Spettabile
CONSOB
Divisione Strategie Regolamentari
Via G.B. Martini, 3
00198 Roma

Milano, 30 maggio 2016

Re: Documento di consultazione sulle modifiche alla disciplina delle relazioni finanziarie periodiche

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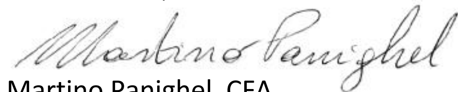
Non esitate a contattarci nel caso desideriate degli approfondimenti sulle argomentazioni espresse[3].

Distinti saluti,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[1] CFA Society Italy (CFASI), fondata nel 1999, è un'associazione senza scopo di lucro che raggruppa i professionisti che operano nel campo finanziario e che hanno scelto di condividere rigorosi standard di integrità, formazione ed eccellenza professionale. Tutti i 404 soci aderiscono al ***Code of Ethics and Standards of Professional Conduct***, il codice di deontologia professionale promosso da CFA Institute. La maggior parte ha conseguito la qualifica di *Chartered Financial Analyst*, certificazione riconosciuta a livello internazionale quale *gold standard* di eccellenza professionale. Per ulteriori informazioni si veda il sito www.cfasocietyitaly.it

[2] CFA Institute è un'associazione professionale senza scopo di lucro che conta ad oggi oltre 139.285 soci tra *investment analysts*, *portfolio managers*, *investment advisors* e altri professionisti del settore finanziario presenti in 150 Paesi. Nell'Unione Europea è presente con 22 associazioni nazionali e 20.349 soci. L'associazione promuove programmi di aggiornamento professionale e pubblicazioni quali il ***Financial Analyst Journal***, sviluppa standard di condotta e codici di autodisciplina come il ***CFA Institute Code of Ethics and Standards of Professional Conduct***, i ***Global Investment Performance Standards (GIPS®)*** e l'***Asset Manager Code of Professional Conduct (AMC)***. Per ulteriori informazioni si veda il sito www.cfainstitute.org

[3] Un ringraziamento particolare a Matteo Lombardo, CFA, per i contributi forniti all'elaborazione della risposta di CFA Society Italy.

La consultazione

Poiché la legge prevede che "*Prima dell'eventuale introduzione degli obblighi* [di pubblicazione di informazioni periodiche aggiuntive rispetto alla semestrale e al bilancio annuale], *la Consob rende pubblica l'analisi di impatto*", è avviata una consultazione preliminare, volta ad acquisire elementi utili per verificare la sussistenza delle condizioni imposte dal legislatore ai fini dell'esercizio della delega e, pertanto, propedeutica all'effettuazione di una compiuta analisi di impatto.

Nell'ambito della consultazione, ***si richiede***:

[…] ai ***piccoli investitori***, alle ***associazioni di consumatori***, agli ***investitori istituzionali***, ai ***consulenti***, agli ***analisti finanziari*** e alle rispettive ***associazioni di categoria***, nonché a ***Università***, ***Centri di Ricerca*** e singoli ***studiosi*** che abbiano condotto specifici studi relativi alle decisioni di investimento, di fornire dati ed evidenze in merito all'***utilità aggiuntiva delle informazioni trimestrali*** ai fini delle decisioni degli investitori, specificando i relativi contenuti, rispetto a quelle pubblicate ai sensi delle normative sul prospetto e sugli abusi di mercato. In particolare, si richiederanno indicazioni in ordine al contenuto minimo ritenuto necessario per formulare scelte di investimento (ad esempio, situazione patrimoniale, risultato netto, andamento dei ricavi, ecc.).

La risposta di CFA Society Italy

Il tema della trasparenza, puntualità e correttezza delle informazioni a disposizione degli investitori è da sempre importante per CFA Society Italy. Nel caso in esame, e con le precisazioni meglio discusse in seguito, **il *Financial Reporting Policy Group* di CFA Institute supporta la pubblicazione di relazioni trimestrali**, raccomandando che queste contengano lo stesso livello di informazione delle relazioni annuali.

In aggiunta, CFA Society Italy e CFA Institute sostengono il principio di massima armonizzazione delle regole, a maggior ragione tra gli Stati membri dell'Unione Europea. Sondaggi compiuti tra i *charterholder* europei indicano come la maggioranza di essi vorrebbero sforzi più concreti nell'implementazione pratica delle nuove regole sui servizi finanziari all'interno dell'Unione Europea. Molti di loro hanno, infatti, fatto notare che le iniziative introdotte dalla crisi del 2008 sono state necessarie e sicuramente positive ma la loro applicazione non è stata omogenea e coerente da parte dei vari Stati membri e sarebbe necessaria una maggiore armonizzazione.

A seguito di questa esigenza, CFA Institute ha deciso di commissionare uno studio per analizzare l'esperienza inglese sul tema in esame: i regolatori UK hanno, infatti, prima introdotto (2007) e poi eliminato (2014) l'obbligo per le aziende quotate di pubblicare le relazioni trimestrali, anche se la maggioranza delle aziende quotate continua a produrle. Lo studio esaminerà in particolare i cambiamenti nei mercati e nel comportamento degli investitori in questo periodo di analisi[4].

Le iniziative intraprese

Policy regulators in tutto il mondo stanno lavorando per affrontare la complessità e la trasparenza nella presentazione dei risultati finanziari: una delle principali questioni in ambito finanziario è, infatti, quella di "semplificare" i requisiti ed i processi contabili richiesti alle aziende, siano esse quotate o non-quotate.

Storicamente, una prima tipologia di interventi ha riguardato le modifiche di specifici principi contabili, in particolare si possono ricordare i progetti di convergenza di *US Generally Accepted Accounting Principles* (US GAAP) e *International Financial Reporting Standards* (IFRS) su aspetti quali *leasing* operativi e classificazione degli strumenti finanziari.

[4] Saremo lieti di condividere i risultati dello studio con Consob, su richiesta, appena saranno resi disponibili.

Un secondo aspetto ha riguardato in maniera più generica la riforma della contabilità aziendale, al fine di assicurare che i rendiconti finanziari rendano più evidente la creazione di valore nel lungo periodo da parte delle aziende. Parte del dibattito nasce dall'osservazione che i bilanci aziendali non sempre riflettono accuratamente gli *assets* immateriali, che sono invece un elemento significativo nell'equazione di creazione del valore. Altro punto riguarda la divulgazione di informazioni "non finanziarie" (come ad esempio quelle relative a *environmental, social and corporate governance* - ESG), un elemento che sta diventando sempre più importante per molti analisti ed investitori.

Infine, un terzo filone di interventi ha riguardato l'introduzione di requisiti differenziali o "in forma ridotta" per i bilanci delle aziende non quotate e la successiva eventuale estensione di questi requisiti alternativi alle aziende quotate (o, più precisamente, a loro sotto-gruppi). Questi sforzi, che si riferiscono nello specifico al tema di questa consultazione, sono principalmente orientati a ridurre gli oneri ed i costi di *compliance* regolamentare.

CFA Institute concorda con l'orientamento della Commissione Europea di evitare "*double reporting standards*": in linea di principio non supportiamo la creazione di standard contabili separati per entità differenti siano essi basati sulle dimensioni dell'azienda, sulla sua struttura legale o sul suo domicilio.

La pubblicazione di relazioni finanziarie separate riduce infatti la possibilità di poter confrontare i dati tra aziende piccole, medie e grandi o domiciliate in giurisdizioni diverse, che è invece un fattore essenziale per chi investe su un ampio spettro di Paesi e settori. **La creazione di principi differenziati ostacolerebbe pertanto l'analisi finanziaria ed il corretto processo di investimento.**

Ancora più importante, la creazione di una "contabilità speciale" per le PMI potrebbe essere vista dagli investitori come di qualità inferiore, con minor divulgazione delle informazioni essenziali, che potrebbe certamente portare ad una riduzione degli oneri regolatori ma anche ad un maggior costo del capitale per le PMI per compensare per questo rischio di minore trasparenza.

Cosa vogliono gli investitori?

Gli sforzi indirizzati a ridurre la complessità nelle relazioni finanziarie sono stati principalmente guidati da chi deve preparare queste relazioni, con l'obiettivo dichiarato di ridurre i costi di *compliance*. Quello che spesso, purtroppo, è mancato nelle discussioni è **il punto di vista degli investitori** che, è sempre bene ricordare, sono i principali fruitori dei rendiconti finanziari.

Lo studio allegato ("***Addressing financial reporting complexity***") è frutto di un sondaggio tra i membri di CFA Institute condotto nel mese di maggio 2014, nel quale è stata chiesta l'opinione degli investitori sull'impatto che le proposte sui cambiamenti nei requisiti di contabilità (sia per le aziende quotate sia per quelle non quotate) potrebbero avere sulla loro decisioni di investimento. I risultati sono inequivocabili: 82% dei rispondenti ritiene che l'introduzione di standard contabili differenziati ridurrà la comparabilità dei risultati, 73% che aumenterà la complessità e 65% che risulterà in una perdita di informazioni importanti.

Il modo nel quale sono preparate e presentate le relazioni finanziarie è, infatti, la lente attraverso la quale gli investitori percepiscono ed interpretano le attività di un'azienda ed i suoi risultati. Per questo motivo, CFA Institute ha anche intrapreso un articolato progetto per sviluppare un modello esauriente per la presentazione dei risultati: iniziato nel 2002 ed aggiornato periodicamente, ha l'obiettivo di raccogliere e catalogare le opinioni dei membri globali di CFA Institute sulle relazioni finanziarie e sulle informazioni richieste dagli investitori[5]. Il modello scelto avrà successo o fallirà a seconda della sua capacità di comunicare questi risultati in maniera chiara, trasparente e completa.

[5] Il documento è disponibile al seguente link: https://www.cfainstitute.org/learning/products/publications/ccb/Pages/ccb.v2007.n6.4818.aspx

CFA Society Italy

Raccomandazioni per eliminare il focus sul breve termine

Per quello che riguarda il rischio, identificato anche nell'analisi della Commissione Europea, che "*l'obbligo di pubblicazione delle relazioni trimestrali, […] incoraggerebbe le imprese (e gli investitori) ad orientarsi verso le performance aziendali a breve termine a discapito di strategie di investimento di lungo periodo*", fin dai primi anni 2000 il ***CFA Centre for Financial Market Integrity*** ha affrontato il problema del cosiddetto *short-termism* in una serie di simposi e tavole rotonde (si veda ad esempio l'allegato: ***"Breaking the Short-Term Cycle - Discussion and recommendations on how corporate leaders, asset managers, investors, and analysts can refocus on long-term value"***).

Le intuizioni dei vari partecipanti hanno confermato quello che le ricerche accademiche suggeriscono: l'ossessione sui risultati di breve periodo porta alle conseguenze non volute di distruggere valore nel lungo periodo, diminuire l'efficienza dei mercati, ridurre i rendimenti degli investimenti e rallentare gli sforzi di rafforzare la *corporate governance*.

Va tuttavia fatto notare come **la pubblicazione o meno di relazioni trimestrali sia un falso problema se altri aspetti riguardanti la diffusione delle informazioni non sono affrontati**. L'eliminazione delle relazioni trimestrali per favorire un maggior focus degli investitori sul lungo periodo rischia di distogliere l'attenzione da fattori ben più importanti. Come ha fatto notare Sandra Peters, *Head of Global Financial Reporting Policy* a CFA Institute, in un recente articolo del Financial Times[6]:

> *"Attempts to eliminate quarterly reporting - as has recently been accomplished in the UK - are a distraction to the more important issues Mr Fink describes in his letter.* ***Moving from 90- to 180-day reporting cycles is not going to advance long-termism in any meaningful regard****. More important, as Mr Fink rightly points out, are companies' public disclosures of long-term strategic objectives and periodic reporting on progress toward those objectives.* ***This is a more effective means of communicating value creation to investors.****"*

Considerazioni simili sono state avanzate da Robert Pozen e Mark Roe[7]: non è chiaro se passare da rendiconti trimestrali a semestrali spingerà effettivamente il management delle aziende a prendere decisioni di più lungo respiro ed allo stesso modo questo non allevierà certo la tendenza al cosidetto *earnings smoothing*. Infine, con la divulgazione dei dati finanziari ad intervalli di sei mesi il gap tra informazioni pubbliche e private si allargherà, facendo aumentare la tentazione per operazioni di *insider trading* e a tutto svantaggio degli investitori individuali che hanno minor accesso al management delle aziende rispetto agli investitori istituzionali.

È opinione di CFA Institute che focalizzarsi sulla tempistica delle relazioni finanziarie sia una sorta di "falso bersaglio" che non risolverà il problema di *short-termism*. Le raccomandazioni di CFA Institute per manager, gestori, investitori, analisti e *policy regulators* sono pertanto:

1. **Riformare le pratiche di *earnings guidance***: tutti gli attori coinvolti dovrebbero riconsiderare i benefici e le conseguenze di fornire dettagliate previsioni sugli utili trimestrali. Si auspica addirittura di eliminare la tradizione di fornire tali previsioni.
2. **Sviluppare incentivi che incoraggino a pensare al lungo termine**: questo vale sia per le aziende, sia per gli analisti ed i gestori. In particolare, la retribuzione e i bonus di tutte le parti coinvolte dovrebbero essere strutturate in modo da allineare la performance di lungo periodo con gli interessi dei clienti finali.
3. **Migliorare la comunicazione e la trasparenza**: comunicazioni più frequenti, ma soprattutto più significative, sulla strategia aziendale di lungo termine favorirebbero una minore dipendenza da *earnings guidance*. Questo può essere ottenuto, ad esempio, spingendo le aziende a divulgare maggiori

[6] "*Investors too need to be more rigorous*", Financial Times, 10 febbraio 2016. L'articolo è disponibile al seguente link: www.ft.com/intl/cms/s/0/bde4e2ec-cc07-11e5-be0b-b7ece4e953a0.html#axzz4950pDnLs

[7] "*Those Short-Sighted Attacks on Quarterly Earnings*", Harvard Law School Forum on Corporate Governance and Financial Regulation, 8 ottobre 2015. L'articolo è disponibile al seguente link: https://corpgov.law.harvard.edu/2015/10/08/those-short-sighted-attacks-on-quarterly-earnings/

informazioni sulle metriche che determinano il successo nel loro settore di appartenenza (utilizzando un linguaggio semplice e diretto invece che quello dominato da termini contabili e legali), piuttosto che semplicemente l'andamento di ricavi e utili.

Indicazioni sul contenuto minimo ritenuto necessario per formulare scelte di investimento consapevoli

Per migliorare la qualità della comunicazione tra aziende ed investitori, i suggerimenti di CFA Institute per le relazioni trimestrali/semestrali includono:

1) **Il ruolo dei rendiconti finanziari è di fornire le informazioni necessarie non solo agli azionisti ma anche ai creditori e agli altri fornitori di capitale di rischio**. Tutti questi attori necessitano di informazioni tempestive, rilevanti, complete e coerenti nel tempo affinché possano essere in grado di valutare il rischio e potenziale rendimento dei titoli nei quali sono investiti.
2) **Le informazioni fornite devono superare una soglia minima di significatività**. I rendiconti finanziari sono, infatti, preparati per tutti coloro che al di fuori dell'azienda necessitano delle informazioni e basano le proprie decisioni su di esse. Di conseguenza, la tipologia di informazioni fornite deve essere basata sugli elementi che influenzano le decisioni degli investitori: la soglia minima deve essere sia qualitativa sia quantitativa. Ad esempio, il dettaglio dell'informazione qualitativa aiuta l'individuazione di eventuali "manipolazioni" dei risultati compiuta dal management. Anche un livello minimo di "manipolazione" compiuta dal management deve essere considerato della massima importanza per gli investitori, che hanno bisogno di determinare l'integrità di chi gestisce le attività nelle quali hanno investito.
3) **Eliminare le previsioni sugli utili del trimestre seguente**: come già detto, questa pratica favorisce il focus sul breve termine a discapito di quello che determina il reale valore aggiunto nel lungo termine. I costi e le conseguenze negative di tale pratica sono significativi ed includono: a) gli sforzi (poco produttivi) da parte del management di preparare queste previsioni; b) trascurare la crescita del business nel lungo termine per raggiungere queste aspettative di breve; c) una cultura finanziaria caratterizzata da reazioni spropositate da parte di attori interni ed esterni a sorprese negli utili effettivi; d) un incentivo a "manipolare" o comunque presentare utili che rispecchiano quanto previsto.
4) **Includere una rappresentazione del conto economico (*income statement*)**. Anche se in genere le informazioni necessarie a riconciliare il testo del comunicato e i dati finanziari (GAAP/IFRS) sono contenute nei comunicati stessi, spesso è complicato trovare i dati rilevanti. Le tabelle presentate dovrebbero fornire sufficienti informazioni, linea per linea, affinché un investitore possa seguire i calcoli che portano dai ricavi agli utili netti ed ai flussi di cassa generati.
5) **Includere il rendiconto finanziario (*cash flow statement*) e lo stato patrimoniale (*balance sheet*)**. In aggiunta, è importante favorire una più estesa discussione di tutte quelle voci che sono maggiormente significative per l'attività in esame. Le informazioni contenute nel rendiconto finanziario e nello stato patrimoniale devono essere facilmente riconciliabili con quanto riportato nel conto economico: ad esempio, una variazione delle spese per interessi passivi nel conto economico non può essere correttamente interpretata senza la corrispondente informazione nello stato patrimoniale sul livello del debito finanziario.
6) **Minimizzare la presenza di informazioni non previste dai principi contabili (non-GAAP/non-IFRS)** e in ogni caso fornire informazioni su come sono state calcolate e come riconciliarle con le metriche previste dai principi contabili. Aggregare informazioni con differenti attributi economici, differenti basi di misurazione o afferenti operazioni differenti porta ad una sostanziale perdita di significato delle informazioni fornite.

Allegati:
- *"Addressing financial reporting complexity"*, CFA Institute, 2015
- *"Breaking the short-term cycle"*, CFA Institute, 2006

ADDRESSING FINANCIAL REPORTING COMPLEXITY: INVESTOR PERSPECTIVES

Separate Private Company Accounting and Beyond

CFA Institute

ADDRESSING FINANCIAL REPORTING COMPLEXITY: INVESTOR PERSPECTIVES

Separate Private Company Accounting and Beyond

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Preface

Standard setters and regulators around the world have been working to address complexity in financial reporting. Current standard-setter initiatives have taken different forms—the creation of differential or reduced reporting requirements for non-public companies, the extension of these non-public company alternative reporting requirements to public companies, and changes in certain public company reporting requirements. These efforts, we believe, have come about primarily in response to preparer concerns regarding compliance costs.

Missing from this dialogue, however, are the perspectives of investors. Consideration of such reform proposals from the investor perspective—the perspective of the main consumer of financial statements—is an important contribution that has yet to be included in a substantial way in the current dialogue. This report provides results from a survey that sought investor insights on the impact of separate non-public company reporting requirements on investors' financial analyses, how investors view extending such reduced requirements to public companies, and their perspectives on efforts related to changes in public company requirements. Finally, we analyze what investors believe are unavoidable (transactional) and avoidable (accounting) sources of complexity and, consequently, how standard setters need to refocus their efforts to eliminate avoidable complexity—that is, to bring greater transparency to complex activities by ensuring proper reflection of the underlying economics of transactions and events.

