companies that surround us in our region. From the window of our offices in Princeton, which literally sits in the shadow of a top-five pharmaceutical company's R&D facilities, I often watch their corporate helicopter deliver people from their New York City offices for meetings – a trip that probably takes at best 20 minutes. This is the same trip that my CEO and I have done several times a week by car or train, which often can take upwards of 3 hours each way. I certainly do not begrudge this company it's success – in fact, in certain aspects of our business, they are a critical business partner of ours. But I do hope that someday Cytogen has access to that level of capital where private aircraft is a necessity, rather than a distant luxury. As we are both competitors for the same intellectual capital in the oncology drug development arena, clearly much of the deck is stacked against a company like Cytogen because of its size and resource constraints. The promise of stock-based compensation among the smaller company's employees may help to level this playing field to some degree.

Further on our employee compensation model, as the cash outlays for employee health insurance programs and defined benefit pension plans increase exponentially, we, and most other small or start-up companies, look to non-cash compensation to supplement cash compensation so as to retain and motivate our employees. In order to compete with large pharmaceutical companies, we need to be able to offer meaningful equity compensation in lieu of the larger cash salaries, bonus programs and other perks offered by other employers in our industry. I am afraid that, with the expensing of stock options, small businesses will be denied yet another form of compensation to level the playing field with its larger counterparts in the industry. We may investigate the same moves made by other companies towards restricted stock grants or performance-based stock options, but each carries with them a complexity that can be difficult for small companies to administer and equally difficult for rank-and-file employees to understand and, perhaps more importantly, believe in their value. Even with these new compensation methods, I hope we will be able to keep the critical ownership and entrepreneurial spirit alive across all employees at Cytogen.

One of my responsibilities as a Chief Financial Officer is to budget and plan for our future growth but also to allocate our scarce capital resources, both human and financial, in the pursuit of our corporate goals. The appropriate mix of cash-based versus equity-based compensation for our employees is just one of these decisions. Clearly, the current market has told us that companies who have not yet set a clear course towards a sustainable and profitable business model will not survive. This initiative is especially challenging in the biotechnology industry with our 10-year-plus drug development
timelines, disappointments or delays inherent to research, and the enormous capital required to progress that research in a timely way. Cytogen has made several conscious choices over the last few years on its march towards sustainable profitability. These include rationalizing its own internal cell signaling R&D efforts in 2002, which resulted in the laying-off of nearly 75% of its R&D workforce, and controlling the growth of its in-house sales force in support of its growing product base. In previous years, my company has also outsourced its manufacturing efforts for both of its lead products with major pharmaceutical companies, when GMP-quality manufacturing became too costly for a small biotechnology company, at the same time forfeiting a degree of control over our own destiny. We have also further rationalized our investment in R&D by the formation of a joint venture with another public company to share the costs, and decidedly the rewards, of developing our proprietary PSMA technology. The market has rewarded us to some degree for these changes, rising from a market capitalization (defined as the number of common shares outstanding multiplied by quoted market price) of just under $30 million in late 2002 to a current market capitalization of $230 million—a greater than 600% improvement in shareholder value. But there is still work to be done.

The FASB’s proposals on options expensing are being handed to Cytogen at a very critical juncture in our history. If adopted, we would need to work these charges into our profitability model before we can determine the true “cost” of our option programs and how we will continue to support them in the future. The results of our initial option valuations, the implementation of the proposed binomial valuation methods and the costs of consultants or software to produce these valuations certainly give us reason to consider the course of discontinuing our broad-based stock option program or reducing the amount of options we grant within that program. We would certainly not be the first company I have read about since this issue began its progress through rulemaking to amend, curtail or eliminate its broad-based employee stock option program. These costs, coupled with the burgeoning costs of recent requirements of the Sarbanes-Oxley Act of 2002 and corporate governance initiatives implemented by NASDAQ, will hit smaller businesses harder than larger, well-established entities. The irony, to some degree, is that many companies are considering doing away with stock options at a time when, as a result of the market rebound over the past few months, they are once again a substantial motivating factor for our employees. Rationalizing this program at this time will be a difficult “sell” to our employee base.

