CFA Institute

560 Ray C. Hunt Drive
Charlottesville, VA
22903-2981 USA

+1 (434) 951 5499 tel
+1 (434) 951 5262 fax
info@cfainstitute.org
www.cfainstitute.org

June 22, 2015

Mr. Jeffrey J. Diermeier
Chair
Financial Accounting Foundation
401 Merritt 7
P.O Box 5116
Norwalk, CT 06856-5116

Re: Comment Letter on Three-Year Review of the Private Company Council ("PCC")

Dear Mr. Diermeier,

CFA Institute,[1] in consultation with its Corporate Disclosure Policy Council ("CDPC")[2], appreciates the opportunity to comment on the Financial Accounting Foundation's ("FAF") Request for Comment ("Request for Comment"), *Three-Year Review of the Private Company Council*.

CFA Institute is comprised of more than 130,000 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.

---

1 With offices in Charlottesville, New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of more than 130,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 147 countries, of whom more than 113,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 138 member societies in 60 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.

CFA Institute

OVERALL COMMENTS

Previous Commentary

CFA Institute has previously commented regarding the development of differential accounting and reporting standards for private companies and the creation of the Private Company Council ("PCC").[3] In our two previous comment letters, we have expressed the following concerns:

- *No Illustration of Differing Reporting Requirements Requested By Private Company Investors* – We noted that no compelling argument nor evidence had been presented that investors in, or lenders to, private companies have different financial reporting objectives or that users of private company financials were requesting a change.
- *Reduced Comparability Will Result* – We observed investors allocate capital across public and private companies and that comparability for investors will suffer as a result of this initiative. We noted that private companies compete for capital globally and the lack of comparability not only diminishes their ability to compete but also raises their cost of capital.
- *Complexity* – Complexity is not a result of financial reporting standards but of the complexity of underlying transactions. If standard setters develop accounting requirements that best reflect the economics of a transaction, the nature of who owns the entity should not alter the recognition, measurement and disclosure criteria.
- *Transferring Cost of Preparers to Investors* – We communicated that the costs and benefits of a separate set of accounting standards for private company standards had not been fully considered. While preparers' costs may be reduced, the cost to investors of lower quality, less comparable information had not, in our view, been adequately considered in the cost vs. benefit analysis.
- *Perceived Lower Quality Financial Reporting Standards Priced By Investors* – We explained that investors perceive private company standards as lower quality standards and they price such risk in their cost of capital.
- *What is a Private Company? Public vs. Private Entity Definition* – We noted that a private company had not been fully defined. While we recognize the FASB has defined a "public business entity" subsequent to our original comment on this issue, we believe investors – because their information needs are not substantially different across entities – have a much broader definition of public business entity than the FASB has set forth. We provided our comments on the FASB's definition of public business entity at that time.
- *There Are Few Truly Private Companies* – We highlighted that there are few truly private companies and provided illustrations of very large private companies which would, in theory because of their capital structure, be allowed to apply these lower quality standards. We highlight our growing concern with this issue below.
- *What is US GAAP?* – We expressed concern that the development of separate private company standards will raise the question of what represents U.S. GAAP. The lack of communication in financial statements regarding what private company options had been

[3] CFA Institute comment letters:

- *Private Company Plan*, January 30, 2012 (www.cfainstitute.org/Comment%20Letters/20120130.pdf.)
- *Definition of a Public Business Entity*, October 28, 2013 (www. cfainstitute.org/Comment%20Letters/20131028.pdf)

CFA Institute

elected and the overall optionality allowed with respect to private company alternatives, to our mind, raises questions regarding what constitutes U.S. GAAP. We noted that the proliferation of financial reporting regimes within the United States (the AICPA's Other Comprehensive Basis of Accounting, the alternatives allowed under the Jobs Act, separate private company standards, and unique reporting requirements for public companies) only serves to increase complexity, diminish the brand of U.S. GAAP and defy the objective of accounting standards which is to create a uniform set of principles upon which investors can rely.

- *Impact on Public Company GAAP* – We highlighted our concern that private company alternatives would be used as a back door agenda setting mechanism to alter the reporting requirements for public companies. We note this has occurred in the context of impairment of intangible assets.