Mohini Singh, ACA

Director, Financial Reporting Policy, CFA Institute

Executive Summary

Discussions are underway on how to address complexity in financial reporting. Complexity can be seen from various perspectives—those of preparers, accountants, auditors, and investors. Differences in perspectives lead to differences in views as to how complexity should be tackled.

Current standard-setter efforts aimed at addressing financial reporting complexity have primarily focused on the creation of differential or reduced reporting requirements for non-public companies—separate standards for small- and medium-sized entities (SMEs) published by the International Accounting Standards Board (IASB) and US private company standards currently under development by the Financial Accounting Standards Board (FASB).

As we examined these efforts, we found that they had been undertaken largely at the behest of the preparer community as it argued for changes in reporting requirements principally aimed at reducing preparer compliance costs. Missing from the present discourse are the perspectives of investors. Consequently, CFA Institute, whose members are investment professionals, undertook a study to obtain investor perspectives on this subject by conducting a survey of CFA Institute members in May 2014—hereafter referred to as the 2014 Private Company Survey.[1] Based on the findings of the survey, we developed this report, which discusses the implication of differential standards for investors in their financial analyses.

Arguments for Differential Standards: Are They Sound?

The report begins by examining the main arguments of proponents of the creation of differential standards for non-public companies and considers whether they are sound. We find that the arguments do not withstand scrutiny. In fact, research studies demonstrate that non-public company users prefer financial statements based on generally accepted accounting principles (GAAP).[2] Nonetheless, both SMEs and US private companies maintain they need reduced reporting requirements. The question is: Why? If complying with a particularly complex standard within

[1]Background on the approach and methods of the 2014 Private Company Survey and information on the number of respondents are presented in Appendix A. The survey questions are focused on US private companies, not SMEs, because the IASB has already issued the International Financial Reporting Standard (IFRS) for SMEs.
[2]The term GAAP in this report refers to its general use; US GAAP is specific to the United States.

GAAP is too expensive, GAAP statements can be issued with a qualified audit opinion that explains the departure from GAAP. In addition, US private companies have the option to use some other comprehensive basis of accounting (OCBOA).

But according to research findings, there is a certain stigma attached to qualified audit opinions and OCBOA financial statements. Because of this stigma as well as users' preference for GAAP financials, the FASB has created a rather convoluted situation: Both the reduced private company financial reporting requirements and public company reporting requirements are considered US GAAP. This is not only confusing for investors but also leaves the entire burden on them to discern the differences between private and public company requirements, both of which are US GAAP.

Investor Concerns with Differential Standards: Comparability, Complexity, and Loss of Information

As part of the 2014 Private Company Survey, we asked CFA Institute members how they believe US private company standards will affect their financial analysis. They believe differential standards will decrease comparability (82%), create greater complexity (73%), and result in the loss of decision-useful information (65%).[3] Investors do, however, believe the private company initiative will achieve reduced compliance costs. These results illustrate that

- the private company initiative addresses preparer concerns regarding compliance costs and
- the costs of this initiative to investors will likely outweigh the benefits for private company managers.

If the FASB continues down its course of creating differential standards despite the aforementioned investor concerns, we believe the differences should be limited. The underlying assets and liabilities of an entity do not change based on the type of entity or its legal structure. Therefore, similar items should be accounted for—recognized and measured—similarly across all entities. Also, the US private company proposals appear to suggest that the presentation of an item in the main financial statements could be substituted by its disclosure in the footnotes. However, placing information in the disclosures only makes it less visible to investors.

[3]Percentages include respondents who selected "agree" and "strongly agree."

Thus, we believe the FASB should consider providing some relief only for private companies that are truly small with limited resources and only in the areas of disclosure requirements and effective dates of new accounting requirements.

Extending the Complexity Argument beyond Differential Standards

The FASB is now contemplating extending certain private company accounting alternatives—meant to reduce compliance costs—to public companies. We are concerned by the notion that changes to private company accounting will subsequently be used to alter the accounting and disclosure requirements for public companies when the basis for the change to private company accounting is not grounded in the need to most appropriately reflect the underlying economics of transactions in the financial statements and provide the most decision-useful information to investors. Accordingly, only 6% of survey respondents believe that private company alternatives should be extended to public companies.

In addition to creating differential private company standards and extending some of those alternatives to public companies, the third leg in the FASB's efforts to address perceived complexity is to "simplify" requirements under full US GAAP. However, similar to its efforts to create separate US private company standards, this initiative appears focused on reducing costs and complexity for the preparer community as reflected, for example, in its proposals to simplify inventory accounting and accounting for extraordinary items.

Focus on Providing Transparency for Complex Transactions and Decreasing Accounting Complexity

For reforms to simplify financial reporting—for both public and non-public companies—to be meaningful to investors, we need to examine what investors believe are the principal sources of financial reporting complexity, determine which sources are avoidable and which are unavoidable, and refocus simplification initiatives to eliminate the avoidable sources of complexity.

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Our experience suggests three key sources of complexity: complex businesses and transactions, inadequate communication, and inadequate accounting standards. Much of the added complexity in financial reporting standards is a function of the increased complexity of business transactions. Such complexity is unavoidable; it is a reality investors have to face. However, inadequate communication and inadequate accounting standards are avoidable sources of complexity that contribute to lack of transparency in the financial statements, thereby making it difficult to estimate the fundamental inputs needed to value a firm. Simplification efforts need to focus on these avoidable sources of complexity.

Inadequate Accounting Standards

Complexity is increased by accounting standards that do not reflect the underlying economics of transactions and, therefore, do not provide investors with needed transparency. This type of complexity may occur because of inadequate recognition or measurement of items in the financial statements, poor presentation, optionality that provides firms with discretionary power in how they account for transactions and events, accounting constructs (as opposed to economic conventions) that have crept into standards over time, and standards that include exceptions to principles.[4] Such complexity is avoidable.

Aswath Damodaran comments on the consequences of such complexity. He notes that "fuzzy" accounting standards exacerbate complexity in financial reporting by allowing discretionary power in the measurement of income and capital.[5] Accounting can be used to report higher earnings, lower capital invested, and higher returns on capital. Investors who look at earnings stability as a measure of equity risk are misled into believing that these firms are less risky than they truly are. Ultimately, the opacity of a firm's financial statements is likely to be reflected in its value because investors may discount value based on such complexity.

Any simplification initiative should focus on simplifying financial reporting requirements to the extent that not all complexity is the result of transaction complexity. The principal aim of accounting standards should be to ensure reflection of the underlying economics of transactions and events. To that end, standard setters need to work toward making sure that all economic assets and obligations are recognized on the balance sheet; that investors receive economically relevant measures (fair value) to understanding an organization's financial position; that financial statement presentation is enhanced with a focus on disaggregation, cohesiveness, and the use of roll-forwards and the direct method cash flow statement; and

[4]The full report amplifies the issues with each of these items.
[5]Aswath Damodaran, "The Value of Transparency and the Cost of Complexity," Stern School of Business (January 2006).

that disclosures are not used as a substitute for poor presentation. Furthermore, efforts should aim to increase transparency by eliminating accounting constructs, optionality, earnings smoothing, and exceptions to principles.

Inadequate Communication

Inadequate communication can also compound transaction complexity and is avoidable. CFA Institute's "Financial Reporting Disclosures: Investor Perspectives on Transparency, Trust, and Volume" provides recommendations on increasing communication effectiveness in financial statements—enhancements in communication style and presentation that could improve the way information is transmitted to investors.[6]

[6]Mohini Singh and Sandra J. Peters, "Financial Reporting Disclosures: Investor Perspectives on Transparency, Trust, and Volume," *Codes, Standards and Position Papers*, vol. 2013, no. 12 (July 2013).

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I. Creation of Differential Reporting Standards: Initiatives across the Globe

One of the big questions of the day in financial reporting is how to "simplify" the financial reporting requirements of businesses—both public and non-public companies. The purpose of this report is to examine the views of different parties—preparers, accountants, auditors, and investors—on financial reporting complexity, current initiatives to reduce such complexity, and investor perspectives regarding the efficacy of these initiatives. We also consider what investors believe are the true sources of financial reporting complexity and, consequently, what the focus of any initiative to simplify financial reporting requirements should be.

Although current initiatives pertain to both public and non-public companies, this report begins by examining efforts initiated by regulators and accounting standard setters related to reducing complexity through the creation of differential standards for non-public companies. Managers of non-public companies have long argued that the cost and complexity of existing GAAP has become onerous for such entities, especially in light of increasingly global and complex businesses and business transactions.

As noted, simplification of reporting requirements can be seen from many perspectives—preparers, accountants, auditors, and investors. Current initiatives to create differential or reduced reporting requirements for non-public companies have been, in our view, at the behest of managers of non-public companies and their accountants and auditors and aimed at reducing compliance costs. Missing from this dialogue, however, are the perspectives of investors and what the creation of differential standards might mean for their financial analysis. In our quest to identify how best to reduce financial reporting complexity, we begin by examining the impact of differential standards on the investor community and whether this effort achieves the desired simplification in financial reporting from an investor perspective. We will explore the principal regulatory and standard-setting endeavors in this area.

Regulatory Initiative

In 2007, the European Commission (EC) set out its vision for changing the regulatory environment for European businesses, particularly in the areas of accounting, auditing, and company law. The aim of the proposed measures was to "remove or reduce a range of administrative requirements that are considered outdated or excessive" (p. 1).[7]

To this end, in 2008 the EC put forth proposals to "make life easier for SMEs by cutting the following burdens on enterprises."[8]

> In the accounting area, parent companies with no material subsidiaries no longer need to prepare consolidated accounts. Furthermore medium-sized companies can be exempted from providing detailed data in the annual accounts. (p. 1)[9]

European Commissioner for Internal Market and Services Charlie McCreevy said in support of the proposals:

> Unnecessary and disproportionate administrative costs severely hamper economic activity. With these proposals, we deliver on the promise we made in July 2007 when we set out our plans for the simplification of the business environment. (p. 1)[10]

[7]European Commission, "Commission Sets out Vision for Simplifying EU Rules on Company Law, Accounting and Auditing" (12 July 2007): http://europa.eu/rapid/press-release_IP-07-1087_en.htm?locale=en.

[8]In EU law, the main factors determining whether a company is an SME are the number of employees and either turnover or balance sheet total.

Company Category	Employees	Turnover	or	Balance Sheet Total
Medium-sized	<250	≤€50m		≤€43m
Small	<50	≤€10m		≤€10m
Micro	<10	≤€2m		≤€2m

[9]European Commission, "Commission Cuts Unnecessary Administrative Burdens in EU Company Law" (17 April 2008): http://europa.eu/rapid/press-release_IP-08-598_en.htm.

[10]European Commission, "Commission Cuts Unnecessary Administrative Burdens in EU Company Law."

Standard-Setting Initiatives

The IASB and FASB have also undertaken efforts to create differential—that is, reduced—financial reporting requirements for SMEs and US private companies,[11] respectively. Unlike the EC definition, however, the IASB and FASB definitions of an SME and a US private company are both based on the nature of an entity rather than on its size.

According to the IASB, SMEs are entities that (1) do not have public accountability and (2) publish general-purpose financial statements for external users. An entity has public accountability if it has publicly traded securities or holds assets in a fiduciary capacity.[12] US private companies are somewhat different from SMEs as defined by the IASB: US private companies cannot have publicly traded securities but may hold assets in a fiduciary capacity.[13]

International Financial Reporting Standard for SMEs

In 2009, the IASB published a standard for SMEs—the IFRS for SMEs. The SME standard has reduced requirements that the IASB contends reflect cost–benefit considerations and the needs of users of SME financial statements. Compared with full IFRS, it is less complex in a number of ways:

- Omission of topics. Certain topics are omitted, such as interim reporting.
- Fewer accounting policy choices. Where full IFRS allows accounting policy choices, the IFRS for SMEs permits only the easier option.
- Different measurement principles. Many of the principles for recognizing and measuring assets, liabilities, income, and expenses in full IFRS are different from those under the SME standard.
- Fewer disclosures. Significantly fewer disclosures are required.

[11]Hereafter, SMEs (as defined by the IASB) and US private companies (as defined by the FASB) will collectively be referred to as non-public companies.
[12]The definition of an SME (as defined by the IASB) does not include quantified size criteria for determining what qualifies as a small- or medium-sized entity.
[13]See Footnote 15 for a detailed definition of a US private company.

US Private Company Standards

Similarly, in the United States, there has long been a call by private company managers and their auditors for reduced financial reporting requirements. To address this call to action, in May 2012, the FASB established the Private Company Council (PCC), tasked with determining whether exceptions or modifications to existing US GAAP are necessary for private companies.

Since the inception of this initiative, the FASB and PCC have issued the following:

- "The Private Company Decision-Making Framework: A Guide for Evaluating Financial Accounting and Reporting for Private Companies."[14] The primary purpose of this guide is to assist the FASB and PCC in determining whether and in what circumstances to provide alternative recognition, measurement, disclosure, presentation, effective date, and transition guidance for private companies reporting under US GAAP. The guide also contains a separate definition of a public business entity—a de facto definition of a private company.[15]
- Specific studies. Four alternative accounting treatments for private companies with respect to[16]
  - accounting for goodwill,

[14]Hereafter referred to as *Private Company Decision-Making Framework*.

[15]A business entity is not within the scope of the guide if it meets any one of the following criteria:

a. It is required by the SEC to file or furnish financial statements or does file or furnish financial statements (including voluntary filers) with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).

b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.

c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.

d. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.

e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare US GAAP financial statements (including footnotes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.

An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity's filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.

[16]See Chapter IV for a more detailed discussion.

- applying variable interest entity guidance to common control leasing arrangements,
- a simplified hedge accounting approach, and
- accounting for identifiable intangible assets in a business combination.

The FASB is currently contemplating extending certain private company alternative reporting requirements to public companies. This is different from its normal due process, whereby topics are added to the technical agenda based on a demand from constituents for improvements in financial reporting rather than exceptions simply owing to compliance costs.

Current Focus: Preparers, Accountants, and Auditors

As we reviewed these efforts toward the creation of differential standards, we found that they were heavily informed by preparers, accountants, and auditors rather than investors. They came about in response to a common complaint heard from managers of non-public companies—that their time and resources could be better used pursuing other opportunities than complying with requirements not relevant to their business and not helpful in their decision making. The report of the Blue Ribbon Panel (BRP)[17]—established to address how US accounting standards can best meet the needs of private company financial statement users—goes on to argue:

> Since it also appears that the least relevant standards for private company users are often the most complex, the BRP believes that private companies are incurring significant unnecessary cost for GAAP financial statement preparation and audit, review, or compilation services. Indeed, the increase in costs to provide potentially irrelevant information has led to more users who are willing to accept qualified opinions—a development that calls into question whether those aspects of GAAP are truly "generally accepted." These increasing instances of nonacceptance, coupled with a concern about the overall complexity of GAAP expressed by many private company preparers and their CPA [certified public accountant] practitioners—a concern that some BRP members have noted extends to public companies as well—have led the BRP to conclude that, at a minimum, the current

[17]In December 2009, the BRP was established by the American Institute of Certified Public Accountants (AICPA), the Financial Accounting Foundation (FAF), and the National Association of State Boards of Accountancy (NASBA).

> accounting standard-setting system needs to be improved to better address the needs of users of private company financial statements in a cost-effective manner. (p. 6)[18]

Furthermore, accountants and auditors argued that because of the complexity of GAAP, they were unable to pass on the cost of their services to non-public companies.

CFA Institute Study: Need for Investor Perspectives

The principal aim of financial reporting is to provide useful information to investors in their capital allocation decisions. But as previously noted, the push for different standards has not been driven by investors. The calls for reduced reporting requirements have come largely from the preparers of financial statements—be they managers of SMEs or US private companies—and auditors. Consideration of such reform proposals from the investor perspective—the perspective of the main consumers of financial statements—is an important contribution that has yet to be included in a substantial way in the current dialogue on creating differential reporting requirements.

CFA Institute—whose membership is composed of investment professionals—undertook a study to provide investor views on the creation of differential financial reporting standards for non-public companies. To obtain investor perspectives, CFA Institute conducted a survey of its members in May 2014—hereafter referred to as the 2014 Private Company Survey.

Based on the findings of the survey, we developed this report, which discusses the implication of differential standards for investors in their financial analyses. The survey questions are focused on US private companies, not SMEs, given that the SME standard has already been issued. The report, however, draws parallels between the two standards to demonstrate the similarities in the approaches taken and their impact on the investment decision-making process. It also demonstrates that the FASB approach in creating differential standards goes further than the IASB and deliberates what that means for the investor community.

[18]Blue Ribbon Panel on Standard Setting for Private Companies, "Report to the Board of Trustees of the Financial Accounting Foundation" (January 2011).

CFA Institute believes that such a study is essential given the importance of both SMEs and US private companies in the world's economy. According to the IASB, SMEs are estimated to account for more than 95% of all companies around the world. And among the more than 150,000 firms operating in the United States that generate greater than $10 million in annual revenues, roughly 90% are privately held.[19,20]

Furthermore, we provide investor perspectives on the true sources of financial reporting complexity and how investors believe current initiatives should be refocused to bring about greater transparency to complex transactions and events.

Differences in SME and US Private Company Reporting Regimes

In many IASB countries, public and non-public companies are legally subject to the same reporting requirements. SME managers have argued that in the face of high compliance costs with full IFRS, the only options available to them were to either (1) adopt full IFRS in totality and bear the associated compliance costs or (2) adopt full IFRS but not comply with all its complexities and face the stigma of a qualified audit report.

In the United States, however, private companies are not subject to public company US GAAP. If following US GAAP is viewed as too expensive, companies can elect to use another basis of accounting. In practice, we see private firms using tax-basis accounting, cash-basis or modified-cash basis accounting, statutory basis accounting, and other approaches. Therefore, although it is argued that separate non-public company accounting principles may be justified in some IASB countries, the need is less clear in the United States. An investor quote from the 2014 Private Company Survey says it best:

> This effort to create a private company GAAP should be scrapped. Most small private companies are already not subject to many of the most costly accounting standards under GAAP and so do not need to "rescued" by the FASB. If the

[19]Data obtained from PrivCo (the Private Company Financial Data Authority, a financial research database focused exclusively on privately held companies).

[20]In support of these statistics, a 2008 paper by the Centre for Corporate Governance Research, "Corporate Finance and Governance in Firms with Limited Liability: Basic Characteristics," by Janis Berzins, Øyvind Bøhren, and Pål Rydland, from the Norwegian School of Management, states in its abstract that in most countries around the world, non-publicly listed firms have (in aggregate) considerably more employees, greater revenues, and more in total asset values than do publicly listed firms.

> FASB is getting pressure to make exceptions under the guise of private company reporting, it should be taking a closer look at the effectiveness of existing accounting standards.

In the next section, we examine the main arguments of proponents for the creation of differential financial reporting standards for non-public companies and consider whether they are sound.

II. Arguments for Differential Standards: Are They Sound?

The principal arguments made by preparers, accountants, auditors, and standard setters in favor of differential non-public company standards are that the needs of non-public company users are different from those of public company users, that non-public company users have greater access to management than public company users and thus are in a position to obtain any information they need in addition to the financial statements provided to them, and that such companies have limited resources to apply complex GAAP requirements. This section addresses each argument in turn to determine whether it does, in fact, support the development of differential standards.