We are also concerned at Cytogen about the market’s reaction to a potential setback in our path towards profitability as a result of the proposed stock option accounting rules. Cytogen’s access to capital on terms favorable to the company is a critical factor to the future success of our business. My CEO and I spent much of the first quarter of 2004 engaged in capital raising activities, leading up to a successful $26 million capital raise during April. This process involved many face-to-face meetings over several months with bankers and advisers developing our strategy and getting them comfortable with the Cytogen model. This process culminated in a condensed 2-day deal “road show” to interested investors. During this 48 hour period, we met with approximately 15 potential
institutional investors – most of which were less than an hour in length. I would argue that helping a potential investor become truly knowledgeable about your financial model and cash flow prospects in less than one hour, especially on a company as multifaceted as Cytogen, is going to be near impossible if we are soon asked to carve out substantial non-cash charges like stock-based compensation. The core cash flow models of companies like ours is a critical marker of their eventual success or failure. An investor’s understanding here is critical to their decision whether or not to invest. I would rather be spending that hour discussing the future promise of our marketed products and the quality of our research and development programs than dissecting our true cash flows from our public financial statements.

I would like to sum up my comments with my reflections as to why I, and perhaps many other employees like me, choose to work for small, development-stage businesses, particularly in the life sciences arena. It is not for the stability of a big company around you with adequate capital to insure its existence. It is not for businesses that to some degree run themselves due to their market penetration or vast resources. Among many other reasons, small businesses offer:

- The speed of innovation;
- The responsiveness to change;
- The ability to work with leaders and co-workers filled with entrepreneurial spirit; and
- The chance to change the face of a dreaded disease like cancer and improve the quality of life of the patients and their families who it affects.

For the anxiety, the long hours, the working weekends, and last-minute travels – I hope that my company’s leaders, my co-workers and my staff can share in the reward of their company’s success, commensurate with the enormous risks they assume in working for a small business. An important and effective tool for sharing this success is through the broad-based grant of employee stock options.

I fear that bringing subjective, assumption-based accounting charges to bear on the current system of employee equity compensation puts undue pressure on small companies and their ability to attract, retain and motivate the very employees that are critical to their success. I believe delaying the current rulemaking on stock-based compensation until 1) we have addressed the accountants’ and investors’ concerns over valuation methodologies and comparability among companies and 2) we better understand its broad economic impact to small business is of vital importance.

On behalf of Cytogen, and other similar small businesses, I sincerely appreciate the opportunity to express our views on these important issues.
Testimony of

Keith Carron, Ph.D.

On behalf of the University of Wyoming and CC Technology

Presented to the

U.S. Senate Committee on Small Business
and Entrepreneurship

on the topic of the FASB and Small Business Growth in
Rural States

April 28, 2004

CC Technology, dba Delta Nu
813 South Second Street
Laramie, WY 82070-0610
Phone     (307) 745-9148
FAX:       (307) 745-9152
www.deltanu.com
Senator Snowe and Members of the Committee:

My name is Keith Carron, founder and President of a small business start-up, the primary engine for the nation's economic growth and job creation. Thank you for offering me an opportunity to tell the story of my small business, CC Technology, in Laramie WY, and to explain the role that stock options play in the growth of my company. I do not wish to represent myself as an expert on stock options, but rather to provide you with a story of how they are used to create small businesses and why I believe the proposed FAS 123 would be detrimental to the growth and perhaps even the survival of my company.

CC Technology -- The Origin of a University Spin-Off

CC Technology was conceptualized in 1997 by two University of Wyoming chemistry professors: Keith Carron and Robert Corcoran. I use the word conceptualized, as we did not follow the traditional approach of capitalizing a company; rather we followed a plan more familiar to university professors. We initially wrote Small Business Innovation Research (SBIR) and Small Business Technology Transfer (STTR) proposals to the National Science Foundation and the National Institutes of Health. The proposals centered on ideas developed at the University, which we felt, had commercial potential. When the proposals were funded we incorporated as CC Technology. Being two university professors naïve about business, we added an experienced entrepreneur, Eugene Watson, to our founding team.

As I tell the story of CC Technology, I want to emphasize points concerning stock in small businesses and the role of stock options. I will summarize these points in a succinct statement at the end of this testimony. At this point it is important to understand that our business was founded with three shareholders who held 100% of CC Technology’s stock.

• 100 % of CC Technology’s stock was owned by its three founders.

