Setting the global standard for investment professionals

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John Brennan, Chairman
Financial Accounting Foundation Board of Trustees
401 Merritt 7
Norwalk, CT 06856

Reference*:* Private Company Plan

CFA Institute[1], in consultation with its Corporate Disclosure Policy Council ("CDPC")[2], appreciates the opportunity to comment on the Financial Accounting Foundation Board of Trustees' (FAF*) Plan to Establish the Private Company Standards Improvement Council* (Plan).

CFA Institute is comprised of more than 100,000 investment professional members, including portfolio managers, investment analysts, and advisors, worldwide. CFA Institute seeks to promote fair and transparent global capital markets and to advocate for investor protections. An integral part of our efforts toward meeting those goals is ensuring that the quality of corporate financial reporting and disclosures provided to investors and other end users is of high quality.

What is A Private Company?:
Recommendation to Establish A Separate Standard Setter Is Premature

We have reviewed the report of the Blue-Ribbon Panel on Standard Setting for Private Companies (Blue-Ribbon Report) and found the report did not answer an important fundamental question: What is a private company? The Blue-Ribbon Report recommends the establishment of a separate standard setting board without defining what entities will follow the standards developed by such a standard setting body. It seems premature to consider the need for a separate standard-setting body, voting committee or advisory committee without having first come to a common understanding of what entities would be subject to the scope of this body or committee.

Our view is that there are few truly private companies and that it is almost impossible to draw the line between public and private companies as there are many investors in private entities and

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1 With offices in Charlottesville, VA, New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of more than 100,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 133 countries, of whom nearly 83,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 135 member societies in 57 countries and territories.

2 The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The CDPC is comprised of investment professionals with extensive expertise and experience in the global capital markets, some of whom are also CFA Institute member volunteers. In this capacity, the CDPC provides the practitioners' perspective in the promotion of high-quality financial reporting and disclosures that meet the needs of investors.

users of their financial statements. Simply because an entity does not have common equity traded on an exchange does not make it a private company. One needs to ask:

- Are issuers of public debt private or public companies?
- Are insurers who issue products which require they make SEC filings – even if they have no public debt or equity – public or private companies?
- Are enterprises that borrow money from a financial institution (which may participate the loan to other institutions or investors) private or public entities?
- Do “private equity capital” investors require less information and different measurements than “public investors”?
- Do employees and outside shareholders of "private" enterprises require less information and different measurements than those of public companies?
- Is an entity which wants to raise capital on emerging direct marketing sites a public or private company?
- Do suppliers to "private" companies require less information and different measurements than those to "public" companies?

These questions have not been addressed by the Blue-Ribbon Report. When answered we believe it is apparent there are few truly private companies. Our view is that the only truly private companies are those with a single owner-manager and no external financing. A single owner-manager can choose to have financial statements prepared in whatever form he or she finds useful. All other enterprises have either investors or creditors who need financial statements to evaluate their investing or lending decisions.

Until the basic question – “What is a private company?” – is answered, there is no need to discuss the establishment of a separate standard-setting body as doing so will only create confusion and conflict. We believe the FAF’s current recommendation goes further than needed in an attempt appease those who have raised this issue. Irrespective of the form chosen by the FAF, the issue of what entities will apply any separate private company guidance will need to be addressed.

Support for One Set of Financial Reporting Standards

CFA Institute has long supported one set of high-quality financial reporting standards which includes no distinction between standards used by public companies and private companies or based upon the size of the enterprise. Financial statements should serve the needs of all who provide capital to a company and bear risk as a result, including the various classes of creditors as well as equity owners. Our long-held view has been that one of the primary objectives of financial reporting and disclosure must be to provide all of the information that owners of common equity require to evaluate their investments. In doing so, our view is that all other investors information needs will have been addressed given that equity holders are the residual interest holders in the enterprise.

<u>No Compelling Argument Nor Evidence Presented That Investors in or Lenders to Private Companies Have Different Financial Reporting Objectives or that Users of Private Company Financials are Requesting Changes</u>

CFA Institute concurs with the observations provided in the dissenting view articulated in the Blue-Ribbon Report. The dissenting view makes a strong case that there is no compelling evidence to suggest that the objectives of financial reporting are not being met for private companies. As noted in the report:

> *An argument presented to the Panel in support of differential standards is that users of private company financial statements are more likely to be lenders than equity holders and the US GAAP focuses on information needs of equity investors. However, financial statements presented under US GAAP are intended to provide decision-useful information for external users in general, and the Panel has not been presented with arguments or evidence that private company financial statements do not meet the needs of users. In fact, the push for differential standards has not been driven by users of private company financial statements, suggesting that the financial statements are providing decision-useful information.*

<u>Comparability Will Suffer</u>

When making capital allocation decisions, investors look across a broad spectrum of global investment opportunities – some private, some public. The lack of comparability created by establishing different accounting standards for private companies in the U.S. would run counter to what investors need to make appropriate investment decisions. Still further, the establishment of private company accounting standards in the U.S. – at the same time the SEC considers the adoption of IFRS under a condorsement approach for U.S. public companies – will result in even less comparability for investors. Private companies in the U.S. – whether this is directly apparent or not – are competing in the global markets for capital. As such, the use of IFRS by some countries, a potentially different version of IFRS for U.S. domestic issuers, and now a potentially different version of U.S. GAAP for private companies will only making this capital allocation decision more difficult. Comparability is essential for capital providers.