Non-Public Company User Needs: Are They Different?

One of the principal arguments made by preparers and standard setters in support of the creation of non-public company standards has been the differing needs of users of non-public company financial statements. Managers of non-public companies maintain that the needs of their financial statement users—primarily lenders and other creditors—are different from those of public company users in that they are more concerned with cash flows rather than value-based financial statements. In support of this, the FASB's "Private Company Decision-Making Framework" states:

> Lenders and other creditors are concerned most about financial statement amounts and notes that affect reported amounts of cash, liquidity, and cash flow from operations available to service debt.…Most private company investors…indicate that they are less interested in accounting guidance that does not affect reported cash amounts or probable future cash flows. They also are less interested in accounting guidance that produces or results in volatility in reported earnings and asset and liability values resulting from underlying changes in fair value that are expected to reverse contractually in the future if the company has the intent and ability to hold the related instrument to maturity or term. (p. 8)[21]

[21]FASB, "Private Company Decision-Making Framework" (23 December 2013): www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176163703583&acceptedDisclaimer=true.

The contention is that users of non-public company financial statements are more likely to be lenders than equity holders and that GAAP focuses on the information needs of equity investors. The conceptual frameworks of both the FASB and the IASB, however, state that financial statements presented under GAAP are expected to provide decision-useful information for external users in general. The *Conceptual Framework for Financial Reporting* of both the FASB and IASB state:

> The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling, or holding equity and debt instruments and providing or settling loans and other forms of credit. (p. 1)[22]

This observation that the objective of financial reporting is the same for all companies, whether public or non-public, is in line with the dissenting member of the BRP. According to the dissenting view, no compelling evidence or framework was presented to suggest that the objectives of financial reporting differ between non-public and public companies. The BRP was merely presented with a list of standards that accountants and auditors of private companies do not find desirable.[23]

User Needs: Research Studies

Several research studies have been conducted to ascertain the views of users of non-public company financial statements regarding the usefulness of GAAP statements. In 1983, the FASB conducted a research project[24] focusing on the three principal groups involved with private company financial reporting—managers, bankers, and accountants. Results from interviews and surveys indicated that[25]

- company managers are the principal users of financial statements followed by bankers and suppliers;
- managers find US GAAP financial statements useful in making decisions and facilitating borrowing;

[22]FASB, "Chapter 1: The Objective of General Purpose Financial Reporting," in *Conceptual Framework for Financial Reporting, Statement of Financial Accounting Concepts No. 8* (September 2012).
[23]CFA Institute comment letter "Private Company Plan," dated 30 January 2012, agrees with this dissenting view: www.cfainstitute.org/Comment%20Letters/20120130.pdf.
[24]A. Rashad Abdel-khalik, "Financial Reporting by Private Companies: Analysis and Diagnosis," FASB Research Report (August 1983).
[25]Abdel-khalik, "Financial Reporting by Private Companies," pp. 7–8.

- bankers find US GAAP financial statements provide reliable and understandable data helpful in making lending decisions;
- all groups agreed that financing through debt is easier if private companies use US GAAP rather than another basis for financial reporting; and
- bankers (90%) and managers (60%) agreed, on average, that the expected benefits from using US GAAP exceeded the costs.

Eighty-five percent of bankers but fewer than forty percent of accountants reported that[26]

- the same information is needed from private and public companies for the purpose of making similar decisions and
- financial statements will become less useful if an accounting basis other than US GAAP is used for private companies.

The Financial Accounting Standards Committee of the American Accounting Association cites the following studies in support of the aforementioned findings in their paper "Financial Accounting and Reporting Standards for Private Entities."[27]

1. Nair and Rittenberg[28] conclude that
    - bank lenders are the primary external users of private company financial statements;
    - small business lenders perceive their needs to be similar to decision makers dealing primarily with larger companies;
    - external users want more, not less, disclosure from small businesses; and
    - in terms of the cost–benefit trade-off, users generally conclude that the benefits of US GAAP financial statements justify the cost of providing them.

[26]Abdel-khalik, "Financial Reporting by Private Companies," pp. 12–13.
[27]Financial Accounting Standards Committee, "Financial Accounting and Reporting Standards for Private Entities," *Accounting Horizons*, vol. 20, no. 2 (June 2006).
[28]RD Nair and Larry Rittenberg, "Alternative Accounting Principles for Smaller Businesses: Proposals and Analysis," *Journal of Commercial Bank Lending*, vol. 65, no. 8 (1983):2–22.

2. A survey of 233 bank loan officers conducted by Baker and Cunningham[29] finds that the participants perceive US GAAP–based financial statements to be useful. Participants also exhibit greater confidence in US GAAP–based financial statements compared with tax-based financial statements, and they perceive lower default risk when borrowers provide US GAAP financial statements.

These studies demonstrate that external users of non-public company financial statements believe their information needs to be similar to those of public companies. Further, they believe that GAAP financial statements provide the necessary information in a manner more reliable than any other basis of accounting. This refutes the claims of preparers, accountants, and auditors, as previously noted, that producing GAAP financial statements places an undue cost burden on the company because it does not provide users with the most relevant information. It also explains why the push for differential standards has not been driven by *users* of non-public company financial statements. Given that the purpose of the primary financial statements is to provide the information needed by investors, creditors, and other suppliers of risk capital, as we maintain in our seminal publication *A Comprehensive Business Reporting Model* (CBRM),[30] we question financial reporting reforms that are not made at the behest or for the benefit of the users of financial statements.

Greater Access to Non-Public Company Management: Is This Sufficient to Supplement Loss of Information?

Preparers and auditors argue not only that GAAP-based financials are less useful for users but also that because most non-public companies typically have a smaller number of users than those of public companies, they can directly obtain information from management—in addition to the financial statements—and hence do not need detailed financial statements.

[29]William Baker and Gary Cunningham, "Effects of Small Business Accounting Bases and Accounting Service Levels on Loan Officer Decisions," *Journal of Business Finance & Accounting*, vol. 20, no. 4 (June 1993):465–477.

[30]CFA Institute, *A Comprehensive Business Reporting Model* (Charlottesville, VA: CFA Institute, 2007): www.cfapubs.org/toc/ccb/2007/2007/6. The CBRM is CFA Institute's financial reporting framework that articulates 12 core principles that should govern financial reporting. Principle 1 of the CBRM, Information Needed by Suppliers of Capital, states that the primary objective of financial reporting is to meet the information needs of equity investors, creditors, and other suppliers of risk capital so that they can make their resource allocation decisions.

"The Private Company Decision-Making Framework" argues:

> Because private companies often have fewer financial statement users, those users also may have greater influence on preparers because they tend to provide a larger percentage of resources to private companies when compared with typical users of public companies. As a result, users of private company financial statements have continuous access to management and the ability to obtain financial information throughout the year. That access creates less demand for interim financial statements and a potential willingness to accept a greater lag in timing of when audited or reviewed financial statements are made available for issuance. Generally, there are fewer restrictions on the ability to share selective financial information with individual users of private company financial statements. In contrast, there generally are more users of public company financial statements with less economic leverage and generally more restrictions on the ability to share selective financial information with those users. That creates greater demand for timelier (interim and annual reports) and more detailed general-purpose financial statements in a public company environment. (pp. 6–7)

The contention is that users of non-public company financial statements typically interact with management at regular intervals throughout the year and receive monthly or quarterly financial information. Information contained in the financial statements is thus used as an annual check or assessment of the entity's performance by users. That is, users "view annual financial statements as third-party confirmation of their prior observations of the company's performance over the year" (p. 41).[31]

CFA Institute maintains that non-public companies vary greatly in size, and as a result, the number of users differs among these companies. Consequently, access to management and the ability of users to obtain information will differ across firms. For example, private equity general partners have greater access to management than the limited partners.

Also, a user can only *request* additional information. If management is unwilling to provide that information, the user has no recourse other than, for example, not to lend to the company. Moreover, while in theory it may be the case that non-public company users can obtain additional information, it may be more difficult to do so in practice. For example, the willingness of management to provide information may depend on the competitive pressures faced by the company.

[31]FASB, "Private Company Decision-Making Framework."

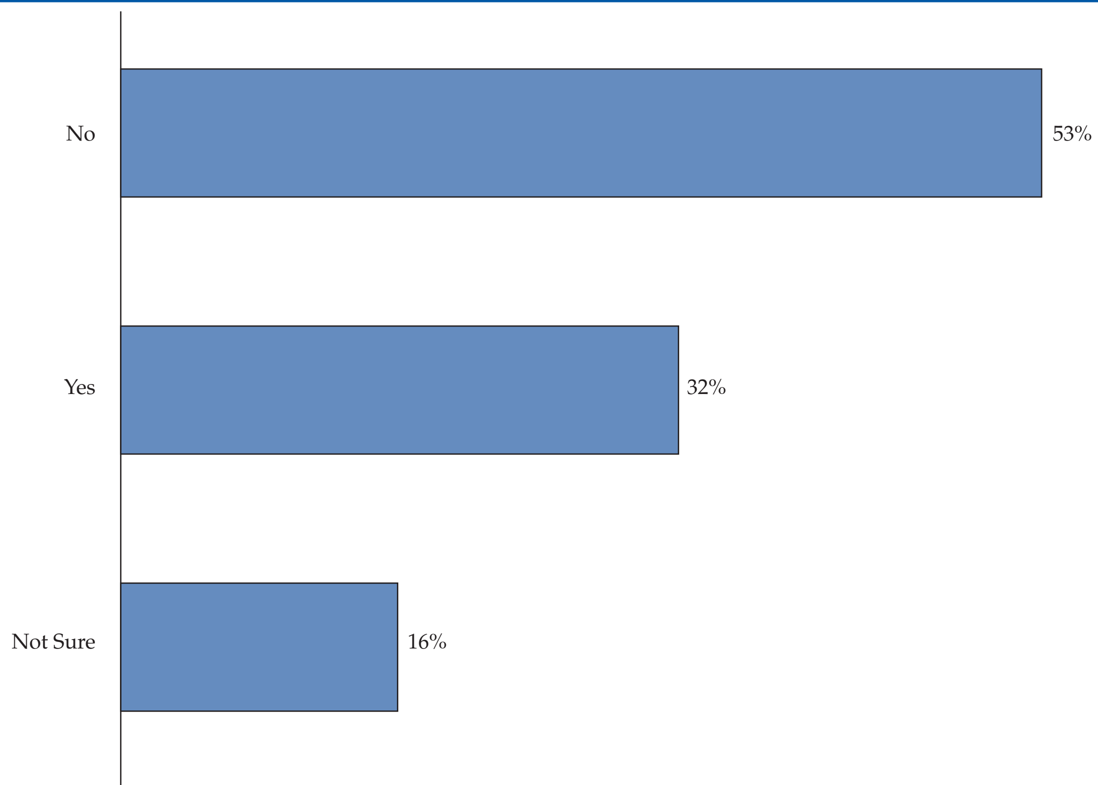
The findings in **Figure 1** support the assertion that greater access to management of non-public companies does not ensure that investors would be able to obtain all the information they deem necessary. The majority (53%) of the respondents to the 2014 Private Company Survey indicated that they do not believe that greater access to management would supplement any potential omission of useful information from the financial statements.

The following investor quotes from the survey are representative of this belief:

> Not all private company investors have as direct access to management as others.

> Not all managements of private companies are able to or willing to communicate information to investors, nor do all investors have equal access to those managements.

Figure 1. Access to Management Insufficient to Supplement Loss of Information



Notes: The question was, In your opinion, can any potential omission of useful information be sufficiently supplemented by greater access to management? As for responses, *N* = 158.

Finally, producing GAAP-based financial statements may be more credible and less costly than communicating information individually to parties or providing information only to those parties who request it explicitly. Credibility is gained because producing GAAP financial statements reduces the information asymmetry between different agents. Costs are also reduced because it is no longer necessary to provide more specific information to individual parties.

Do All Non-Public Companies Have Limited Resources?

As previously noted, the definition of an SME (as defined by the IASB) and a US private company (per the FASB's de facto definition) is based on the nature of an entity rather than on its size. A company of any size that meets either the definition of an SME or a US private company is, therefore, eligible to use the IFRS for SMEs or US private company standards respectively.[32]

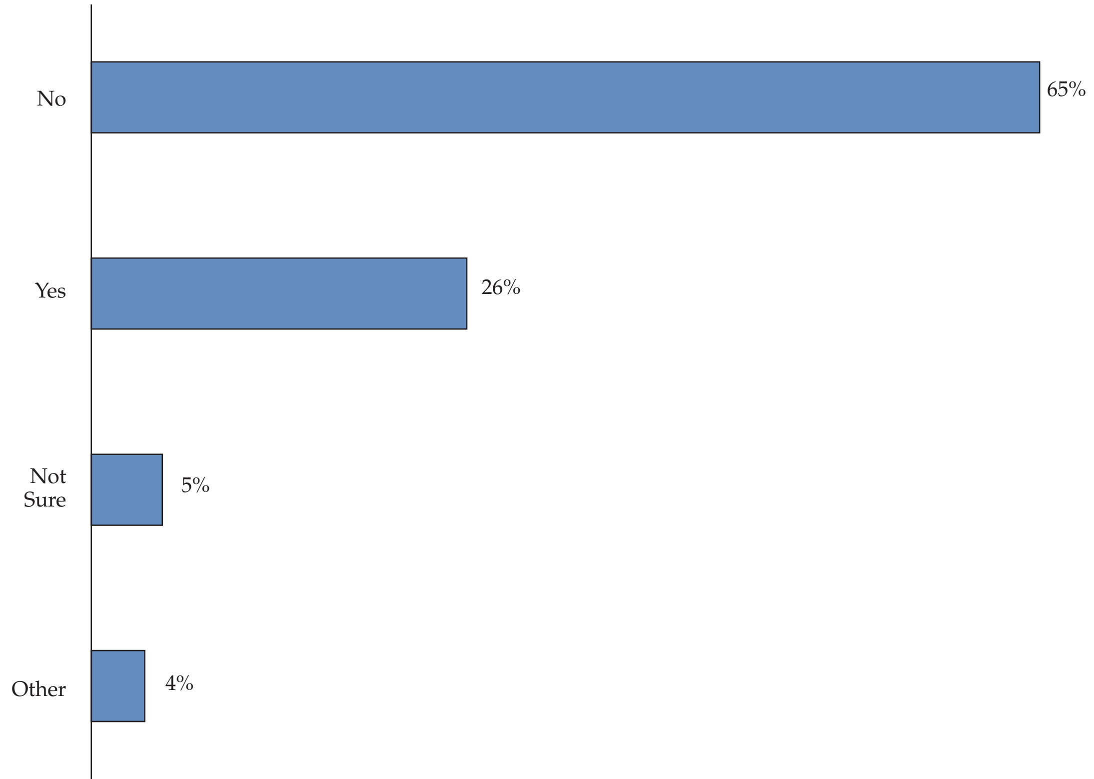
Non-public company managers maintain they face high compliance costs when they prepare GAAP financial statements that result in information not relevant to their business. Further, they maintain that they have limited resources to devote to such complex reporting. We have, as previously noted, refuted the claims that GAAP financials are not relevant for non-public companies. We also contend that non-public companies are not homogenous. They differ greatly in size, complexity of activities that they undertake, and the resources available to them. Given that there are no size limits on SMEs and US private companies, there are many large, non-public companies to whom issues of cost and limited resources do not pertain but may nonetheless apply differential standards. We, therefore, disagree with the notion of basing the scope of non-public company guidance primarily on compliance costs for these companies. The issue of cost or limited resources does not pertain to large and sometimes widely held—that is, when shares are distributed over a number of shareholders—non-public companies.[33]

[32]A criterion that the IASB considered but did not include in its SME definition was to exclude an entity that is economically significant in its home country based on, for example, total assets, total income, number of employees, degree of market dominance, and nature and extent of external borrowings. Such a criterion would have precluded larger, widely held entities from using the IFRS for SMEs. Instead, now it is up to a jurisdiction to add a quantified size test to the definition of an SME, if it chooses to do so.

[33]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 that will be allowed to apply these private company exceptions.

Accordingly, the results in **Figure 2** demonstrate that the majority (65%) of respondents to the 2014 Private Company Survey believe that large, widely held private companies should not be permitted to apply reduced private company reporting requirements.

Figure 2. **Large, Widely Held Private Companies Should Not Apply Reduced Requirements**



Notes: The question was, In your opinion, should widely held private companies be permitted to apply reduced private company reporting requirements? As for responses, *N* = 167.

Impossible to Draw Line between Public and Non-Public Companies

Moreover, we believe it is almost impossible to draw the line between public and non-public companies because there are many investors in non-public entities and many users of their financial statements. It is our view that there are few truly non-public companies. The only truly non-public 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. Consequently, we believe that if relief is provided, such relief should apply only to non-public companies that are truly small and have limited resources. CFA Institute believes this result could have been achieved by the inclusion of quantified size and restricted ownership criteria in the definition of SMEs and private companies.

Investor quotes from the survey say it best:

> The definition should not be so broad and should have limitations to what is truly private.
>
> Only small, privately held companies with owner/managers with average risk would benefit from such reduced reporting requirements.

The Real Reason for Change: Stigma Associated with Qualified Audit Report and Other Bases of Accounting

Notwithstanding the breakdown of the arguments of proponents for differential standards, both SMEs and US private companies maintain that they need reduced reporting requirements. Why? If complying with a particularly complex standard within GAAP is too expensive, GAAP statements can be issued with a qualified audit opinion that explains the departure from GAAP. In addition, US private companies have the option to use OCBOA.

But it appears there is a certain element of stigma attached to a qualified audit opinion. Further, there may be some stigma attached to OCBOA financial statements. The June 2006 paper of the American Accounting Association argues the point as follows. In a survey of

member firms of the American Institute of CPAs' (AICPA's) private companies practice section, O'Dell and Cohen[34] find that 81% of respondents said that selected clients prepare their financial statements using OCBOA. However, they also find that third-party resistance is a major obstacle to greater use of OCBOA financial statements. This third-party resistance suggests that OCBOA financial statements do not meet the information needs of some users. Consistent with this, the June 2006 paper notes, Benston and Krasney[35] find that a majority of the sample of users they surveyed who could request any financial data from firms preferred GAAP financial information. And lenders in the FASB research report sample frequently face situations where financial statements are prepared with departures from GAAP and bankers respond by further restricting loan agreements.

Because of the aforementioned stigma, the IASB has provided and the FASB is working to provide non-public companies with differential reporting requirements. As a result, SMEs who do not wish to comply with full IFRS may publish financial statements that comply with the reduced reporting requirements of the SME standard. These SME financial statements will state that they are prepared "in accordance with the IFRS for SMEs," as will the audit reports.[36]

The situation in the United States, however, is worse. Because of users' preference for GAAP-based financial statements, the FASB has created a rather convoluted situation where both the reduced private company financial reporting requirements and public company reporting requirements are considered US GAAP. The financial statements of companies that comply with private company standards will simply state that they have been prepared in accordance with US GAAP. This is not only confusing for investors but also leaves the entire burden on them to discern the differences between private and full public company requirements, both of which are US GAAP.