Over our short history, CC Technology has been quite successful in writing SBIR and STTR proposals that have led to a total of over $3.7 million dollars in funding. Our technology developed through these grants has led to two important outcomes: first, intellectual property in the form of patent applications that are owned by the University of Wyoming and exclusively licensed back to CC Technology for commercial development; second, a manufacturing division of CC Technology, operating under the name Delta Nu, which designs, manufactures and sells Raman spectroscopy systems.

Allow me to first address the first outcome - a direct result of the Bayh-Dole act of 1980, which was specifically conceived to capitalize on the pool of knowledge that exists in academia. The SBIR/STTR programs have provided us the perfect avenue to take our knowledge and expertise out of academia into the
marketplace. The concept of university ownership and licensing back to the inventors as a vehicle of carrying academic concepts to the marketplace has led to many successful companies and will continue to do so. The SBIR/STTR programs facilitate this movement of innovative ideas.

The second outcome, our manufacturing division, Delta Nu, has already created jobs and wealth in Laramie WY. Laramie is a university community of about 30,000 people. I believe it is fair to say that most money that comes into Laramie is through the university, directly or indirectly. Those dollars circulate around the community through local shops and services. Companies like CC Technology are rare but we are now demonstrating how such enterprise can play a vital role in bringing new wealth to Laramie by applying our knowledge and skills to the creation of high value-added products, now being sold world-wide. These “new” dollars represent significant job creation and economic growth potential for our community.

Delta Nu stemmed from our SBIR/STTR funding. Our proposals discuss new chemical assays and new instrumentation to perform the assays. The newly developed instrumentation required formation of a manufacturing arm of CC Technology. To create this new instrumentation, we hired an Electrical Engineer to assist me in the creation of a new device: a portable, inexpensive Raman system. Unknown to us at the time, this technology and instrumentation enables a major shift in chemical instrumentation, from central labs to distributed locations. Just as computers moved from central mainframe computers to portable computers (PCs), chemical sensors, too, are moving from large centralized devices to small portable systems.

When CC Technology hired its first product development engineer we moved from a company totally dependent on SBIR/STTR funding to a business capable of designing, manufacturing, and selling a product, thereby generating revenue. The R&D needed to develop our first product came from our grant funding. However, as we approached marketability of our first product, the need for working capital became clear. Our R&D payroll could be met with grant funds but not the funds needed for manufacturing, marketing and sales. At this point I wrote our first business plan and approached a local bank for a working capital line of credit. We were able to secure our line of credit with personal guarantees from the two principal shareholders. We received the line of credit because we had personal assets and no business debt. I had my first lesson in bank loans; if you have money, they like to lend; if you don't, they won't. We did not have a stock option plan at the time, but if we had, I believe the loss shown on our income statement due to expensing stock options would likely have resulted in our line of credit application being refused.

- SBIR/STTR companies by their nature operate at a near-zero level of profitability and expensing stock options would result in a loss on the income statement, possibly resulting in an inability to negotiate loans or outside
investment to break out of the dependence on SBIR funding.

Delta Nu has grown from a single engineer to a business with 6 full-time employees and 5 part-time employees. We have a board of directors and offer full-time employees a complete benefits package. Prior to our adoption of a stock option plan for our key employees, we had grown from three shareholders (founders) to seven shareholders. It is interesting to note that of the four additional shareholders, three no longer contribute to our growth. These individuals were not restricted by a vesting period that a stock option plan usually requires. The fourth shareholder is the University of Wyoming in recognition of our licensing relationship. The vesting period of an option plan clearly is advantageous and is a key feature of our plan.

- Stock options usually include a vesting period requiring ongoing employee contributions, thereby adding value to a business after the grant is made.

CC Technology -- Our Stock Option Plan

Over the last 4 years we have had employees who have shown themselves to be key employees. By key, I mean employees who have made significant contributions to the growth of the company, who will continue to contribute significant value to the company, providing a basis for potential liquidation opportunities for the shareholders of the company. In Laramie such employees are difficult to find and are easily attracted to the high-pay “front range” of Colorado or other areas of concentrated economic activity. The alternative is to recruit employees with experience and potential from elsewhere. Retention and/or recruitment require cash. Start-up businesses usually exist in a cash starved environment - and as I am often reminded; in a small start-up company, when you are out of cash, you are out of business.