<u>Complexities Arise From Need to Explain Economics</u>

CFA Institute also concurs with the view that complexity in U.S. GAAP arises principally from the need to explain the economics of the business and its transactions. Whether a public or private entity, appropriate accounting is required to capture the economics of complex transactions. Accordingly, we do not find the notion of complexity a compelling case in favor of a separate set of accounting standards for private companies. The accounting is complex because the transactions are complex.

<u>Costs vs. Benefits – Several Elements of Equation Not Considered</u>

We do not believe that the Blue-Ribbon Panel has appropriately considered the costs and benefits of a separate set of accounting standards. Much of the discussion of the cost of private companies having to apply U.S. GAAP standards as issued by the FASB is focused on the need to prepare and audit the accounting and disclosures with no analysis of the costs of not having such information (e.g. the risk premium attached to the lack of information) or the benefits of having the information for users (e.g. the benefit of not having to translate the financials to a comparable analytic basis). This cost-benefit equation does not include any capital provider considerations. Accordingly, it is difficult to find this argument compelling.

<u>*Some Investors Perceive That Private Company GAAP is Lower Quality GAAP*</u>
One factor which is also not considered, but we think is important for private companies to consider, in the cost vs. benefit analysis is that many investors, creditors and other suppliers of capital perceive that entities not fully applying U.S. GAAP – or in countries where such differential exists – are perceived to be of lower quality and higher risk. The cost of this perception is indirectly tied to borrowing rates of such enterprises. Our view is that those seeking to benefit from private company should consider this perceptual difference.

Private Company Standards Improvement Council (PCSIC) Goes Further Than Needed
We believe that it is constructive to incorporate private company considerations – where there may be valid and compelling arguments made on a case-by-case basis to support such differences – into the standard setting process. However, we believe this can be accommodated through the FASB's existing structure with the introduction of an advisory council to the FASB on private company matters.

We question the need to go as far as is being suggested in the establishment of the Private Company Standards Improvement Council (PCSIC). Currently, the Investors Technical Advisory Committee (ITAC) is considered a standing resource to the FASB and the Financial Accounting Standards Advisory Council (FASAC) an operating arm of the FAF. It appears that the PCSIC will have a more significant stature than either of those resource/advisory bodies.

We agree that the PCSIC's should have a role in developing criteria for determining whether and when exceptions or modifications to U.S. GAAP would be warranted for private companies. However, we believe the PCSIC goes further than needed. Our view is that the PCSIC should be an advisory body to the FASB by providing focused input on how private companies would be impacted by the standard setting activities with the FASB retaining responsibility for ratifying any changes through the normal due process, including public comment and outreach. We believe that this will strengthen the new standards to be cognizant of how the changes will impact private companies while preserving a single-set of U.S. GAAP standards.

Investor & User Primacy Should Be Focus
The FASB mission statement clearly indicates that the interests of investors and other users should be first in the standards-setting process. The mission statement reads as follows:

> *The mission of the FASB is to establish and improve standards of financial accounting and reporting that foster financial reporting by nongovernmental entities that provides decision-useful information to investors and other users of financial reports.*

CFA Institute questions why private companies deserve a higher status in the standards-setting process than users and investors. Why should private companies be allowed to make recommendations, take votes on standards and send recommendations to the FASB for ratification when investors and users are not provided with similar stature and authority? In fact, ITAC holds a lower stature than FASAC and the proposed PCSIC would have higher stature than both ITAC and FASAC under the proposed governance structure.

We believe the FAF and FASB should adhere to the aforementioned mission of providing decision-useful information to investor. Lobbying efforts and form letter writing campaigns by non-investor and user stakeholder consistencies – without reasonable, comprehensive and substantive arguments which support furthering the investor and user focused mission of the FASB – should not detract the FAF and FASB from the aforementioned mission. Further, doing so establishes a precedent whereby lobbying efforts endanger the independence of the mission and subject the FAF and FASB to similar effort by other stakeholders with vested consistencies.

Closing Remarks

We thank the FAF for the opportunity to express our views on this plan. If the FAF has questions or seek furthers elaboration of our views, please contact Matthew M. Waldron by phone at +1.212.705.1733, or by e-mail at matthew.waldron@cfainstitute.org or Sandra J. Peters by phone at +1.212.754.8350 or by e-mail at sandra.peters@cfainstitute.org.

Sincerely,

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