[34]Judith O'Dell and Jacob Cohen, "The OCBOA Solution: Bottom-Line Relief for Small Business Clients," *Journal of Accountancy*, vol. 171, no. 2 (February 1991).
[35]George Benston and M. Krasney, "DAAM: The Demand for Alternative Accounting Measurements," *Journal of Accounting Research*, vol. 16, Supplement (1978):1–30.
[36]There is no quantitative analysis of the departure from full IFRS.

III. Investor Concerns with Differential Standards: Comparability, Quality, Cost, and Complexity

In this section, we examine the implications of differential reporting requirements for the investor community and what it would mean for their financial analysis.

Comparability Issues

CFA Institute's long-standing position has been that to operate efficiently, capital markets require financial information that is

1. comparable from firm to firm,
2. relevant to investment and financing decisions,
3. a reliable and faithful depiction of economic reality, and
4. neutral.

To achieve this, transactions and economic activities that are similar should be reported similarly in financial statements—irrespective of the nature of the underlying ownership structure of the entity engaging in the transaction. For that reason, CFA Institute opposes different reporting standards based on ownership (public, private, not-for-profit), size, or industry.

Moreover, in an increasingly global economy, investors need comparable information not only across different types of companies but also across jurisdictions. To support these investment activities, the IASB has a constitutional mandate to "…develop, in the public interest, a single set of high quality…financial reporting standards to help investors…and other users of financial information make economic decisions."[37]

Notwithstanding this mandate, the IASB developed a second set of IFRS—IFRS for SMEs—essentially creating a two-tier system across the globe. The comparability issue is confounded by the optionality provided to SMEs. SMEs may choose to apply either the SME standard or the full IFRS. Furthermore, there are some limited elections an SME could make. For example, an SME following the SME standard may elect to apply IFRS 9, Financial Instruments, from the full IFRS rather than the financial instruments requirements in the SME standard.

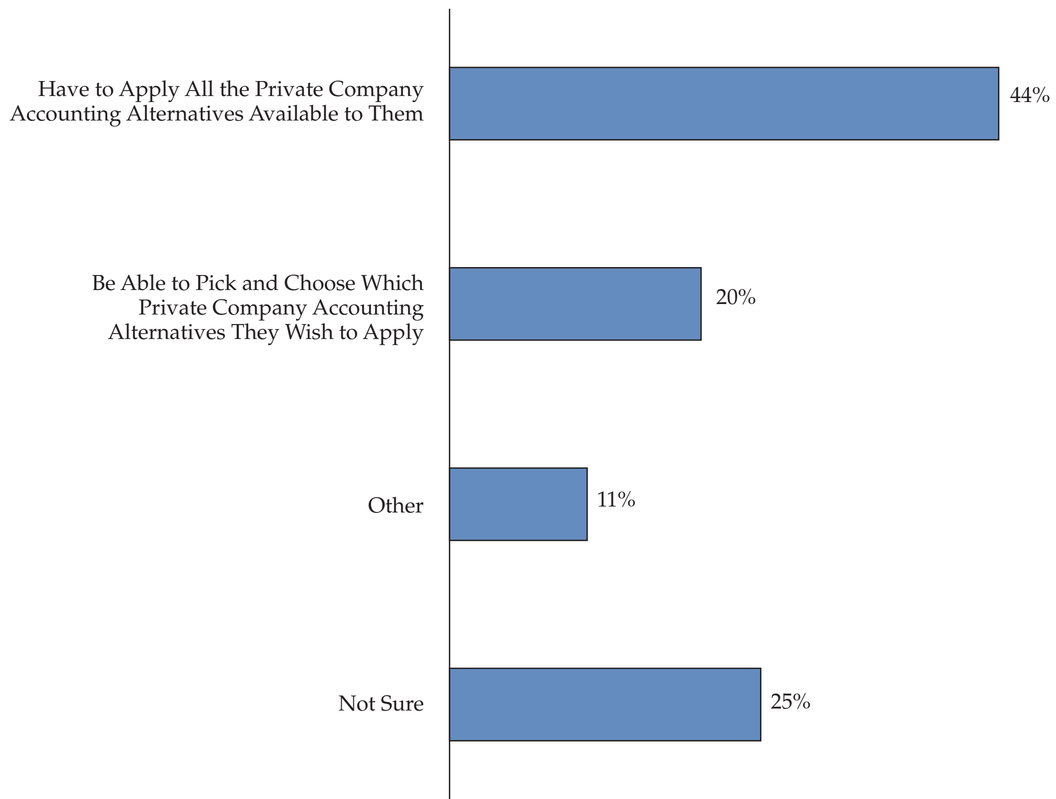
Similarly, the creation of US private company standards would result in the loss of comparability between the financial statements of public and private companies vital to investors who invest across both public and private companies. Permitting an alternative accounting regime for private entities hinders investors' financial analysis and their investment decision-making process. But the impact would be worse for US investors because the US private company standards provide a higher degree of optionality than the SME standard. Like SMEs, private companies have the option to apply either private or full public company standards. However, the PCC and FASB have leeway in determining which private companies may use certain private company accounting alternatives. Furthermore, private companies also have the choice of applying some, but not all, of the private company reporting alternatives available to them. This is far more extensive than the limited elections SMEs are allowed. Survey respondents indicated their concern over such optionality, intimating that private companies that use private company standards should have to apply all the private company alternatives available to them (see **Figure 3**).

The following are representative investor quotes from the survey:

> The lack of comparability will make it extremely difficult to compare similar companies.
>
> This will let people pick and choose which rules they follow. They will only do what is to their advantage. There will be no accountability.

[37]IFRS Foundation Constitution, revised and approved by the trustees, January 2013 (www.ifrs.org/The-organisation/Governance-and-accountability/Constitution/Documents/IFRS-Foundation-Constitution-January-2013.pdf), p. 5.

Figure 3. **Private Companies Should Not Have Choice of Applying Only Some Private Company Requirements**



Notes: The question was, The FASB proposes to allow private companies the choice of applying some but not all of the private company reporting alternatives. Do you believe that private companies that use private company financial reporting standards should...? As for responses, *N* = 166.

This is a very slippery slope. Relaxed requirements might sound appealing but could come back to bite the investor community.

While I am sure there are some individual initiatives that make sense in a micro context, what this does to consistency of reporting is harmful. If these changes are good and efficient, then do them for all, but let's not have substandard accounting for private companies.

Furthermore, during the last several years, there has been a movement in the United States toward the creation of separate accounting and disclosure requirements for different types of entities. If adopted, the following differing bases of accounting and disclosure requirements would be applicable in the United States.

- Small- to medium-sized entities: AICPA's OCBOA
- Emerging growth companies: Limited disclosures under the JOBS (Jumpstart Our Business Startups) Act
- Private companies: Private company US GAAP
- Public companies: Compliance with full US GAAP and SEC requirements
- Foreign filers: Financial statements prepared in accordance with full IFRS as issued by the IASB without requiring reconciliation to US GAAP

This movement toward the creation of multiple bases of accounting and financial reporting standards is antithetical to the pursuit of comparable, relevant, and decision-useful financial information for investors and to the pursuit of a single set of global standards. Our view is that this proliferation of accounting and disclosure requirements will compound the comparability issues and increase, rather than reduce, complexity in financial reporting for users.

Financial Statements and Audit Reports: Need to Identify Use of Private Company Standards

As previously noted, a major difference between the SME and US private company reporting requirements is that the IASB requires that enterprises following the SME standard must state that their financial statements have been prepared "in accordance with the IFRS for SMEs."[38] However, the financial statements of both public and private companies in the United States—despite all the differences—would simply state that they were prepared in accordance with US GAAP. Audit opinions will also state that the financial statements of private companies have been prepared in accordance with US GAAP. Investors disagree with this approach. Given the concerns over comparability, investors believe that, at the very least, financial statements and audit reports of entities applying private company alternatives need to identify the application of those standards. One respondent to the 2014 Private Company Survey put it best:

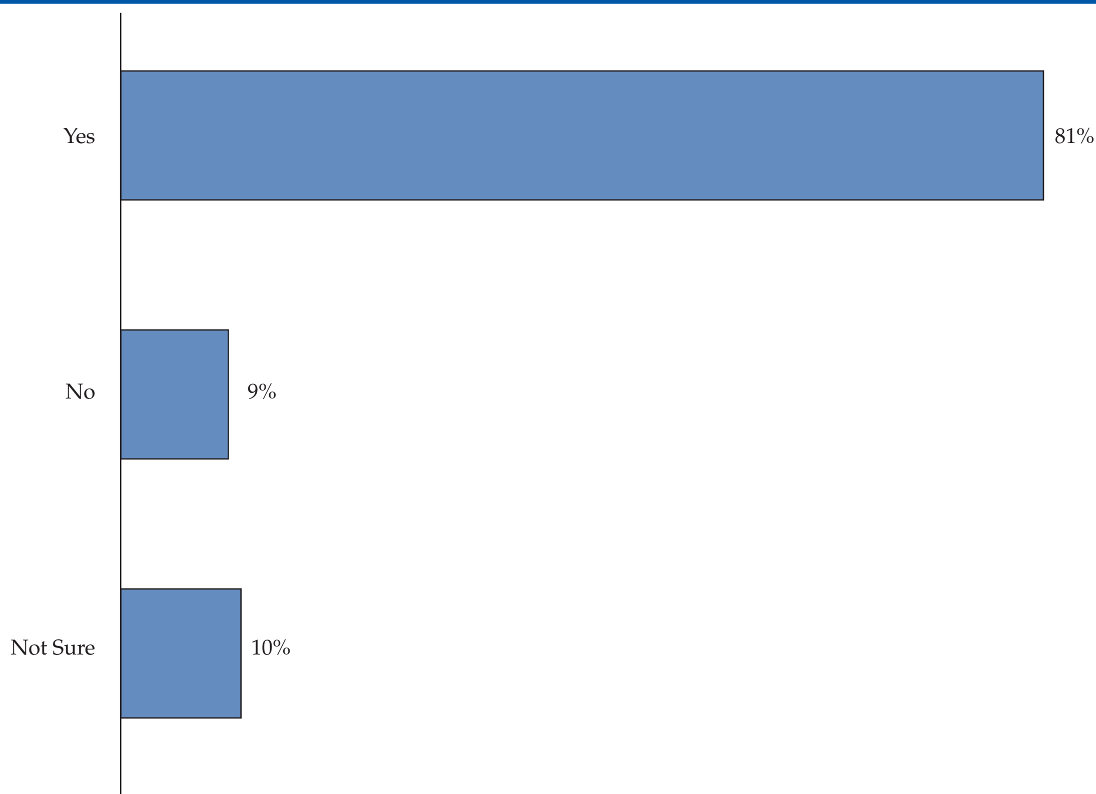
[38]And with the requirements of the relevant country's Corporation Act or other applicable national law.

> Comparability is paramount in financial statements. This whole concept [private company standards] is a bad idea, but if there is a second set of standards, there should be a full, complete, detailed disclosure letting everyone . . . investors, lenders, regulators, stakeholders . . . know that financial statements are not presented in the same manner with public company standards.

Indeed, an overwhelming majority (81%) of survey respondents believe that the financial statements and audit reports of private companies should identify whether or not they have used private company standards (see **Figure 4**).

When asked to explain how this could be achieved, survey respondents said:

Figure 4. **Financial Statements and Audit Reports of Private Companies Should Identify Whether They Use Private Company Accounting Standards**



Notes: The question was, In your opinion, should the financial statements and audit reports of private companies also identify whether or not they used private company accounting standards? As for responses, *N* = 168.

Perhaps it should be called a different type of GAAP.

In the audit opinion it should state "in accordance with Private Company Accounting Standards."

In accordance with US GAAP under FASB private company accounting options.

By stating as such and including a schedule of exceptions.

There should not be separate standards. Either private companies are in compliance or they are not. If they are not, they should explain in detail how they are not in compliance.

Need for Narrative and Quantitative Disclosure of Differences

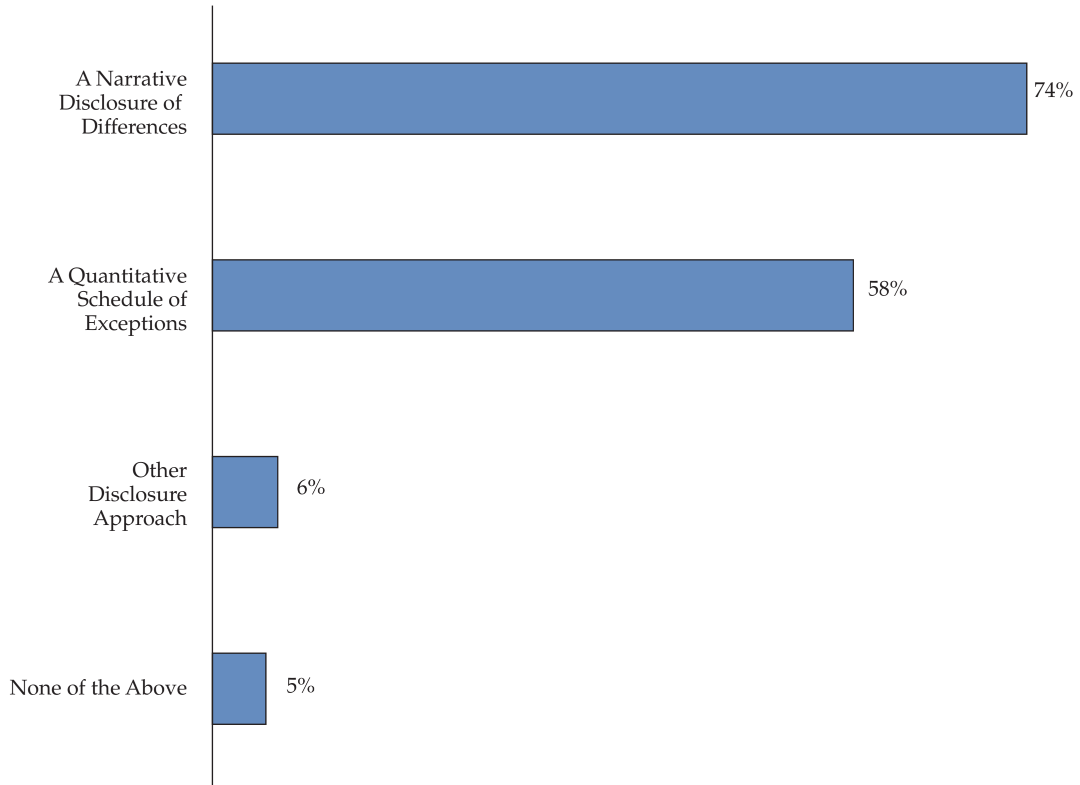
Investors not only believe that financial statements should identify the use of private company standards but that footnote disclosures should provide not just a narrative but also a quantitative analysis of the differences.

Accordingly, the findings in **Figure 5** indicate survey respondents overwhelmingly believe that both a narrative disclosure of differences between the private company options applied and full US GAAP along with a quantitative schedule of exceptions would be necessary to enable investors to discern the differences in a meaningful manner.

Private Company Standards: Perceived to Be of Lower Quality

CFA Institute is concerned that the creation of a private company version of US GAAP compounded by optionality as to when and by whom it may be used raises the question of what constitutes US GAAP. The basis of presentation footnotes are likely to be very generic in their qualitative description of the options taken—without any quantification of the differences. And as already noted, audit opinions will simply indicate that the financial statements of private companies have been prepared in accordance with US GAAP. Such

Figure 5. Narrative and Quantitative Disclosure of Differences Necessary

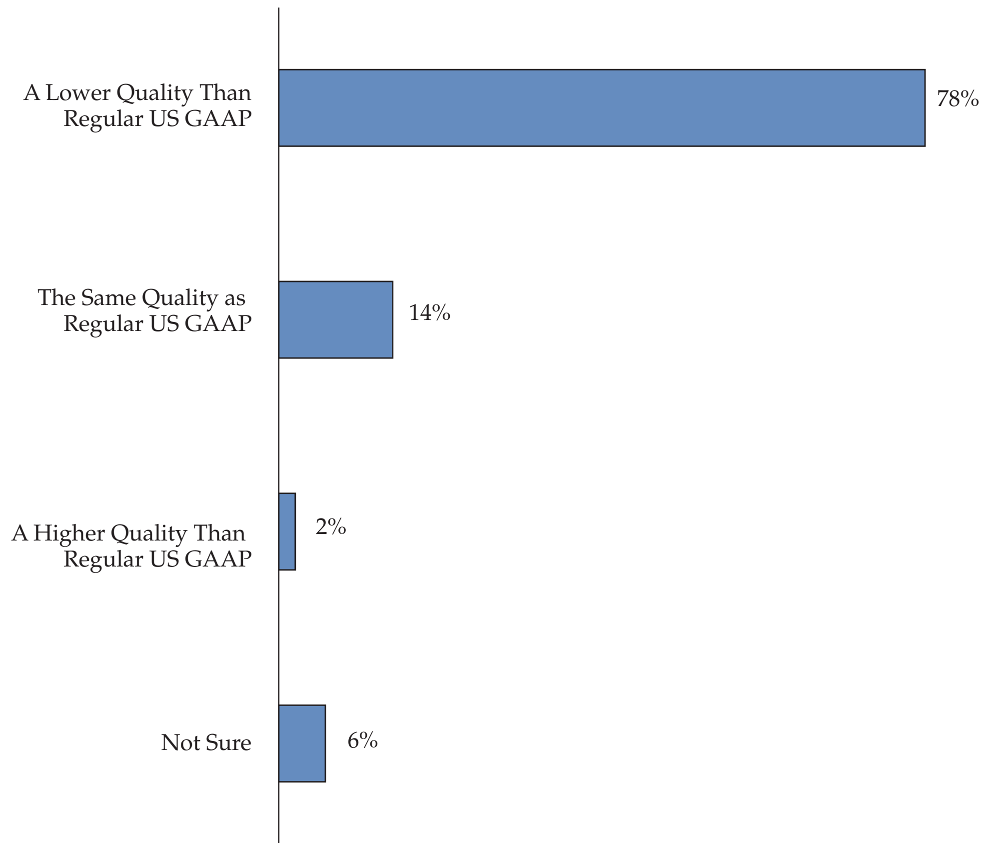


Notes: The question was, Private company financial statements should disclose the differences between the private company accounting options applied and regular/full US GAAP using...? As for responses, *N* = 168.

optionality and lack of comparability, we believe, will lead to the perception that the quality of US GAAP has declined as investors realize that the standards are not, and no longer need be, uniformly applied.

As can be seen in **Figure 6,** the majority (78%) of survey respondents believe that private company accounting standards will be perceived to be of a lower quality than the full US GAAP.

Figure 6. **Private Company Standards Will Be Perceived to Be of Lower Quality**



Notes: The question was, In your opinion, investors will perceive private company accounting standards to be of…? As for responses, *N* = 158.

Private Company Accounting: Opens Door for Optional Adoption of IFRS by US Public Companies

Reduction in comparability between the financial statements of US public and private companies is one reason specified by IFRS opponents for not allowing adoption of IFRS by US public companies. Because comparability between US private and public companies will be reduced by separate private company standards, investors—who rely on comparability—are likely to query why optional adoption of IFRS shouldn't be allowed if it improves comparability for large multinationals, with peer companies preparing their financial statements under

IFRS. The existence of multiple bases of accounting raises the question, Does development of multiple bases of accounting in the United States open the door to investor support for the optional use of IFRS in the United States?