One important component in our cash preservation plan is to replace cash incentives with stock in the company. The best method for an employee is the IRS-accepted incentive stock option (ISO) plan. The ISO provides employees the opportunity to participate in the creation of wealth that is a consequence of their on-going contributions to the enterprise.

To date we have offered stock options to two key employees as a means of retention and are now considering offering options to a high-salaried employee from California whose recruitment is essential for our growth. During the interview process, we were able to show a past history of sales and excellent future prospects. But the vital selling point to this potential employee was the opportunity to be more than a tool in creating wealth for existing shareholders. We demonstrated through the offer of options that we want this individual to participate in the wealth they will help create. This is possible through an ISO.
CC Technology -- Tangibles and Intangibles

FAS 123 would require us to show our stock options as an expense on our income statement. How would that affect CC Technology?

- It would decrease profits (or increase losses)
- It would prevent or make it difficult to obtain working capital under the current method of income statement analysis.
- Culture could change, where bankers or investors neglect or suspect the expense due to stock option plans.

First, decreased profits due to stock options create a circular problem. Under FAS 123, options will be expensed, showing a decreased profitability. This in turn makes the grantee less likely to exercise the option. This makes the original assumption about the expense incorrect. Accounting stems from the root to account for. Accounting is a science; economic forecasting is not. Meaningful financial data is used to grow companies. This ruling adds tremendous negative value to a company that uses stock options. This decreases profits, most likely into the red or further into the red, such that investment is not possible. This makes it impossible to attract working capital investment. The company fails.

Or, the culture changes and financiers learn to ignore the expensing of stock options. After all, who knows if they will ever be exercised? Then my question is, why add something to financial statements that is not reliable or credible?

Synopsis

At this point I would like to summarize the bulleted statements and succinctly explain my views on FAS 123 and stock options.

Small companies are founded by a handful of individuals. In order to retain those employees that make significant contributions and grow, ownership in the company must be shared with those employees. The best way to include employees in the ownership is to provide options to purchase stock after a vesting period (period of sustained employment and productivity). Our small business started from a business model and seed capital provided by the United States government through the SBIR/STTR program and this model leads to balanced income statements. It is not, nor is it intended to be a source of wealth creation in and of itself. When a company wants to breakout of the grant R&D mode to commercialization it must try to maintain balanced income statements to attract working capital. The expensing of stock options adds an intangible imbalance to an income statement. Why is it intangible? The majority of small businesses fail. The expensing of options will only increase this failure rate. But the irony is that the expense will never occur because the option will never be exercised.
The creation of an ISO must be ratified by the shareholders. This informs them of the potential dilution of the value of their shares. They vote yes or no depending on their belief that the options will increase their stock value further down the road. In a true startup, the number of shareholders is small. The diluting event cannot nor should not be hidden in a hundred pages of CEO reports and beliefs and difficult to interpret financial statements. Small businesses with a handful of shareholders must be prepared to see their shares diluted by the addition of individuals who will be making the value of those shares grow.

Last of all, I would like to make a statement about the public awareness of FAS 123. I heard about it two weeks ago! A week ago I was entertained by two bankers from Wheatland, WY. They were not aware of FAS 123. They want to try to work with CC Technology and the Ex-Im Bank by offering an export working capital line of credit. The Ex-Im Bank is a government agency designed to help small companies export their products and to reduce the country's trade imbalance. Please note, the Ex-Im Bank considers a positive equity to be a requirement for assistance. Expensing stock options would greatly increase the likelihood of not receiving government assistance to help reduce the trade imbalance and this failure would all be based on an expense that may never be realized because the option is never exercised. But, my point for this story is that the bankers knew nothing of FAS 123 and my accountant never mentioned knowledge of FAS 123 to me!! Had we followed FAS 123, we would have provided these bankers with distorted income statements based on the incalculable probability of the future exercise of our options and the incalculable value of our shares at the time of exercise. My point is, why turn the rigors of accounting logic into the realm of astrology and palm reading?

It seems to me that in their zeal to address recent widely-perceived abuses of stock options by a few disreputable top level executives in an even fewer large public companies, the FASB will be creating the unintended consequence of doing significant harm to the nation's economy and competitiveness by throttling back that primary engine of growth, the struggling private small business start-up.