Given that we believed these investor concerns remained unanswered, we constructed a survey to obtain investor views on these topic with the objective of informing further discussion of the issue. The results of such survey are outlined in the next section.

Recent Commentary: Investor Input

Recently, CFA Institute published a report, *Addressing Financial Reporting Complexity: Investor Perspectives*, which incorporates such previously articulated concerns and provides investor perspectives, based upon a survey of our members, on the issue of differential accounting standards. The paper also considers the extension of the private company initiative toward the notion of complexity.

We constructed the survey to gather investor perspectives on the aforementioned concerns. The survey results demonstrate that the overwhelming majority of investors have apprehensions regarding the creation of differential or reduced reporting requirements for private companies as noted through their response on the following topics:

- *Decrease Comparability* – 82% of respondents believe the creation of separate private company standards would create comparability issues as investors invest across public and private companies;
- *Increase Complexity* – 73% believe it may actually increase complexity;
- *Loss of Information* – 65% believe it would result in the loss of information useful to their financial analyses;
- *Greater Access to Management Won't Remediate Loss of Information* – 69% believe that access to management won't sufficiently, or aren't sure it will, remediate the loss of information created by private company standards;
- *Large Private Companies Should Not Be Able to Apply* – 65% believe large private companies should not be able to use private company standards;
- *Disclose Use of Differential Standards* – 81% believe financial statements and audit reports should disclose the use of private company accounting standards – 58% wanted a quantitative schedule of exceptions;
- *Perceived As Lower Quality Standards* – 78% believe private company accounting standards will be perceived as lower quality than U.S. GAAP;

CFA Institute

- *Reduced Costs, But Benefit of Reduced Costs Not Greater Than Increase Risk Premium and Cost of Capital* – 74% believe private company accounting standards will reduce preparation costs, but 52% don't believe the reduced preparation costs will cover the resulting increase in risk premium and cost of capital resulting from the loss of information and perceived lower quality standards; and
- *Complex Transaction Should Be Accounted for the Same for Private Companies* – 63% believe private companies with complex transactions should not be able to use reduced private company reporting requirements.

The survey findings substantiate our previously articulated investor concerns regarding the creation of differential standards for private companies. Investors aren't supportive of the creation of private company standards because it increases complexity, decreases comparability, results in the loss of information which cannot be remediated by access to management, has the potential to reduce the economic usefulness of information based upon the legal structure of the organization (private vs. public) irrespective of the complexity of the transaction or the size of the organization, and is likely to increase the cost of capital because of the perceived lower quality of private company standards and the lack of disclosure of the private company options elected. We would observe that each of these issues are inconsistent with the objectives of high quality accounting standards.

Evolution of Private Markets & Exchanges

Our Previous Commentary – As we stated in our 2013 comment letter to you on the definition of a public business entity, we believe there are few truly private companies. We reiterate our remarks here:

> As we noted in our 2012 comment letter to the Financial Accounting Foundation's, *Plan to Establish the Private Company Standards Improvement Council,* it is our view 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 many users of their financial statements. 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.
>
> Private companies differ greatly in size, complexity of activities that they undertake, and the accounting personnel they retain. The Proposed Update states that "the FASB and the PCC aim to achieve an appropriate cost-benefit balance by providing accounting and reporting alternatives to entities that are within the scope of the guide (which is not based on the notion of public accountability)." We disagree with the notion of basing the scope of private company guidance primarily upon compliance costs for private companies. The issue of cost or limited resources does not pertain to large (and sometimes widely held) private companies such as Cargill, Mars Koch Industries. Furthermore, in the case of widely held private companies (and even some closely held private companies), investors do not necessarily have any access to management – a faulty assumption which underlies the private company differential framework – that they might with truly small private companies. As noted in the 2012 Forbes listing of America's largest private companies, there are a significant number of private companies with substantial revenues, employees and resources which will be subject to these private company exceptions.
>
> It is our view, that if the FASB and PCC were to consider providing some relief for private companies, such relief should only be considered for private companies that are truly small with limited resources. Further, we believe there is a need for a logical definition of a public entity rather than the current multiple definitions that are in place simply to address the scope issues of individual standards.