Investors Will Need to Price the Differences: Will That Cost Be Greater Than the Cost of Compliance?

The non-public company initiatives are premised, in large part, on reducing the cost of compliance for these entities without consideration of other costs, such as a higher cost of capital owing to the lack of comparability and the perception by investors that non-public company accounting is of lower quality.

With the implementation of the JOBS Act, we have observed that many companies registering under the legislation (e.g., Twitter) do not avail themselves of the ability to provide less information (e.g., two versus three years) than other publicly listed companies must provide. They do not avail themselves of this relief because of the negative perception investors may have of the company, its results, or its management if they do. Registrants under the JOBS Act understand that investors will price the perceived risk associated with lesser-quality accounting and disclosures. The same will be true of users of financial statements prepared under the proposed US private company accounting rules.[39]

Similarly, some argue that international acceptance of the IFRS for SMEs may be questionable because it may be considered a "second-best" standard. The argument is that those countries that have adopted or propose to adopt the standard appear to be developing nations that currently have lower-quality local accounting standards relative to the SME standard.

As we discuss more fully in the next section, investors and users of non-public company financials will price the lack of comparability, transparency, and clarity in non-public company financial reporting. Companies will incur the cost of not providing the information through a higher cost of capital. Studies have shown that the indirect cost of not providing the information is likely higher than the direct cost of providing the information.

The following investor quote from the survey represents this perspective well:

[39]These firms may nonetheless suffer unintended consequences; extant research suggests that firms that are eligible to reduce their disclosure but voluntarily maintain their disclosure level may experience an increase in market illiquidity. See Appendix B.

> The creation of alternative accounting treatments for private companies under GAAP will make financial statements less comparable, which will increase the burden on users of financial statements. While this might lower the cost of preparing the financial statements, it may also raise the cost of debt financing (as the lender will likely need to expend greater effort to understand the subject company's credit risk). There may be other unforeseen impacts to providing alternative accounting rules.

Additional Costs of Differential Standards

Proponents of differential standards have, in our view, considered only the cost of providing financial information and having the information reviewed/audited. This is a narrow view of the costs and benefits associated with financial reporting. Establishing separate standards for non-public companies will add complexity and cost to other dimensions of financial reporting. For example, differential accounting standards will make it more costly for users to understand, standards setters to develop and maintain, educators to teach, and assurance providers to obtain proficiency in financial reporting.

These investor quotes from the survey illustrate the idea:

> I am the Executive Director of Finance/Treasury for a not for profit "private company"($2 billion in assets and $2 billion in revenue) which issues municipal bonds through a conduit issuer. We are deemed a private company yet have more complex and sophisticated activities than most public companies. Now rating agencies and investors and banks (all of whom we work with and rely upon) will have two sets of GAAP standards to apply and this will only drive up costs. It will also drive up our audit costs since there will be more specialization within the accounting firms and complexity for the young accounting staffers to address. There is nothing good that will come forth from this change.

> A second set of accounting standards is a terrible idea! It's already difficult enough to learn, maintain, recall and update accounting standards for one philosophy. The concept seriously compromises the "G" and "A" in GAAP, in that standards for both public and private will no longer be "generally accepted." (Would Partially Accepted Accounting Principles really be of any use?) Ultimately, I think this raises the cost of capital for everyone, public and private, in both debt and equity.

> The regulatory burden would probably become more cumbersome and the likelihood and impact of fraud would rise. Collectively, these costs would dwarf the presumed reduction in compliance costs.

Greater Complexity and Confusion

We contend that separate non-public company financial reporting standards may in some instances create greater complexity for public companies. Consider the following two examples.

Public Company Acquiring Interest in Non-Public Company

When a public company acquires an interest in a non-public company, it needs to disclose this to the public company regulator through a filing that includes the financial statements of the non-public company. In such a case, the non-public entity may have to eliminate any previously elected non-public company accounting alternatives from its historical financial statements before including them in the public entity's regulatory filing.

Non-Public Company That Turns Public

Non-public companies that consider accessing the public markets in the future would have to decide whether to adopt the accounting and reporting non-public company alternatives available to them. When they turn public, they are likely to have to apply public company accounting policies in all historical financial statements presented in a registration statement filed with the public company regulator. The following representative investor quote from the survey sums it up:

> As companies grow and entertain the idea of becoming public, they will have the extra burden of restating prior statements or risk not being able to adequately present data to the SEC and potential investors.

Moreover, the proposed US private company reporting rules raise a number of questions for private companies.

A Private Company That Is a Subsidiary of a Public Company

Is it appropriate to permit a private company that is a subsidiary of a public company to apply accounting and reporting alternatives for private companies, given that the existence of potentially conflicting accounting information (where the financial statements of a private subsidiary may not reconcile to information about the subsidiary included in the consolidated financial statements of the public company parent) may cause confusion for investors?

Would it be appropriate to apply private company accounting when the private subsidiary's operations are a substantial portion of the public company's financial results?

A Private Company That Controls a Public Subsidiary

Is it appropriate to permit a private company that controls a public subsidiary to apply private company accounting specifically when that controlling private company has a significant number of public subsidiaries or when its primary operations consist of holding an investment in one or more public subsidiaries?

Definition Issues

The "Private Company Decision-Making Framework" provides a definition of a public business entity (PBE) to establish which entities do not fall (a de facto definition for those entities that do fall) within the scope of the guide. This definition was proposed in response to inquiries by stakeholders about the inconsistency and complexity of having multiple definitions of a non-public entity and public entity within US GAAP. The accounting literature in the United States includes five definitions of a non-public entity, three definitions of a public entity, and two definitions of a publicly traded company.[40]

The "Private Company Decision-Making Framework," however, does not resolve the differences between all the definitions of a public entity contained within the accounting literature. In fact, the literature continues to include numerous definitions of a public entity (and related terms, such as "publicly traded company") with the new definition of a PBE being used to distinguish between different types of entities in *future* standard setting. We believe

[40]Private Company Council, "Agenda Report: April 29, 2014 Agenda Discussion."

the FASB needs to resolve the differences between and consolidate all the definitions of a public entity. Otherwise, complexity and confusion for investors remains and may increase with the inclusion of yet another definition for a PBE.[41]

Furthermore, CFA Institute believes that the definition of an SME—and, as a result, the scope of the SME standard (in terms of the entities that may adopt the standard)—is better than the definition of an entity in the United States that may apply private company standards. US private companies include entities with fiduciary responsibilities, such as private financial institutions. As previously noted, we believe that there are few truly private companies—those with a single owner/manager and no external financing—and relief should be provided only to such entities. We do not believe that entities with fiduciary responsibilities fall within the scope of "true private companies" and thus should not be permitted to apply reduced private company reporting requirements.

Need for More Comprehensive Cost–Benefit Analysis

It is unclear whether the standard setters, in their cost–benefit analysis, have comprehensively weighed the benefits of reduced compliance and administrative costs for preparers against the additional complexity and costs for investors brought about by the creation of differential standards as outlined earlier.

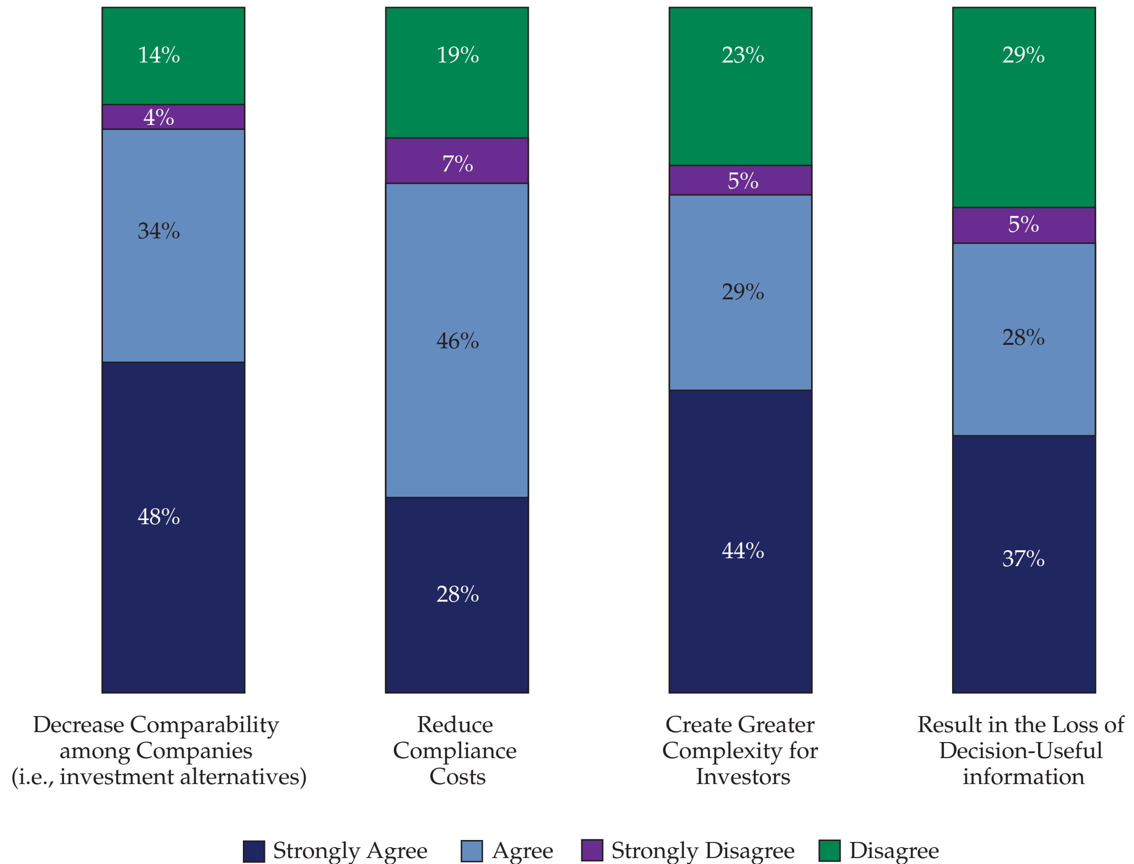
In support of our aforementioned assertions regarding lower comparability and quality and increased complexity, survey respondents, as can be seen in **Figure 7**, indicated that private company standards would affect investment analyses by decreasing comparability (82%), creating greater complexity (73%), and resulting in the loss of decision-useful information (65%).[42] Investors do, however, believe the private company initiative will achieve reduced compliance costs.

These results clearly demonstrate that investors believe that

- the private company initiative addresses preparer concerns regarding compliance costs and

[41]CFA Institute, "Comment Letter on Definition of a Public Business Entity" (28 October 2013): www.cfainstitute.org/Comment%20Letters/20131028.pdf.
[42]Percentages include respondents who selected "agree" and "strongly agree."

Figure 7. **Impact on Investment Analysis: Lower Comparability, Greater Complexity, Loss of Information**



Notes: The question was, The creation of private company accounting standards will have the following impact on the investment analyses of investors who invest across private and public companies…? As for responses, *N* = 155.

- the costs of this initiative to investors will likely outweigh the benefits for private company managers.

Furthermore, if private companies were to provide a quantitative schedule of exceptions, as investors seek to afford greater transparency, we do not believe there would be any meaningful cost savings at all.

The following investor quotes from the survey are representative of this issue:

The only reason to use the private company alternative treatments appears to be to reduce the time/effort/cost of preparing the financial statements.

Reduced reporting requirements may initially reduce compliance costs for private companies. However, many of those same private companies are backed by private equity and venture capital investors seeking a liquidity event. Upon liquidity, the private companies may have to restate their financial statements to U.S. GAAP for compliance purposes, thus eliminating the initial cost savings. Further, introducing private company reporting standards will have the unintended consequence of creating greater complexity for all stakeholders (thus increasing tangible and intangible costs) and decrease comparability among companies.

Modifications Should Not Create Differences in Recognition, Measurement, and Presentation

The US private company initiative allows standard setters to consider alternative accounting treatments in the following areas:

- Recognition (timing and method of recording transactions and events)
- Measurement (how items are measured in the financial statements)
- Presentation (structure and content of financial statements)
- Disclosure
- Effective dates (when new requirements need to be applied)

That is, the US private company proposals suggest that there may be occasions when an item included (i.e., recognized) in public company financial statements may not be recognized in private company financial statements. They further suggest that similar items may be measured differently in public and private company financial statements.

An asset is an asset and a liability is a liability, no matter the capital structure of the entity. The underlying assets and liabilities of an entity do not change based on the type of entity or its legal structure. Therefore, similar items should be accounted for—recognized and measured—similarly across all entities. There is no basis for any change in recognition and measurement that would make financial information less useful for investors.

As previously mentioned, private company managers argue that to "simplify" private company financial statements, private companies should not have to provide all the information provided by public companies. The "Private Company Decision-Making Framework" suggests that differences in recognition and measurement "should be driven primarily by relevance and secondarily by cost and complexity considerations. However, once it has been decided that a recognition and measurement alternative should be provided, access to management can be considered in evaluating potential alternatives for private companies within U.S. GAAP" (p. 7). The argument is that private company investors have greater access to management and can simply ask management for any additional information they want. But if an item does not appear in the financial statements, investors may not know to ask about it because they are not aware of its existence.

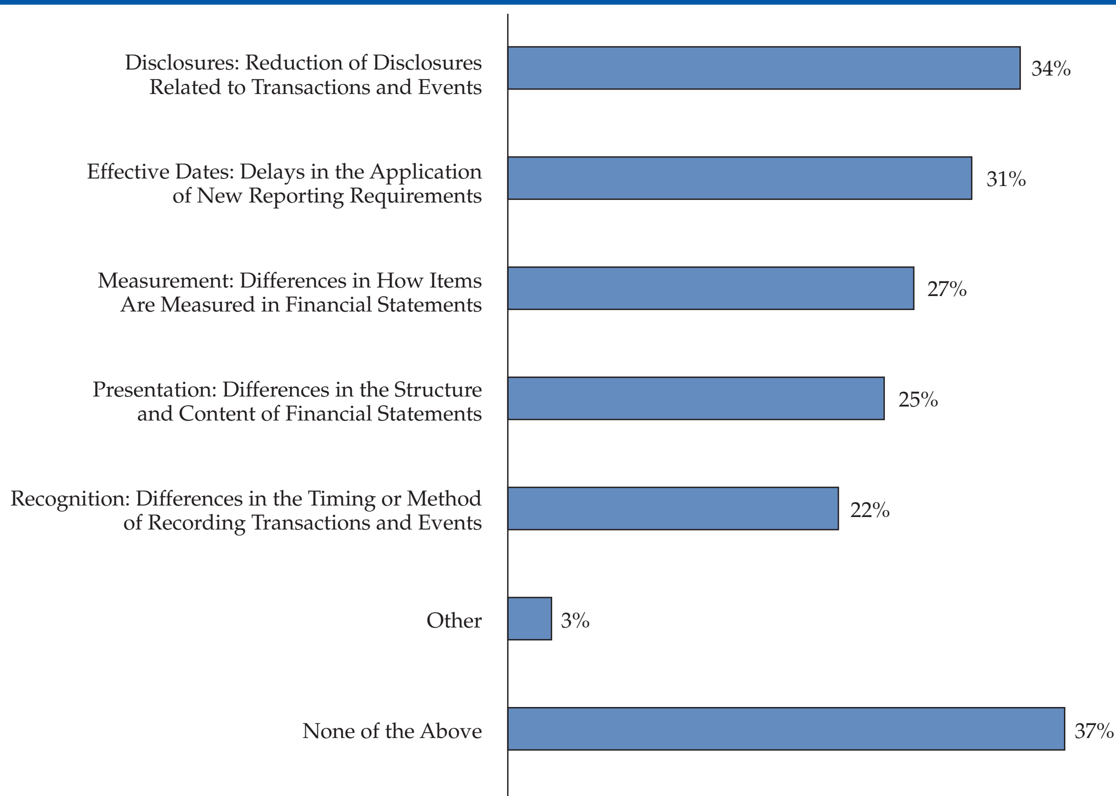
The private company proposals also appear to suggest that the presentation of an item in the main financial statements could be substituted by its disclosure in the footnotes. It is unclear what the basis for this could be or who would benefit from it. In reality, it would benefit no one. There is no cost savings for preparers because they need to generate the information, whether it is presented on the face of the financial statements or in the disclosures. And placing information in the disclosures only makes the information harder for investors to see.

If the FASB were to consider providing some relief for private companies, such relief should only be considered for private companies that are truly small and have limited resources and only in the areas of disclosure requirements and effective dates of new accounting requirements. With respect to disclosures, the FASB could provide some relief to private companies by not requiring the narrative that accompanies tables, charts, reconciliations, and roll forwards. In addition, the FASB could consider allowing private companies extra time to adopt new accounting requirements.

In the same vein, the dissenting view of one IASB member with respect to the SME proposal was that the IASB had not demonstrated the need to make modifications to recognition and measurement requirements in IFRS for SMEs on the basis of either cost–benefit analysis or user needs. As a result, the view was that there should not be any differences in recognition and measurement requirements compared with the full IFRS. Alternatively, modifications could be made to the disclosure requirements.

Figure 8 shows the survey responses, indicating their preference for exceptions and modifications to US GAAP to be provided to private companies in the area of disclosures or effective dates or not at all.

Figure 8. Exceptions and Modifications to US GAAP to Be Provided in Area of Disclosures or Effective Dates or Not at All



Notes: The question was, In your opinion, exceptions and modifications to US GAAP requirements for private companies should be provided in which of the following areas? As for responses, *N* = 166.

The 2014 Private Company Survey asked respondents what reasons, if any, might justify a reasonable basis for reduced reporting requirements for private companies. Investor quotes from the survey say it best:

> The only possible reasonable basis for reduced reporting requirements for private companies should be the availability of resources (money, management's time), but I do not think there should be reduced reporting requirements based on a company being private.

A reasonable basis for reduced reporting requirements would be if the only users of the financial statements are a small group of family owners (related parties). If any third-parties use the statements then full reporting requirements should be used.

There is no reasonable basis for reduced reporting requirements. Private companies need to be more transparent in their operations and financial statements.

Very small companies should have reduced reporting requirements.

For exceedingly small companies, maybe different standards could work. The FASB needs to define small and large. Maybe revenues less than $10 million or $50 million?

It can be cumbersome for a small company with $1,000,000 in revenues to comply with all the U.S. GAAP standards. I do believe there should be a limit to which entities use private company standards based on revenues and potentially the number of investors. If it is a father son company, they shouldn't have to report the same way as a company with 100 shareholders.

In addition to size (revenue), the number of investors in a private company should still be relevant to what accounting standards are applied, rather than using a one-dimensional criterion (ownership structure).

IV. Differential Standards: Impact on Valuations

Proponents of differential standards stress that non-public company users focus on cash balances, cash flows, and liquidity, unlike public company investors, who focus on the value of the company as a whole. Although that may be true, equity investors in a private company have the need to know the value of the company at key junctures as well. In this chapter, we examine the need for valuations of non-public entities and the impact of differential standards upon such valuations.