Thank You,

Keith Carron
Professor and CEO
University of Wyoming, CC Technology
Mr. Chairman and Members of the Committee:

I am Jere W. Glover with Brand and Frulla, a law firm specializing in litigation and regulatory and administrative law. I also serve as Executive Director of the Small Business Technology Coalition, the largest organization of Small Business Innovation Research companies in the United States. I am pleased to be here today to testify about Financial Accounting Standard Board's, FASB, proposal to require expensing of stock options.

While I'm not an expert on accounting, accounting standards or FASB, but I do have a lot of experience as counsel to this Committee and the House Small Business Committee, and as Chief Counsel for Advocacy of the Small Business Administration. During my tenure as Chief Counsel, we issued over 100 reports and economic studies, testified before Congress over 30 times, intervened in over 200 agency rulemaking proceedings, and reviewed over 5,000 regulations.

I have spent much of my career trying to reduce the regulatory burden on small businesses to create a fair economic playing field that allows small businesses to grow and to ensure that regulations imposed on small businesses are really necessary, while addressing the problems actually caused by small business but without compromising public policy objectives.
During the last three years of my tenure as Chief Counsel we reduced unnecessary regulatory burdens on small businesses by over $20 billion. We constantly were faced with agency claims that protecting the “public interest” forced agencies to place this burden on small business, just as FASB is claiming now. These officials routinely said that if their regulations were not finalized exactly as proposed, the environment, worker safety, investor trust, etc. would cease to exist. Forced to re-examine the problems regulations were designed to address, agencies often found that small businesses were not the cause of the problem, at least not significantly, that the regulatory burdens as proposed were usually unnecessary and could in fact be modified. In some instances small businesses could be exempt entirely and the public interest still served.

I do not disagree with what FASB is trying to accomplish. I don’t disagree with the need to require the expensing of stock options for public companies. I certainly don’t disagree with the Sarbanes-Oxley Act.

I will, however, always disagree with any agency or organization, in this case the FASB, imposing unnecessary and unintended burdens on small business. FASB’s proposal, while well intended, will have a devastating impact on growing small businesses, especially those who are in government contracting and who need to finance their businesses. The burden in dollars, lost management time and lost opportunities will adversely affect innovation and job creation in America.
Let me explain why I believe the expensing proposals will have an adverse small business impact that is contrary to the public interest.

1. Small companies will simply stop giving employee stock options to key employees. This is the worst possible outcome. For years, companies have used stock options to recruit and retain key employees. Small businesses in their start-up and intermediate growth phases simply do not have the working capital to compensate key employees commensurate with their contributions to the firm's successful growth. By allowing these key employees, engineers, scientists, managers, and even CEOs to have stock options and the potential for future monetary gains, small firms are often able to hire the best employees to help them grow their businesses.

2. Many small companies will not even learn of the new restriction on employee stock options until it is too late to comply. Small firms don't read the Federal Register, the Congressional Record and certainly don't read the FASB's proceedings and press releases. I understand that the FASB expects compliance by the end of the year. This virtually guarantees that most small companies will be in violation.

3. The companies that find out about the requirements will not be able to comply because the cost is prohibitive. From what I understand, the computation methods selected by FASB are designed for publicly traded
companies and are extremely difficult to apply to small privately owned companies. Since the CPAs most often used by small businesses have never done a valuation of employee stock options under these methods, the companies will have to hire one of the big four accounting firms to value their employee stock options. The big four will probably be too busy valuing the public companies to work on small firms. In addition to such delays, I’ve seen cost estimates of several hundred thousand dollars for such valuations. Small firms don’t have that kind of money and it certainly isn’t a productive use of their limited funds.

4. What happens to firms who choose to comply? If they are government contractors it can create real problems. They may be found to be “not financially feasible” as that term is used in Federal contracting decisions. Because of the expensing of employee stock options, many will suddenly find themselves to have a negative net worth and significant losses. Under the Federal Acquisition Regulations, such companies are not eligible for government contracts. If a company is seeking to borrow money, it will have difficulty borrowing with a negative net worth and operating losses caused by expensing requirements. Even if the company finds a bank which understands the problem, how will the bank regulators, Comptroller, FDIC and Federal Reserve see the situation? Has the FASB even met with the bank regulators and SBA to examine the impact of its new standards on commercial lending practices?
5. What are the tax consequences of FASB? I’m not sure what the impact of FASB will be on the treatment of stock options. In the past, there has been flexibility in how options have been treated for tax purposes. I’m concerned that this flexibility will be lost once FASB’s proposal becomes final.