CFA Institute

Our Concerns Only Increase: Growth in Private Equity & Technological Advances in Connecting Suppliers and Providers of Capital – Over the last several years we have seen even greater emergence of private equity investments – some even referred to as "private IPOs." Further, we have seen technology used to facilitate access to capital for private companies. The growth in the private equity market combined with the emergence of new exchanges and funding sources (e.g. crowd funding) has only increased the use of private markets for capital access.

A recent article in the New York Times, *Main Street Portfolios Are Investing in Unicorns*, explains the growth in these private equity investments and the concern over how valuations are being made in mutual funds holding such private company investments:

> It's virtually impossible to know exactly how the mutual funds determine the value of private companies. Not one of the mutual fund companies with which I spoke was willing to fully explain its methodology.
>
> T. Rowe Price offered this statement: "Valuations are the responsibility of a cross-disciplinary valuation committee, which operates independent of portfolio management." The company added: "The factors we consider include significant transactions in these securities, new rounds of financing, the company's financial and operational performance, strategic events impacting the company and relevant valuations of similar companies."
>
> Fidelity was equally noncommittal. "We have a rigorous and thorough fair-market valuation process for mutual fund holdings," the company said. BlackRock declined to comment.

As can be seen from this article, there is very little information on how these private company valuations are being performed. Yet the T. Rowe Price quote indicates that financial performance and presumably financial statements are still being reviewed[4] and the information contained within the financial statements is applied as a valuation input. The growth in such investments, and the possibility of inflated large private companies' valuations, exacerbates our concern over the establishment of differential and in our opinion, lower quality accounting standards for these types of companies. We are also concerned that these companies may potentially apply the proposed private company reporting standards without a clearly differentiated label or a precise description of type of standards in the audit opinion. We are concerned that it will be difficult for investors to identify where either public or private reporting standards have been applied given the labelling of all these different reporting standards as "U.S. GAAP" within the audit opinion. We recognize that only some entities will elect to apply the private company reporting framework, but the central issue is that the proposed differential reporting framework will pose a challenge to the quality and comparability of the information provided within and across reporting entities under the name of U.S. GAAP.

[4] Anecdotally we have been told that the release of financial statements to those seeking to perform due diligence on such enterprises has been restricted to a greater degree over the last several years because auditors are suggesting the potential investor or acquirer is not a party to the engagement letter. This trend in the limited distribution of financial statements results in extensive cost and due diligence for new investors. While the movement to create private company standards does not drive this, we find that the existence of such lower quality standards without appropriate labelling can only serve to increase the perceived risk and reduce auditors' incentive of sharing such financial information with investors.

CFA Institute

Given the aforementioned issues investors see with differential standards and the increasingly blurred line between public and private companies, we believe further work to progress this private company initiative at a time when the private market is expanding may only exacerbate issues investors see with differential standards for private companies.

RESPONSES TO QUESTIONS

We believe the FASB has the ability to understand and respond to the needs of private company preparers and that responsibility for any special consideration of financial reporting for private companies should rest with the Board. Just as the FASB is charged with incorporating and balancing the interests of various stakeholders group, we believe the FASB should have sole responsibility for considering the needs of private companies. Retaining a separate committee charged with special consideration of private company matters – and with a higher level of authority than other committees to the Board – will only expand the development of differential accounting standards for private companies which we believe will act to intensify the concerns of investors and users as noted above. We have not responded in detail to the questions for comment posed in the Request for Comment as we believe the perspective articulated in this letter provides an overarching framework upon which our responses to the detailed questions can be drawn.

****

Thank you again for the opportunity to comment. If you or your staff have questions or seek further elaboration of our views, please contact either Mohini Singh, ACA, by phone at +1.434.951.4882, or by e-mail at mohini.singh@cfainstitute.org or Sandra J. Peters, CPA, CFA by phone at +1.212.754.8350 or by email at sandra.peters@cfainstitute.org.

Sincerely,

/s/Sandra J. Peters
Sandra J. Peters CPA, CFA
Head, Financial Reporting Policy
Standards & Financial Markets Integrity Division
CFA Institute

/s/ Ashwinpaul C. Sondhi
Ashwinpaul C. Sondhi
Chair
Corporate Disclosure Policy Council

cc: Corporate Disclosure Policy Council