Need for Non-Public Company Valuations

Investors primarily need to know the value of a non-public company to monitor the return on their investment (i.e., appreciation in the company's value). Determining a non-public company's worth and knowing what drives its value is also a prerequisite for

- assessing how to enhance the company's value;
- deciding on the appropriate price to pay or receive in an acquisition, corporate restructuring, and sale of securities;
- a divorce settlement;
- estate planning;
- an employee stock ownership plan;
- taxation purposes; and
- shareholder disputes.

Furthermore, the need for valuations arises in the types of investment held by venture capital and other types of private equity funds that constitute a significant allocation in many investors' portfolios.

Challenges with Non-Public Company Valuations

Many of the same techniques used to value public companies can be used to value non-public companies as well. Finding the true intrinsic value of a non-public company, however, can be a challenging task. It includes adjusting of financial statements and applying the appropriate business valuation methodology and entails a set of calculations and assumptions based on industry-wide and company-specific factors. Factors that may influence a non-public company's valuation are, for example, its size, operating history, management and operational control, capital structure, business risk, and breadth of liquidity in the market for the company's stock. Company valuations are discounted based on these risk factors.

Moreover, an accurate valuation of non-public companies largely depends on the availability and reliability of the company's historical financial information. The following issues could impact the quality of a company's financial information and consequently lead to an increase in the risk premium investors apply to such entities.

- Shorter history. Non-public firms often have been around for much shorter time periods than most publicly traded firms. There is, therefore, less historical information available.
- Different accounting standards. The financial statements for non-public firms are often based on different accounting standards than public firms, which operate under much tighter constraints on what to report and when to report.
- Unaudited financial statements. Public company financial statements are officially audited, documented, and overseen by a government regulator. Alternatively, non-public firms do not have government oversight unless operating in a regulated industry, and audited financial statements are usually not required.

The last point is well articulated in the CFA Program curriculum:

> Private companies may have their financial statements reviewed rather than audited. Reviewed financial statements provide an opinion letter with representations and assurances by the reviewing accountant that are less than those in audited financial statements. The preparation of reviewed rather than audited financial statements and other factors suggest a potentially greater need for analyst adjustments to the reported financials of some private companies. Compiled financial statements (that are not accompanied by an auditor's opinion letter) suggest an even greater need for analytical adjustments. (p. 546)[43]

[43]Raymond D. Rath, "Private Company Valuations," Reading 39, CFA Program Level II, vol. 4 (Hoboken, NJ: John Wiley & Sons, 2013).

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Loss of Information from Non-Public Company Standards: May Lead to Increased Risk Premiums and Cost of Capital

There are three primary approaches to company valuations:

- Income approach, based on the present value of expected future cash flows or income
- Asset-based approach, based on the value of the company's net assets
- Market approach, based on pricing multiples from sales of similar companies

Among these valuation techniques, income- and asset-based valuations are sometimes less feasible options because they require detailed financial information from inside the non-public company, which may not be available. And the discount rates used in a discounted cash flow analysis need to be carefully modified given the lack of liquidity and sometimes increased business risk[44] associated with non-public companies. As a result, often a more feasible approach is to find comparable public companies whose values are known, derive pricing multiples for the companies, and adjust the pricing multiples for relative risk and growth prospects.

Although there are the aforementioned difficulties associated with the income- and asset-based approaches, it is preferable if different approaches are used to derive a company's value because it is doubtful that any one analysis by itself will yield an exact, reliable number. The use of multiple approaches will yield a range of values for a non-public company, with each methodology providing additional clarity on the other valuations. Evaluating the results of numerous methods provides a better understanding of a business's true worth.

In the next section, we examine some of the alternative accounting treatments permitted by the SME and US private company standards. We compare these accounting treatments with those required by full IFRS and public company US GAAP to highlight the ensuing loss

[44]Private companies are generally riskier than their public comparables, often because of

- Internal criteria. Private companies tend to be smaller in size and may lack a demonstrable financial track record.
- External criteria. Private companies may face the risk of business concentration or may be competing in an expansive industry. Whether a private company operates within a niche or has a variety of product mixes can impact the valuation discount. Market share and product concentration often add to business risk.

of information. We believe that the loss of information resulting from non-public company standards may further limit the use of some valuation models, thereby hindering investors from assessing a range of valuations and having one valuation approach validating another.

Aswath Damodaran contends that if investors perceive firms that disclose less information to be more risky, they are likely to attach higher risk premiums and costs of capital and lower values to these firms.[45] The CFA Program curriculum reaffirms this position:

> The more limited availability of financial and other information for private companies results in an increased burden for the prospective investor considering an equity investment or loan. This type of information difference presumably leads to greater uncertainty and, hence, risk. All else equal, the higher risk should lead to a relatively lower valuation. (p. 537)[46]

Investors adjust the value of a firm for lack of transparency in various ways—for example, by adjusting the cash flows, discount rate, expected growth rate, or length of growth period. That is, investors and users will price the lack of transparency in, and lower quality of,[47] private company financial reporting. Companies will incur the cost of not providing the information through a higher cost of capital. Hence, the loss of decision-useful information for investors will likely lead to an increase in risk premium and cost of capital for non-public companies.

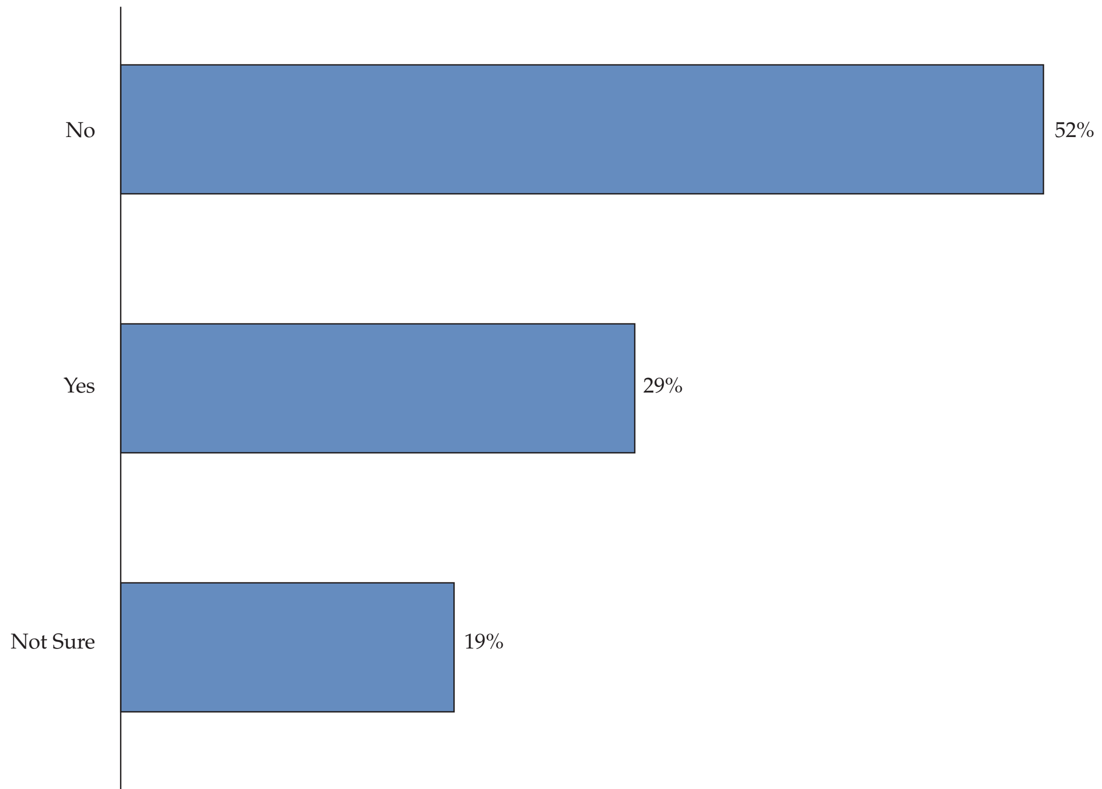
As we have seen from previous results of the 2014 Private Company Survey, investors believe that private company reporting requirements will achieve lower compliance costs. However, as can be seen in **Figure 9**, the majority of survey respondents (52%) indicate that the reduction in compliance costs will not sufficiently cover the potential omission of useful information for investors. Further, they believe the result of this could be an increase in the risk premium and cost of capital for private companies.

The following is an investor quote from the survey that illustrates this point:

> One of the reasons accounting standards exist is to eliminate the normal information asymmetry between investors and company management of both public and private companies. In my opinion compliance costs are irrelevant when compared to providing the necessary transparency and maintaining information symmetry between companies, investors and analysts.

[45]Aswath Damodaran, "The Value of Transparency and the Cost of Complexity," p. 30.
[46]Raymond D. Rath, "Private Company Valuations."
[47]In line with the findings in Figure 6.

Figure 9. Reduced Compliance Costs Will Not Cover Loss of Information and Resulting Increase in Risk Premium and Cost of Capital



Notes: The question was, In your opinion, will the reduction in compliance costs sufficiently cover the potential omission of useful information for investors (the result of which could be an increase in the risk premium and cost of capital for private companies)? As for responses, *N* = 158.

Comparative Analysis of Public and Non-Public Company Standards: Demonstrates Information Loss

Small- and Medium-Sized Entities Accounting

Move toward Cost-Based Measures

Under the SME standard, items are usually accounted for at their historical cost; a few exceptions exist, such as particular categories of financial instruments. We believe this step to be regressive because it results in the loss of fair value information. That is, investors will not have the necessary inputs for the valuation of such entities. We provide some examples in **Exhibit 1**.

Exhibit 1. IFRS for SMEs vs. Full IFRS

IFRS for SMEs	Full IFRS
Intangibles	
The cost model is the only permitted model. The amortization approach applies to all intangible assets, including goodwill, with finite or infinite lives. These intangibles are tested for impairment only when there is an indication of impairment.	The revaluation model is permitted, under which intangible assets may be carried at a revalued amount (based on fair value) less any subsequent amortization and impairment losses if fair value can be determined by reference to an active market. Under IAS 38, Intangible Assets, the useful life of an intangible asset is either finite or infinite. The latter is not amortized and requires an annual impairment test.
Property, Plant, and Equipment (PPE)	
Only the cost model is permitted, under which all the cost model classes of PPE are carried at cost less accumulated depreciation and any impairment losses. The revaluation model is not permitted.	In addition to the cost model, the revaluation model is an option, in which classes of PPE are carried at a revalued amount less any accumulated depreciation and subsequent accumulated impairment losses.

(continued)

Exhibit 1. (continued)

IFRS for SMEs	Full IFRS
Financial Instruments	
There are two sections dealing with financial instruments: a section for basic financial instruments and another for more complex financial instruments. Basic financial instruments are measured at amortized cost and complex instruments are generally measured at fair value through profit or loss. Examples of financial instruments that normally qualify as being "basic" are • cash, • demand and fixed deposits, • commercial paper and bills, • accounts and notes receivable and payable, • debt instruments where returns to the holder are fixed or referenced to an observable rate, • investments in nonconvertible and non-putable ordinary and preference shares, and • most commitments to receive a loan. All other financial instruments are measured at fair value through profit or loss.	IFRS 9 is based on a business model approach and distinguishes three measurement categories of financial instruments—that is, fair value through profit or loss, fair value through other comprehensive income, and amortized cost. Some items classified as basic financial instruments and measured at amortized cost under the SME standard may be measured differently (i.e., at fair value) under regular, full IFRS—for example, certain debt instruments.
Agriculture	
If the fair value of a class of biological asset is readily determinable without undue cost or effort, the fair value through profit or loss model is used. If the fair value is not readily determinable, or is determinable only with undue cost or effort, biological assets are measured at cost less accumulated depreciation and impairment.	Similar to IFRS for SMEs, however, exemption from measurement at fair value requires a higher bar and is only allowed if the fair value cannot be measured reliably. The exemption does not apply on the basis of cost or effort.

Other Differences in SME Accounting: Leads to Loss of Information or Need for Analytical Adjustments

Exhibit 2. Implications of Other Changes

IFRS for SMEs	Implication
Goodwill	
As already noted, the amortization approach applies to all intangible assets, including goodwill.	What this approach fails to consider is the loss of information for investors. Goodwill write-offs, if done in a timely manner, are of interest to investors in terms of the signal they send about the value of the company's intangible assets, the company's future earnings prospects, and an assessment of the amounts paid for acquisitions.

(continued)

Exhibit 2. (continued)

IFRS for SMEs	Implication
Hedge Accounting	
The hedging model under the SME standard is based on the principles in the regular, full IFRS.[a] Under the SME standard, management should expect the hedging instrument to be highly effective in offsetting the designated hedged risk to apply hedge accounting. However, no quantitative effectiveness test is required.	We acknowledge that rigid quantitative tests that are used in the effectiveness assessment in the regular, full IFRS may lead to distortions in the judgment of economic hedge effectiveness by issuers. A purely qualitative assessment, however, is likely to impair the ability of users to make judgments on whether legitimate hedging relationships are in place and to assess whether they are, in fact, effective. Moreover, in the case of a purely qualitative assessment, it is not transparent as to how the effectiveness determination is made, which allows companies greater latitude to be inconsistent across reporting periods in their evaluation of hedge effectiveness. This may increase the number of wrongly designated hedging relationships.
R&D and Borrowing Costs	
All research and development costs and all borrowing costs are recognized as expenses.	Under the full IFRS, research costs are expensed as incurred; development costs and borrowing costs are capitalized if certain criteria are met. The differences between the SME standard and the full IFRS may cause investors and analysts to make adjustments for amounts that should have been capitalized.

[a]There are, however, a number of detailed application differences, some of which are more restrictive under the IFRS for SMEs. For example, a limited number of risks and hedging instruments are permitted.

US Private Company Accounting Alternatives

Exhibit 3. Implications of Private Company Alternatives

Change	Implication
Accounting for Goodwill	
The private company standard permits a private company to amortize goodwill on a straight line basis over a period of 10 years or less if the company demonstrates that another useful life is more appropriate. It also permits a private company to apply a simplified impairment model to goodwill, including testing for impairment only when there is a triggering event instead of every year.	The loss of information for investors is similar to that from the SME standard.

(continued)

Exhibit 3. (continued)

Change	Implication
Applying Variable Interest Entity Guidance to Common Control Leasing Arrangements	
Public company US GAAP requires a reporting entity to consolidate a variable interest entity (VIE) when that reporting entity is considered to be the primary beneficiary of the VIE. As a result, VIE guidance could, in certain circumstances, require a reporting entity (lessee) to consolidate a lessor entity when both entities are under common control. The PCC decided that when the arrangement between a private company lessee and a lessor entity meets certain conditions, the private company lessee can elect the private company alternative, which is not to apply the VIE guidance to the lessor entity.	In essence, the guidance makes it easier for private company lessees to enter into off-balance-sheet leasing arrangements with affiliates. It has been our long-standing position that all economic assets and obligations that meet our definition of accounting assets and liabilities should be recognized on the balance sheet. No economic assets and liabilities should be omitted from the balance sheet.
Simplified Hedge Accounting Approach	
This approach gives private companies—except financial institutions—the option to use a simplified hedge accounting approach to account for swaps that are entered into for the purpose of economically converting variable-rate interest payments into fixed-rate payments. The simplified hedge accounting results in presenting interest expense in the income statement as if the company had issued a fixed-rate borrowing instead of a variable-rate borrowing and an interest rate swap. The guidance makes it easier for companies to apply hedge accounting. A private company can assume that the hedging relationship is perfectly effective if the swap and debt meet certain conditions. The guidance permits companies to recognize swaps at their settlement value rather than their fair value and to complete formal hedge documentation up until the date when the company's financial statements are available to be issued.	The implications of this alternative are twofold for investors. 1. Fair value information will be lost. 2. As with the IFRS for SMEs standard, a purely qualitative assessment is likely to impair the ability of users to make judgments on whether legitimate hedging relationships are in place and to assess whether they are, in fact, effective.

(continued)

Exhibit 3. (continued)

Change	Implication
Intangible Assets in Business Conbinations	
Discussions have been underway at the PCC to alter the accounting for identifiable intangible assets in a business combination that will enable private companies that elect the alternative to recognize only those intangible assets arising from non-cancelable contractual terms or those arising from other legal rights. Consideration has been given as to whether any other intangible assets should be recognized separately from goodwill even if separable. The PCC has finalized an alternative that would exempt private companies from separately recognizing and measuring non-competition agreements and customer-related intangible assets that are not capable of being sold or licensed independently in a business combination.	Who ultimately benefits from this change? Preparers, accountants, and auditors maintain that identifying, recognizing, and measuring such assets is too complex and that the reporting requirements need to be simplified. Investors, however, assess the value of such assets every day. It appears that a central element in the conversation regarding "complexity" in this context is an increasingly evident skill gap of the accounting profession, that of valuation. Regressing by not recognizing or measuring assets that are clearly value drivers may simplify matters for preparers, accountants, and auditors but not for investors. In fact, it will make their financial analysis more complex. Insufficient information on intangible assets will hamper the valuation of a company because many intangibles, such as a recognizable brand, protected intellectual property, or a solid client base, are indicators of higher business valuations.

Other Items

The PCC also serves as the primary advisory body to the FASB on the appropriate treatment for private companies for items under active consideration on the FASB's technical agenda. The PCC has shared its views with the FASB on the leases project currently underway and discussed potential changes in accounting for stock-based compensation. The PCC is also advising the FASB on accounting for financial instruments, the disclosure framework, and reporting discontinued operations.

Conclusion: Differential Standards Are a Move Backwards

Both the SME standard and the US private company accounting alternatives appear to move us back to a cost approach, allow certain off-balance-sheet arrangements, and create complexities for investors that will require further analytical adjustments. The consequent loss of information or decrease in the quality of financial reporting information of non-public companies will likely lead to an increase in the risk premium and cost of capital for such companies. The results in Figures 6 and 9 indicate that investors believe this to be the likely outcome.[48]

[48]Conversely, research studies, through empirical evidence, demonstrate that financial reporting quality positively affects investment efficiency. Further, the relation between financial reporting quality and investment efficiency is an increase in bank financing. See Appendix B.

V. Extending Complexity Argument beyond Differential Standards

Extending Private Company Alternatives to US Public Companies: Not Based on the Need for Relevant, Decision-Useful Information for Investors

The FASB is now contemplating extending private company accounting alternatives—meant to reduce compliance costs—to public companies. As already noted, this is different from its normal due process whereby topics are added to its technical agenda based on a demand from constituents for improvements in financial reporting.