One bit of ironic good news is that when a company’s key employees leave, the company will have a windfall profit when the stock options are cancelled.

This collateral damage could have been avoided and regulatory proposals more finely tuned to address actual problems if FASB had

1. adequate small business representation on the Board who understood the impact of the proposal on small and emerging companies;
2. a small business advisory group in place when they were formulating the standards. (It appears that the new small business advisory group that is being set up now is arriving too late in the process to change the Board’s decisions.);
3. completed a small business regulatory analysis of the impact of the standard on small emerging companies. (All federal agencies and most state agencies are required to conduct such an analysis before they take regulatory actions.);
4. proposed a separate and more appropriate regulation for expensing small company stock options;
5. delayed the effective date of the standard for small companies for several years;
6. exempted small companies from these regulations entirely;
7. used some combination of the above.

To date FASS, with the exception of belatedly appointing a small business advisory group, has done none of the above.

FASS’s failure to consider in some depth the impact of its action on small and emerging companies or the predictable adverse impact on the nation’s economy is not new. Federal, state and quasi-government agencies and organizations will always tend to write one set of standard or rules and apply them to all businesses regardless of the size. However, experience has taught us that this “one-size-fits-all” approach simply does not work.

Almost 25 years ago, Congress passed the Regulatory Flexibility Act, RFA, requiring each federal agency to conduct a regulatory flexibility analysis of the impact of its actions before the agency even proposed a new regulation. The law also requires agencies to develop and consider less burdensome alternatives and to do affirmative outreach to small businesses to help them formulate the regulations. In 1996 Congress strengthened the RFA and provided for judicial review of agency compliance with the law.

Has the RFA changed the way agencies treat small business? Absolutely! To date over $40 billion dollars of regulatory burdens that the agencies originally proposed to
place on small business have been eliminated - $20 billion during my last three years as Chief Counsel and well over $20 billion by my successor. All this was done without endangering worker safety, the environment or even investor confidence.

Let me give you one example of how the RFA has served the public interest. The Environmental Protection Agency (EPA) proposed requiring oil refineries to reduce the amount of sulfur in gasoline. Originally this requirement would have imposed such costly burdens on the small refineries (especially the one in Wyoming) that the small refineries would have gone out of business, reducing the nation’s supply of gasoline and increasing consumer prices at the pump. With further analysis, we concluded that the small refineries were less than 2% of the problem. The EPA finally agreed that the small refineries could delay compliance for a number of years. This would allow them to take advantages of new technologies that were being developed. Today all of those refineries are still operating and the environment is still being protected.

Would this work for the expensing of employee stock options? Certainly. I have not seen any evidence that the problems FASB seeks to address are caused by small companies. FASB just has to look at the SEC as a model. By complying with the RFA, the SEC has developed an excellent record customizing its regulations to reduce significantly the burdens on small businesses, without compromising its public interest responsibilities.

To illustrate: When I was helping prepare for the first White House Conference on Small Business in 1980, President Carter requested that each agency highlight at least
one major accomplishment to be announced at the Conference. When I went to the SEC to meet with the senior management, they informed me in great detail that they had to protect investor confidence and could not even consider doing anything for the small emerging companies. These upstart companies would have to comply with all of their regulations – period, end of discussion.

I explained to them that they had done such a good job of protecting investors that they had eliminated virtually any new company from going public for a number of years. By analogy I argued that if OSHA wanted to eliminate all worker injuries, the only way they could be sure that no worker was ever injured was to eliminate all workers. The SEC had in effect eliminated the workers. Going public was simply too expensive and complicated for businesses.

Since that time, the SEC has simplified its reporting requirements, granted exemptions for small companies, created new short forms and allowed Regulation D offerings for smaller companies. The SEC also approved an angel accredited investor network to reduce the regulatory burden on angel investing. With all of these changes and burden reductions on small companies, there has been no increase in investor fraud. If these FASB-type standards were being proposed by the SEC, I'm confident the agency would have found a way to lessen the burden on small emerging companies.

FASB could have done likewise. To verify this conclusion we just need to answer
the following questions:

1. What are the public interest issues at stake?
2. How and to what extent does small business contribute to the problem?
3. Will the proposed regulations stimulate or hinder the growth of small business?
4. If hinder, can regulations be designed to eliminate this risk to the economy without compromising the public interest?
5. Should Congress act if FASB does not?
6. Should quasi-governmental boards and organizations, (like FASB) whose decisions have the impact of regulations be forced to comply with the RFA?

I think the answers to these questions are important to the grow the U.S. economy and creation of more American jobs. If we expect small business to be the engine that grows the U.S. economy and creates jobs, we have to feed the engine, not starve it. Regulation, such as expensing of employee stock options for small emerging companies puts the brakes on the small business engine at the very time we need for the accelerator to be at full throttle. I think the public interest is best served when we have a vibrant growing small business economy that is creating jobs, developing new technology and creating whole new industries.
Good morning Mr. Chairman and esteemed members of the committee. Thank you for allowing us to express our opinions on this very important issue. The issue of expensing of stock options is a very significant one to us. Ultralife Batteries is a small but growing public company in Newark, New York, a small town outside of Rochester. The company has been in business for 14 years and when I became CEO, 5 years ago, it had never been profitable. After years of hard work, last year we finally became profitable and we now are growing and employ over 900 people, up from 250 several years ago, primarily involved in the design and manufacture of battery products.

Stock options are an important part of the way that we attract and retain professional talent. Without the engineers, salespeople and professional managers in our company there would be no work for the manufacturing employees that make up 75% of our workforce. Expensing of stock options serves no useful purpose in the basic function of financial reporting and implementing this standard will hurt everyone, but will fall heaviest on small and growing companies like Ultralife.

What is the purpose of financial reporting? The purpose is to provide the shareholders with information on the operational performance of the company and the data with which to calculate the value of the firm. There are multiple methods for calculating the value of the firm, but most of them come down to an evaluation of the discounted present value of expected future cash flows. The expensing of stock options provides no fundamental added value to this function. The only effect of options is to provide a cash flow from the exercise and to create more shares which figure into a per share earnings calculation. Both of these effects are quite adequately accounted for in the Treasury method dilution calculation that we all use today to report on earnings.

What purpose then, is the proposed rule aimed at? It certainly is not aimed at giving investors an easier way to evaluate a company---in fact it does quite the opposite by imposing a non-cash cost that must be backed out in figuring the value of the firm. Is it aimed at giving more information? I don’t believe so, since we already disclose all the data that is required in order to evaluate the effect of outstanding.

It has been suggested that the real reason to do this is to curb excessive executive compensation. I can think of no way less effective than doing this through an accounting change that then obscures the true operating effectiveness of a company. Impose restrictions, standards or additional shareholder approval, but putting an accounting standard in place is absolutely the worst way to do it.

**What does it mean to Ultralife?**

A small company faces some unique challenges.
First, there is the challenge of attracting talent. Expensing of stock options will constrain our ability to attract and retain talent, for both employees and directors. We are not Kodak, Xerox or Baush and Lomb, three of the largest companies in our area.

We have been able to grant stock options down to the lowest level of the company. The majority of our option grants go to non-executives. It was a major reason why we did not lose more than a handful of professional employees during our lean years and a major reason why we are able to retain our talent as we grow. This is what shareholders want and why they approve of option plans.

We also have the challenge of being noticed by the marketplace. Most investors look at the bottom line performance before going down into the details. For Ultralife, we were profitable for the first time in the first quarter of 2003 and then again in the second quarter. Our stock price rose. If we had to expense stock options, the rise in the stock price probably would have caused a change in assumptions. This could have eliminated our profit and put us in a "loss" position in the third quarter even though we had positive results from operations, a positive cash flow and had clearly increased the value of the firm.

Additionally, we need access to capital to finance our growth. The option expensing proposal will be an artificial damper on share price, hence hurting our access to capital. With capital, we can invest in the equipment to keep the labor content of our product down and production in the United States.

This proposal will also impose even more overhead in our financial reporting. This proposal will cost money through our calculation and administration work and through the audit fees connected with certification by our auditors.

Lastly, it will cause artificial fluctuations in earnings and in share prices. Good performance will be rewarded with an increasing share price. This could cause stock option expense to go up in the next quarter and swing earnings down. Share price will then go down and will cause a positive flow back into the earnings, which will swing it up and the cycle will start again. Instability in share price will discourage investors and could have a very negative effect on the company.