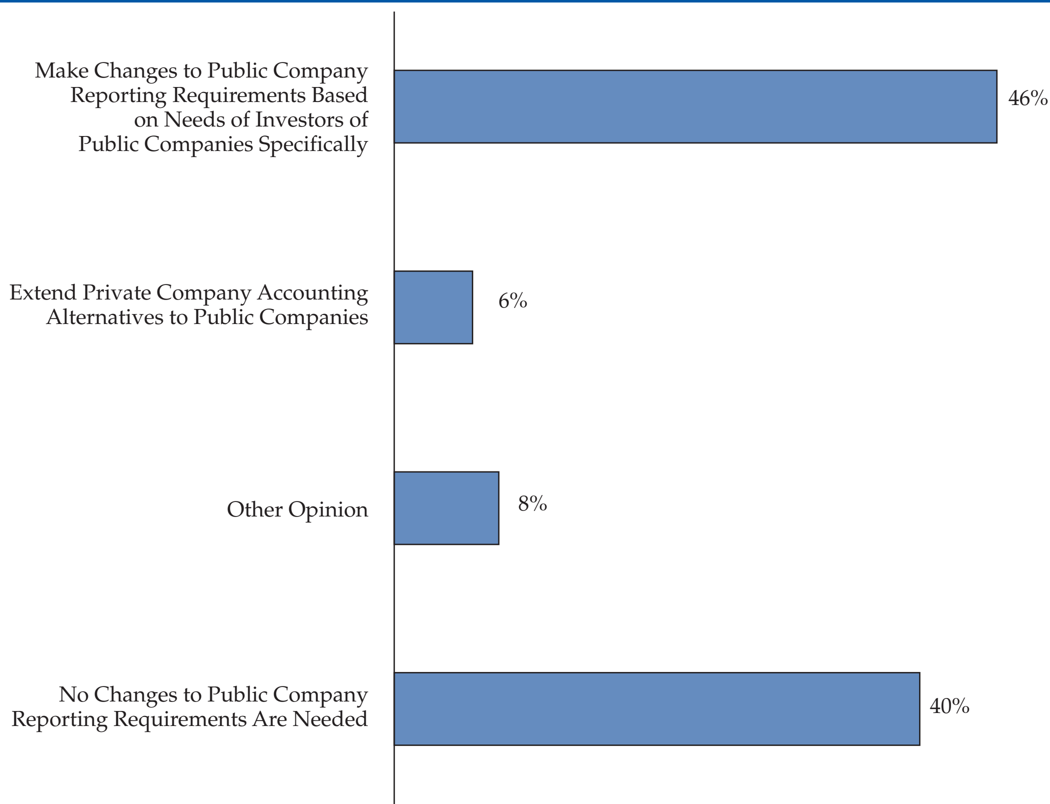
We are concerned by the notion that changes to private company accounting will subsequently be used to alter the accounting and disclosure requirements for public companies when the basis for the change to private company accounting is not grounded in the need to most appropriately reflect the underlying economics of transactions in the financial statements and provide the most decision-useful information to investors. If standards are to be modified for public and private companies, they should be based on the need for relevant, decision-useful information for investors and they should be added to the agenda, subjected to the same due process, and provided with the same degree of profile and awareness as other standards.

The findings in **Figure 10** support our assertion. Only 6% of survey respondents believe that private company alternatives should be extended to public companies. Instead, respondents believe changes to public company reporting requirements should be based on the needs of investors of public companies.

The following representative investor quote from the survey sums it up well:

> Changes in public company reporting are needed but such changes are unrelated to decisions regarding private company reporting.

Figure 10. Private Company Simplifications Should Not Be Extended to Public Companies



Notes: The question was, With respect to the financial reporting requirements of US public companies, do you believe the FASB should...? As for responses, *N* = 156.

FASB: Addressing Perceived Complexity in Public Company GAAP

The third leg (in addition to creating differential private company standards and extending some of these alternatives to public companies) in the FASB's efforts to address perceived complexity is to "simplify" requirements under full US GAAP. However, similar to the efforts to create separate US private company standards, this initiative appears focused on reducing cost and complexity for the preparer community, which is reflected in the following FASB proposals.

- Inventory accounting. The proposal related to inventory is intended to simplify the lower of cost or market assessment for companies. Companies would be required to value inventory at the lower of cost or net realizable value, which is a simpler proxy for market than existing guidance, where "market" is defined as an amount no more than net realizable value but not less than net realizable value less a normal profit margin.

- Extraordinary items. This proposal eliminates the concept of "extraordinary items" from US GAAP, which eliminates some income statement presentation complexity for companies. There is no mention of how these proposals would benefit investors.

- Defined benefit plans. The project, pertaining to the measurement date of defined benefit plan assets, is expected to reduce costs by aligning the measurement date of defined benefit plan assets with the date that valuation information and the fair values of plan assets are provided by third-party service providers. An entity with a fiscal year-end that does not fall at the end of a month would be eligible to measure its defined benefit plan assets and liabilities as of the month-end that is closest to the employer's fiscal year-end.

- Balance sheet classification of debt. Another project, for balance sheet classification of debt, is expected to reduce cost and complexity by replacing the fact-pattern-specific guidance in GAAP with a principle to classify debt as current or noncurrent based on the contractual terms of a debt arrangement and an entity's current compliance with debt covenants.

- Accounting for income taxes. Finally, a project related to accounting for income taxes is expected to simplify accounting for income taxes by eliminating the requirement in US GAAP for entities that present a classified statement of financial position to classify deferred tax assets and liabilities as current and noncurrent and instead requiring that they classify all deferred tax assets and liabilities as noncurrent in the statement of financial position.

Conclusion

As we have seen thus far, current standard-setter initiatives to address financial reporting complexity either address only preparer concerns regarding resources and costs or result in reporting requirements that will impede investors' financial analysis.

Standard setters should instead focus on how investors view complexity and how they believe efforts should be refocused to reduce this complexity. The next chapter examines investor perspectives on how best to tackle financial reporting complexity.

VI. Focus on Providing Transparency for Complex Transactions and Decreasing Accounting Complexity

For reforms to simplify financial reporting—for both public and non-public companies—to be meaningful to investors, we need to examine what investors believe are the principal sources of financial reporting complexity, determine which ones are avoidable and unavoidable, and refocus simplification initiatives to eliminate avoidable sources of complexity.

One way to think about complexity is to begin with the inputs that go into the value of a company and consider all those factors that may make deriving those inputs more difficult. Our experience suggests three key sources of financial reporting complexity:[49]

1. Complex businesses and transactions
2. Inadequate communication
3. Accounting standards that do not clearly communicate the underlying economics of transactions

As noted in the February 2014 bulletin of the European Financial Reporting Advisory Group (EFRAG) on "Getting a Better Framework: Complexity," some of these sources of complexity are avoidable whereas others are unavoidable. As we demonstrate next, complex businesses and transactions are a reality investors have to face. However, inadequate communication and inadequate accounting standards are avoidable sources of complexity that contribute to a lack of transparency in the financial statements, thereby making it difficult to estimate the fundamental inputs that we need to examine to value a firm. From an investor perspective, simplification efforts need to focus on these avoidable sources of complexity.

[49]Singh and Peters, "Financial Reporting Disclosures: Investor Perspectives on Trasparency, Trust, and Volume."

Transaction Complexity

Much of the added complexity in financial reporting standards is frequently a function of the increased complexity of business transactions. Simply put, accounting for complex business transactions is likely to require complex financial reporting. Furthermore, complex business transactions and agreements typically require extensive disclosures to provide underlying context and details to enhance users understanding of the financial reports. Such complexity is unavoidable.

As noted in the EFRAG Bulletin, the IASB's Conceptual Framework acknowledges this point:

> …some phenomena are inherently complex and cannot be made easy to understand. Excluding information about such phenomena might make the financial reports easier to understand but they would be incomplete and hence potentially misleading. Furthermore the Conceptual Framework states that financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyze the information diligently. And even they may need at times to seek the aid of an adviser to understand information about complex economic phenomena. (p. 5)

We agree. By applying simplified standards to complex transactions, the economics of the transaction are not likely to be captured in the same meaningful manner.

Non-Public Companies Can Avoid Transaction Complexity

The financial reporting complexity that non-public entities lament is a necessary consequence of the operating, investing, and financing choices made by businesses throughout the economy. But some non-public companies that may be less likely to engage in these complex business transactions—especially small non-public companies—will not be required to apply the more complex accounting rules.

However, if a company chooses to enter into complex business transactions, then the financial reporting complexity it faces is a consequence of that decision. If non-public companies have the business acumen to enter into complex transactions, then it is reasonable to expect them to have or be able to obtain the accounting expertise to account for such transactions. Accordingly, the majority of survey respondents (63%) indicate that private companies with complex transactions and activities should not be allowed to use reduced private company reporting requirements (see **Figure 11**).

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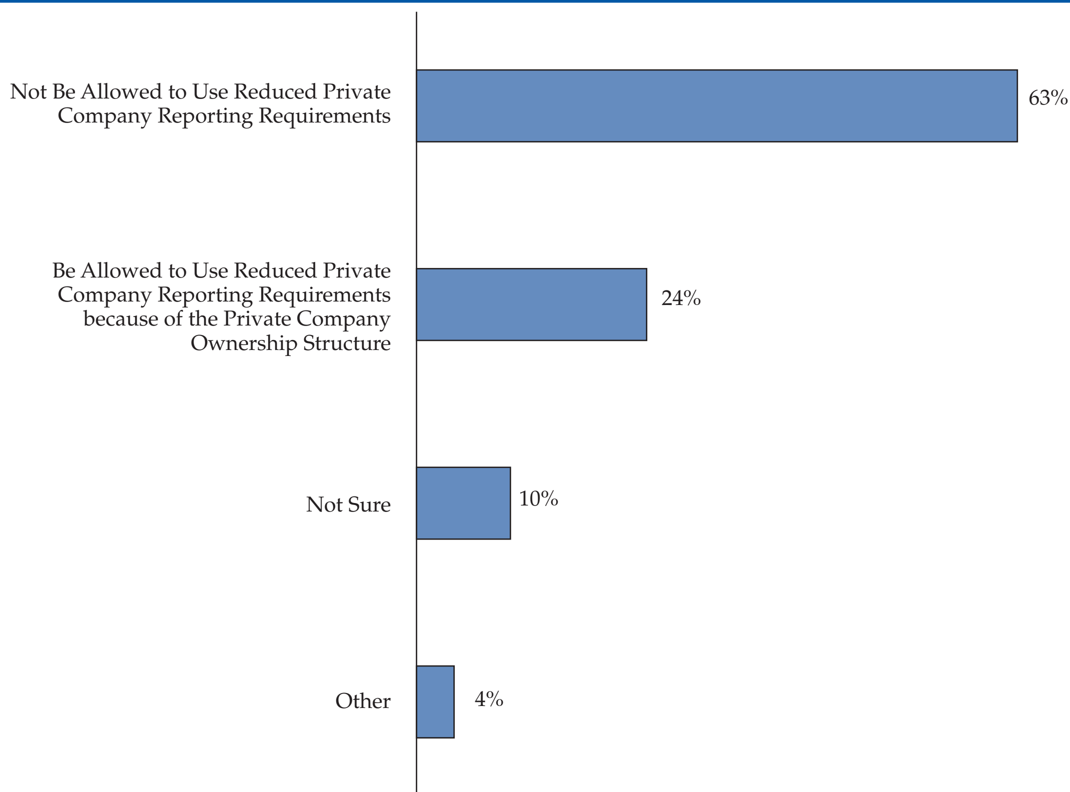
Figure 11. Private Companies with Complex Activities/Transactions Should Not Use Reduced Reporting Requirements



Notes: The question was, Private companies with complex activities and transactions (e.g., hedging, off-balance-sheet vehicles) should…? As for responses, *N* = 167.

This investor quote from the survey is representative of this view:

> There is a big difference between small privately held companies that are reliant on bank funding and large privately held companies that have a substantial number of non-management investors. There is also a big difference in the scope of a company's activities outside of traditional assets and liabilities. Companies with large off-balance-sheet risks, commitments and contingencies need to be understood. Lack of disclosure will only hide the risk. Large, complex privately held companies with multiple classes of non-management investors with a minority stake and inability to gain a seat on the board or influence management would be disadvantaged; and such companies would carry a risk premium.

Inadequate Communication

Increased financial reporting complexity as a result of increasingly complex businesses and transactions is unavoidable. Inadequate communication can, however, compound complexity. This may occur because of management's lack of understanding or intention to communicate certain items—for example, the risks and uncertainties a firm faces. Or it may be caused by poor financial statement presentation that does not facilitate transparency or understanding of the financial position of the company or its transactions. For example, the inability to link income statement and cash flow captions (i.e., lack of cohesiveness) adds to the complexity of financial analysis for investors.

Remediation of Communication Issues

Such complexity is avoidable. CFA Institute's publication "Financial Reporting Disclosures: Investor Perspectives on Transparency, Trust, and Volume" provides recommendations on increasing communication effectiveness in financial statements. The recommendations relate to enhancements in communication style and presentation that could improve the way information is transmitted to investors and investors' understanding of financial reporting information. The recommendations stress the need to

- have greater integration of information within the financial statements and between the financial statements and management commentary,
- provide entity-specific information,
- emphasize matters of importance during a reporting period,
- organize and layer information,
- reduce redundancy by adding cross-references, and
- increase the use of tables and charts.

Inadequate Accounting Standards

Complexity is also increased by accounting standards that do not reflect the underlying economics of transactions and, therefore, do not provide investors with needed transparency. This may occur because of various factors, as described in **Exhibit 4**. Such complexity is avoidable. We examine each factor in turn.

Exhibit 4. Factors that Increase Accounting Complexity

Factors	
1. Inadequate Recognition	Inadequate recognition of items in the financial statements
2. Inadequate Measurement	Inadequate measurement of items in the financial statements
3. Accounting Constructs vs. Economic Realities	Accounting constructs (as opposed to economic conventions) that have crept into standards over time
4. Poor Financial Statement Presentation	Insufficient disaggregation, cohesiveness, and use of roll-forwards and the direct method cash flow statement. Using disclosures as a substitute for poor presentation
5. Optionality Decreases Comparability	Optionality that provides firms with discretionary power in how they account for transactions and events
6. Exceptions to Principles	Standards that include exceptions to principles

1. Inadequate Recognition

The CBRM best articulates how accounting standards sometimes do not provide for appropriate recognition of transactions and events:

> Traditionally, financial reporting standards have permitted companies to avoid recognition of certain arrangements, including executory contracts, commitments, and contingencies, even when an unconditionally binding definitive agreement exists. Such standards permit managers to structure financial arrangements to avoid recognition or disclosure of material risk exposures until it is beneficial to the company to do so, at settlement, or possibly even permanently.…(p. 53)

> …no accounting standard should permit assets or liabilities, and changes in them that can affect shareowners' wealth, to escape recognition at the time they occur in the financial statements. For example, where assets are jointly owned or obligations are shared with one or more entities, then the amounts to be recognized should be based upon the company's and, therefore, the shareowners' potential risk exposures in those activities and their expected rewards for bearing the risks.…This means, of course, that all activities that currently are off balance sheet as a result of accounting standards or other conventions must be recognized, including executory contracts. Executory contracts, arrangements for which performance by the various parties is still in progress, represent commitments entered into by the parties. These commitments will affect shareowners' wealth and should be recognized as any other obligation would be. (p. 10)

Accounting standards also contain inherent contradictions in the recognition of transactions and events. We provide a couple of examples to illustrate the point.

- Intangible assets. A firm that buys a patent from another firm recognizes the patent as an asset, whereas a firm that develops a similar patent based on internal research does not recognize the patent as an asset at all. The CBRM states:

  > Intellectual property and other intangible assets are increasingly the economic drivers for many businesses. These assets may be the major sources of a company's revenue generation or contribute significantly to its expense structure. Hence, clear and complete information about intangible assets, whether on or off balance sheet and whether purchased or generated internally, is essential for investors' analyses. (p. 52)[50]

- Acquisitions vs. leases. A retail firm that borrows money and buys its store sites recognizes the sites as assets and the borrowing as debt, but a competing retail firm that leases these store sites will often not recognize any of the leases as debt and will also not recognize any assets.

2. Inadequate Measurement

Accounting standards may also cause added complexity because they do not use the appropriate measurement basis. Currently, financial statements include some items reported at historical cost while others are measured at fair value, the so-called mixed-attribute system. CFA Institute maintains that fair value should be the measurement attribute for assets and liabilities. The CBRM states:

> It is axiomatic that it is better to know what something is worth now than what it was worth at some moment in the past...Historic cost itself is in reality historic market value, the amount of a past transaction engaged in by the firm....Historic cost data are never comparable on a firm-to-firm basis because the costs were incurred at different dates by different firms (or even within a single firm). There is no financial analyst who would not want to know the market value of individual assets and liabilities. (p. 8)

Fair value measures reflect the most current and complete estimations of the value of the asset or obligation, including the amounts, timing, and riskiness of the future cash flows attributable to the asset or obligation. Such expectations lie at the heart of all asset exchanges. If asset exchanges and financial decisions are based on fair values, then market efficiency

[50]Principle 7 of the CBRM states that "investors require clear and complete information about intangible assets held by a company" (p. 52).

would be enhanced if the information used in such decisions were reported at fair value. The implication is that items in the balance sheet should be reported at current fair value. Furthermore, changes in these values should be reported in the income statement as they occur.

Currently, investors who rely on fair values for decision making must expend considerable effort trying to restate to fair value those decision-relevant financial statement items that are measured at historical cost. Their success depends on the sufficiency of disclosure and on the relative reliability of the measurements in the disclosures.

3. Accounting Constructs vs. Economic Realities

Many complexities in accounting standards are the result of negotiated compromises in financial reporting requirements. Over time, standards have come to include concepts and constructs not based on economic realities. These include, for example, management intent, hedge accounting, and other comprehensive income (OCI), which we expound on later. Accounting versus economic distinctions increase rather than reduce complexity for investors.

Intent-Based Approaches

We believe that accounting should reflect the underlying economic circumstances and should not reflect management intent because management intent does not alter the value of an asset. An asset's value is not different because management expresses an intent to hold the asset or sell the asset. The asset still increases or decreases in value based on market conditions. Moreover, intent can change over time or with a change in management, and such a change should not alter the valuation of the asset.

For example, both the IASB and the FASB require the accounting for financial instruments to be based on the business model governing the management of the instruments. Management intent or business model,[51] however, does not alter the value of a financial instrument. An investor who is contemplating buying a particular entity's securities should not be willing to pay a different price because of different accounting classifications and measurements of an identical basket of securities held by the entity that intends to hold the basket to maturity and another that intends to hold the basket for sale. Accordingly, accounting principles based on such a model do not provide investors with the most decision-useful information. Such reporting flexibility in classification and measurement creates differences in appearance without differences in economics.

[51]We use the terms "management intent" and "business model" interchangeably because a business model is predicated on and intended to capture the idea of management's intent.

Hedge Accounting

The CBRM explains the problems with another accounting construct—hedge accounting.

> Special hedge accounting is an artifact of the mixed-attribute model, is based upon managers' intent, and results in the selective recognition of only some fair value gains and losses. The fact that it exists only to permit managers to offset losses with gains, thereby reducing reported volatility, is arbitrary. Only when all transactions are fully and separately accounted for at fair value and on a disaggregated basis will investors have a clear picture of both the risks to be hedged and the effectiveness of any hedging instruments or strategies used. (p. 16)

The standard setters need to recognize that transactions entered into for the purpose of qualifying for hedge accounting (i.e., income smoothing) often cost more than nonqualifying hedging strategies that could actually be more effective in reducing the kinds of risks that shareholders actually care about. The far better and far simpler solution would be to do away with hedge accounting altogether and to require fair value measurements for financial instruments.

Other Comprehensive Income

Comprehensive income and OCI are terms created by accountants nearly 15 years ago. Although common in accounting parlance, many non-accountants and analysts are not familiar with the terms. Comprehensive income includes all measures of income, including traditional net income and the effects of changes recorded in OCI. OCI includes such items as the unrealized investment gains and losses on certain marketable securities; unrealized gains and losses on derivatives used in cash flow hedging; and gains and losses relating to pensions and other post-retirement benefits, foreign currency translation adjustments, and so forth.