**Summary**

If you allow FASB to implement this, you let them bend a measurement system that is supposed to inform investors, into a tool for influencing behavior. We cannot let the accounting community bow to political pressure and try to quantify something that is adequately disclosed, whose effect is already accounted for in EPS calculations and which adds NOTHING to the ability of investors to assess the value of a company.

Expensing stock options does nothing to help investors understand more about performance or value and in fact will obscure the true measures of performance.
and value. It will also have a disproportional effect on small companies who have a limited ability to educate the marketplace. This is not in the public interest and should be stopped.
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 broad-based 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.
I would like to thank the Committee for giving me the opportunity to testify on this important matter. I believe that the FASB’s position is generally correct, and furthermore that the expensing of options will in fact prove beneficial to small businesses and the entrepreneurial spirit. Essentially I conclude that the analysis of the expensing issue does not differ materially for small companies relative to larger ones, and that no constituency benefits from omitting any compensation cost from the income statement.

The fundamental point of course is whether or not options represent an expense, i.e. a cost which should be deducted from revenue in the income statement in the same way as all the other forms of employee compensation. Since there is general acceptance that options are a highly valued form of employee compensation, it seems clear that options should be expensed provided that (a) it is feasible to measure adequately the cost to the issuer of expensing options; and (b) there is no public policy imperative to require a different, legislatively mandated accounting treatment.

Financial markets provide compelling evidence that it is perfectly practical to value options which are far more complex than compensatory options through the use of models. Each day literally billions of dollars are traded based on models which depend on the fundamental insight of the Black-Scholes-Merton formula. While it is true that models will provide only an estimate of the cost of granting options, this is not a reason for not expensing it. The preparation of financial statements requires judgement and a great deal of reliance on estimates – e.g. amortization and depreciation schedules, and the value of intangibles such as R & D expenses to name but two. Model-based expensing provides the approximately right answer; failure to expense options provides a precisely wrong answer since clearly the cost cannot be zero.

In any event the debate over the accuracy of models probably severely overstates the complexity of the problem. A recent insight by Professors Bulow and Shoven of Stanford University demonstrates that the maturity of an option for expensing purposes is typically 90 days rather than several years. This results from the provision in most option plans that the employee must exercise any vested options within 90 days of leaving the company for any reason – including resignation or dismissal without cause. This suggests that companies should expense each quarter the cost of extending an option for a further 90 days. The Appendix describes this approach in some detail, and has been submitted to the FASB. The critical point is that the 90-day life significantly simplifies the valuation exercise – among other reasons because there are active listed and OTC markets in 90-day options which provide observable market prices for the valuation exercise.

The argument that expensing options through the income statement results in “double-counting” of the expense does not withstand logical scrutiny. To make the point with an extreme example, assume two identical companies with annual income of $100,000, and non-employee compensation expenses of $20,000. One company pays its employees $10,000 in cash plus sufficient option grants to enable it to attract and retain its employees, and the other pays its employees solely in cash of $40,000. If you fail to expense the options the first
company will record pre-tax income of $70,000, while the second one will show pre-tax income of $40,000. Such a result distorts the comparability of financial statements even between two otherwise identical companies.

My final point is that expensing options will actually benefit small companies and encourage start-ups. The calculation procedure will not impose a material cost on management either in terms of time or expense. Income statements which properly reflect the real costs incurred by the business—specifically including all the compensation costs—will make it easier to attract capital because investors will be able to measure properly the potential returns from the investment.

My conclusion is that it would not serve the public interest for the Congress to mandate a different accounting treatment.

I make this point not simply from a theoretical corporate finance perspective, but also from recent personal experience. In December, 2002 my two partners, Peter Hancock and Bob Merton, and myself raised $45 million to start from scratch an international investment banking firm. Our goal is to do an IPO within five years. We have made considerable progress during our first year—we now have forty colleagues, are licensed as a broker-dealer in the U.S. and Japan and are growing rapidly. We told our investors that we planned to expense compensatory option grants whether or not we were required to do so. We believe that this commitment to realistic and transparent accounting helped us to raise the capital for a venture which was both highly risky and highly ambitious.

Thank you.

April 28, 2004