These are items that are politically unpalatable to some for inclusion in traditional net income because of their volatility. OCI is essentially used to defer income statement recognition of valuation changes that would add volatility to reported net income. As a result, OCI has been included in the statement of changes in shareholders' equity, where it is more difficult to find and understates the importance of these measurements.

Some companies present comprehensive income along with OCI in the statement of changes in shareholders' equity, but most include this more complete measure of income—which offers a better picture of economic events affecting the organization in an accounting period—in the notes to the financial statements.

CFA Institute supports comprehensive income as the most complete picture of an entity's financial results and has argued for years against the use of OCI. Our argument against OCI is premised on the fact that OCI has never been properly defined in accounting or economic terms, and we believe it obscures information that is essential to financial statement analysis. The line between net income and OCI has been arbitrary and does not reflect any underlying economic difference.

4. Poor Financial Statement Presentation

One of the main findings of CFA Institute's 2012 Disclosure Survey[52] was that investors believe improved financial statement presentation is a key element to improving financial reporting broadly and disclosures specifically. This finding is consistent with previous CFA Institute surveys, all of which reflect investors' view that poor financial statement presentation limits transparency in financial reporting. Moreover, disclosures are less effective when they exist to complement financial statements that are not an effective foundation to portray financial results or when disclosures are meant to compensate or substitute for poor financial statement presentation. In many instances, disclosures have been required by standard setters in place of the appropriate presentation (e.g., offsetting requirements) and recognition and measurement (e.g., in the case of leases).

5. Optionality Decreases Comparability

The CBRM explains the need for comparability among financial statements for investors and how optionality distorts investment analysis, thereby creating complexity for investors.

> Investors do not make decisions about whether or not to invest in a particular company in a vacuum. Rather, the decision involves the weighing of alternative investment opportunities and the selection of the one that best fits the investor's preferred risk and return profile. Therefore, making comparisons is a critical part of the investment decision-making process.
>
> Even companies in the same industry domiciled in the same country make different accounting policy choices, including different assumptions and estimates that can result in widely different financial statements and reported amounts. Among the most obvious reporting areas that currently provide managers with substantial flexibility are leases, revenue and expense recognition, inventories,

[52]CFA Institute's "Financial Reporting Disclosures: Investor Perspectives on Transparency, Trust, and Volume" was based primarily on this survey.

> depreciation, and employee benefit plans. Investors perform their analyses to understand the underlying economics of a company. Given the flexibility, however, the results of the simplest financial analyses, such as the calculation of financial ratios (for example, interest coverage, return on equity, and debt/equity), will not be comparable across companies. This lack of comparability derives solely from the disparity resulting from available reporting options and not from the underlying economics. Until such flexibility in reporting is removed, investors will require sufficient disclosure to enable them to reconcile and adjust the reported numbers to a common basis. (p. 54)

Current accounting standards contain options that hamper investors' analyses. The high degree of optionality provided by private company standards will only serve to exacerbate this issue, thereby further increasing complexity.

6. Exceptions to Principles

The EFRAG bulletin contends that standards that contain exceptions to principles add avoidable complexity in financial reporting. It suggests that such exceptions arise because of a lack of consensus on the economic substance of a transaction. It points to IAS 32, Financial Instruments: Presentation, as an example of a standard that includes exceptions to principles.

> The requirements in IAS 32 on the classification of a financial instrument as a liability or equity include detailed and complex rules that depart from the basic definitions. Some financial instruments are complex so their classification involves dealing with that unavoidable complexity. However, some argue that the exceptions to principles add unnecessary complexity to the issue. (p. 15)

We agree. Accounting standards that do not ensure reflection of the true underlying economics of transactions and events create complexity. An investor quote says it best:

> For GAAP to live up to its name, the principles must be generally accepted. Specific exceptions to GAAP suggest that GAAP itself is not an appropriate standard, and that perhaps it is the principle rather than the application that must be changed. Financial reports should convey decision-useful information to investors. To the extent that management is unable to provide such information it can be argued that management does not fully understand the consequences of their decisions. To the extent that any exceptions to reporting should be allowed, the ultimate objective should be for the company to be compliant with generally accepted accounting principles.

To ensure reflection of the underlying economics, we believe that in accounting for liabilities and equity, there should not be anything in shareholders' equity other than common stock and retained earnings. A simple and elegant solution would be that only basic ownership interests should be classified as equity. Such a solution would not require any exceptions to the basic principle.

Inadequate Accounting Standards: Conclusion

Aswath Damodaran talks about the consequences of such complexity and how investors reflect the transparency (or the opacity) of a firm's financial statements in its value.[53] He notes that complexity in financial reporting is exacerbated by "fuzzy" accounting standards allowing discretionary power in the measurement of income and capital. Accounting can be used to report higher earnings, lower capital invested, and higher returns on capital. He considers three examples.

1. Firms have been inventive in their use of one-time and non-operating charges to move normal operating expenses below the operating income line. The appearance of these charges year after year essentially overstates operating income and can simultaneously reduce the book value of capital invested.

2. Firms can also use accounting standards to move assets and debt off their books using, for example, off-balance-sheet vehicles.

3. In addition, there are techniques to smooth earnings out over periods. Investors who look at earnings stability as a measure of equity risk are misled into believing that these firms are less risky than they truly are.

> When financial statements are not transparent, we cannot estimate the fundamental inputs that we need to examine to value a firm. For instance, a firm's expected growth should be a function of how much it reinvests (reinvestment rate) and how well it reinvests (its return on capital). If firms funnel their investments through holding companies that are hidden from investors, we cannot assess either of these inputs. To evaluate a firm's cost of capital, we need to know how much debt is owed by the firm, as well as the cost of this debt. For firms that hide a significant portion of their debt, we will underestimate the default risk that the firm is exposed to, and consequently, its cost of capital. (p. 27)

He concludes by stating:

[53] Aswath Damodaran, "The Value of Transparency and the Cost of Complexity."

> If we trust managers to be unbiased in what information they reveal to markets and when they reveal this information, we could argue that complexity by itself is not a problem since the additional uncertainty created by uncertainty is essentially firm-specific and diversifiable. If, on the other hand, managers are more likely to use complexity to hide unpleasant or bad news (losses or debt), complexity will result in more negative surprises than positive ones. In this case, it is appropriate to discount value for complexity. (p. 43)

Need to Eliminate Avoidable Complexity and Increase Transparency

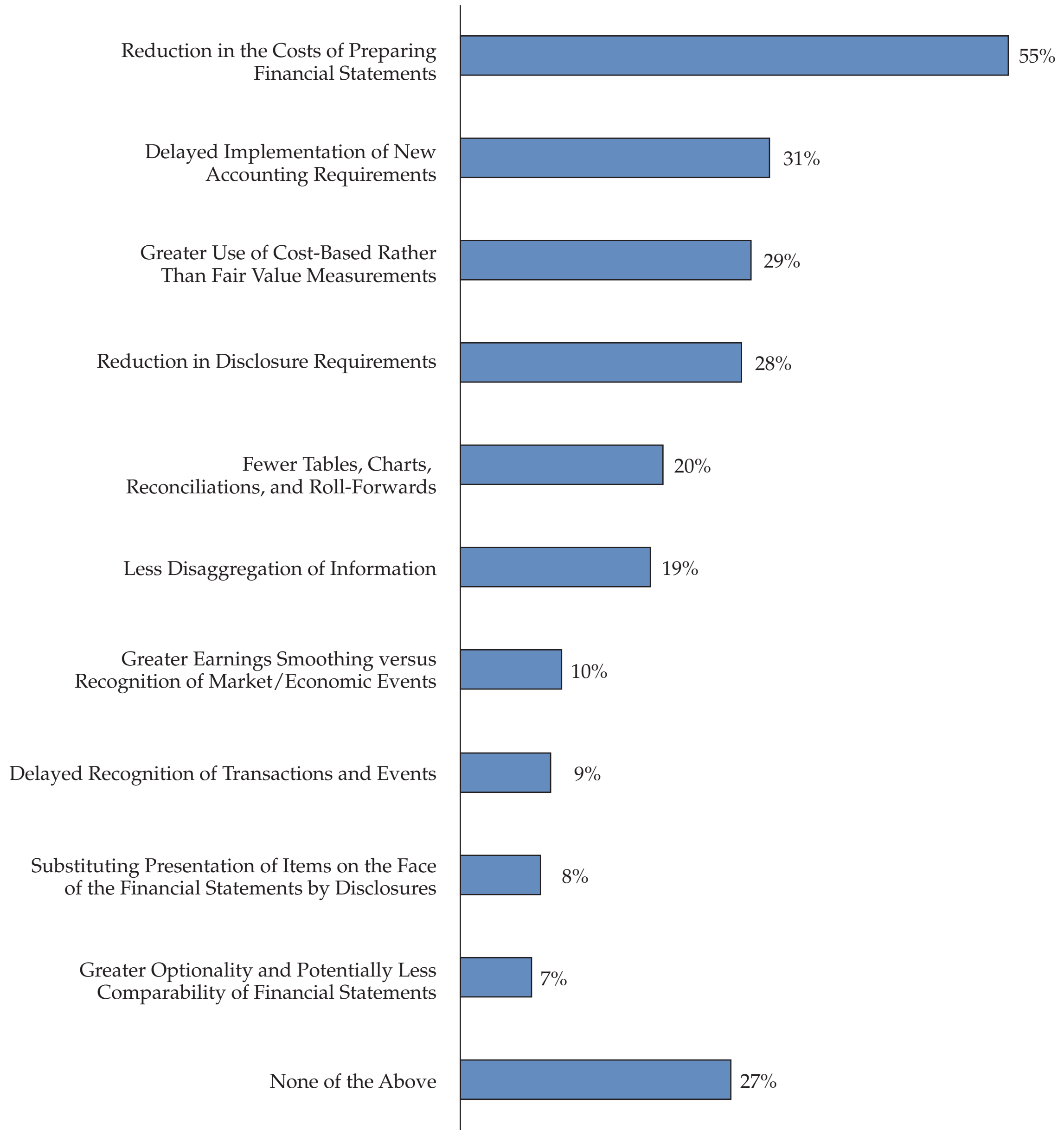
From an investor perspective, any simplification initiative should focus on simplifying financial reporting requirements to the extent that not all financial reporting complexity is a result of transaction complexity. The principal aim of accounting standards should be to bring greater transparency to all activities, especially complex activities, by ensuring reflection of the underlying economics of transactions and events. To that end, standard setters need to work toward ensuring that all economic assets and obligations should be recognized on the balance sheet; that investors receive economically relevant measures (fair value) to understanding an organization's financial position; that financial statement presentation is enhanced with a focus on disaggregation, cohesiveness, and the use of roll-forwards and the direct method cash flow statement; and that disclosures are not used as a substitute for poor presentation. Furthermore, simplification efforts should aim to increase transparency by working to eliminate accounting constructs, optionality, earnings smoothing, and exceptions to principles.

Accordingly, the results in **Figure 12** clearly demonstrate that investors do not support the following potential changes[54] that may increase, rather than reduce, avoidable complexity.

- Inadequate recognition: Delayed recognition of transaction and events
- Inadequate measurement: Greater use of cost-based rather than fair value measures

[54]This refers to potential changes that may come about as a result of the private company initiative.

Figure 12. **No Support for Avoidable Complexity that Decreases Transparency**



Notes: The question was, Below is a list of potential changes that may result from the FASB's private company initiative. Please indicate which of the following changes, if any, you would support. As for responses, $N = 166$.

- Poor presentation:
  - Substituting presentation on the face of the financial statements with disclosure
  - Less disaggregation of information
  - Fewer roll-forwards, reconciliations, tables, and charts
- Reduced disclosures: Reduction in disclosure requirements
- Greater optionality and less comparability: Greater optionality and potentially less comparability of financial statements
- Greater earnings smoothing: Greater earnings smoothing versus recognition of market/economic events

Appendix A. Survey Approach and Methods

Over the past several years, CFA Institute has surveyed members regarding many aspects of financial reporting. These surveys provide a way to aggregate member views on matters of importance in financial reporting. The findings contribute to the development and validation of CFA Institute's positions articulated through position papers, responses to standard setters, and other advocacy initiatives.

Our surveys are completed routinely in the normal course of informing our opinions, not completed specifically to serve any client or commercial interests. We do not pick participants, and our survey reports identify the survey methods, including an unbiased sampling methodology, the response rate, the demographics of participants, and the statistical relevancy of our results. Our interest and commentary as well as our surveys are entirely driven by our mission and membership and supported by our advisory committee.

We do not survey our full 100,000 membership on every topic because to do so would be burdensome to our members. We survey those who are most likely to have an interest in or position on (either for or against) a topic. Each member of CFA Institute has a profile that is updated annually with a job classification, and members are asked about areas of interest.

On matters of financial reporting, we survey those who have job descriptions relevant to financial reporting (e.g., analyst, portfolio manager) and those who have expressed an interest in financial reporting and financial statement analysis. We also have a more targeted financial reporting survey pool that is a subset of these individuals; it consists of those who have positively expressed interest in being contacted on all our financial reporting matters. For this survey, the target sampling frame consisted of all US members who have an interest in financial statement analysis.

An email invitation with a link to a web-based survey was sent to 14,208 members on 9 May 2014, and a reminder was sent on 14 May 2014. The survey closed on 23 May. The survey questionnaire consisted of 14 questions; 170 valid responses were received, for an overall response rate of 1.1%. The margin of error (based on the sampling frame population) is ±7.47% at the 95% confidence level. The margin of error will vary by question because the number of respondents varies by question.

Appendix B. Academic Research on Disclosure and Quality of Financial Reporting Information

Cheng, Lin, Scott Liao, and Haiwen Zhang. 2013. "The Commitment Effect versus Information Effect of Disclosure—Evidence from Smaller Reporting Companies." *Accounting Review*, vol. 88, no. 4 (July):1239–1263.

We examine the commitment effect provided by mandatory disclosure and the information effect of voluntary disclosure on market illiquidity by exploring a regulatory change that allows smaller reporting companies to reduce the disclosure of certain information in their SEC filings. This regime change allows us to separate the commitment effect provided by mandatory disclosure from the information effect of voluntary disclosure. We find that firms that are eligible to reduce their disclosure, but voluntarily maintain their disclosure level, experience an increase in market illiquidity. We also find that the increase in illiquidity is more pronounced for firms with higher agency costs. These findings suggest that mandatory disclosure serves as a credible commitment mechanism and that losing such commitment by disclosure deregulation is costly in the absence of a loss of information. Our study suggests that while voluntary disclosure is effective in reducing information asymmetry, it cannot replace mandatory disclosure in addressing information problems. (Abstract)

Chen, Feng, Qingyuan Li, and Xin Wang. 2011. "Financial Reporting Quality and Investment Efficiency of Private Firms in Emerging Markets." *Accounting Review*, vol. 86, no. 4 (July):1255–1288.

Prior research shows that financial reporting quality (FRQ) is positively related to investment efficiency for large U.S. publicly traded companies. We examine the role of FRQ in private firms from emerging markets, a setting in which extant research suggests that FRQ would be less conducive to the mitigation of investment inefficiencies. Earlier studies show that private firms have lower FRQ, presumably because of lower market demand for public information. Prior research also shows that FRQ is lower in countries with low investor protection, bank-oriented financial systems, and stronger conformity between tax and financial reporting rules. Using firm-level data from the World Bank, our empirical evidence suggests that FRQ positively affects investment efficiency. We further find that the relation between FRQ and investment efficiency is increasing in bank financing and decreasing in incentives to minimize earnings for tax purposes. Such a connection between tax-minimization incentives and the informational role of earnings has often been asserted in the literature. We provide explicit evidence in this regard. (Abstract)

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CFA Centre for Financial Market Integrity/
Business Roundtable Institute for Corporate Ethics

Breaking the Short-Term Cycle

Discussion and Recommendations on How Corporate Leaders, Asset Managers, Investors, and Analysts Can Refocus on Long-Term Value

About the Symposia

Beginning in September 2005, the CFA Centre for Financial Market Integrity and the Business Roundtable Institute for Corporate Ethics co-sponsored the "Symposium Series on Short-Termism" to address the issue of "Short-Termism"—corporate and investment decision-making based on short-term earnings expectations versus long-term value creation for all stakeholders—from a unique cross-group perspective.

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The mission of the CFA Centre for Financial Market Integrity is to be a leading voice on issues of fairness, efficiency, and investor protection in global capital markets and to promote high standards of ethics, integrity, and professional excellence within the investment community.

Its sponsoring organization, CFA Institute, is the 83,000-member, not-for-profit organization that awards the Chartered Financial Analyst® designation worldwide. CFA Institute was known as the Association for Investment Management and Research (AIMR) from 1990 through early 2004, and before that was two separate organizations with roots going back to 1947.

The Business Roundtable Institute for Corporate Ethics is an independent entity established in partnership with Business Roundtable—an association of chief executive officers of leading corporations with a combined workforce of more than 10 million employees and $4.5 trillion in annual revenues—and leading academics from America's best business schools. The Institute, which is housed at the University of Virginia's Darden Graduate School of Business Administration, brings together leaders from business and academia to fulfill its mission to renew and enhance the link between ethical behavior and business practice through executive education programs, practitioner-focused research, and outreach. More information on the Institute can be found at www.corporate-ethics.org.

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Breaking the Short-Term Cycle

Discussion and Recommendations on How Corporate Leaders, Asset Managers, Investors, and Analysts Can Refocus on Long-Term Value

Proceedings of the CFA Centre for Financial Market Integrity and the Business Roundtable Institute for Corporate Ethics Symposium Series on Short-Termism

EXECUTIVE SUMMARY

Beginning in September 2005, the CFA Centre for Financial Market Integrity and the Business Roundtable Institute for Corporate Ethics co-sponsored a "Symposium Series on Short-Termism." The purpose of these symposia was to address the issue of "short-termism"—corporate and investment decision making based on short-term earnings expectations versus long-term value creation for all stakeholders—from a unique cross-group perspective.

The insights of our symposia participants ("the Panel")—thought leaders from the corporate issuer, analyst, asset and hedge fund manager, institutional investor, and individual investor communities—confirm what the academic research suggests: namely, that the obsession with short-term results by investors, asset management firms, and corporate managers collectively leads to the unintended consequences of destroying long-term value, decreasing market efficiency, reducing investment returns, and impeding efforts to strengthen corporate governance.

SUMMARY OF RECOMMENDATIONS

Corporate leaders, asset managers, investors, and analysts should:

1. **Reform earnings guidance practices:** All groups should reconsider the benefits and consequences of providing and relying upon focused, quarterly earnings guidance and each group's involvement in the "earnings guidance game."
2. **Develop long-term incentives across the board:** Compensation for corporate executives and asset managers should be structured to achieve long-term strategic and value-creation goals.
3. **Demonstrate leadership in shifting the focus to long-term value creation.**
4. **Improve communications and transparency:** More meaningful, and potentially more frequent, communications about company strategy and long-term value drivers can lessen the financial community's dependence on earnings guidance.
5. **Promote broad education of all market participants about the benefits of long-term thinking and the costs of short-term thinking**.

The Panel asserts that our broad set of recommendations—focused on the issuer, analyst, institutional investor, asset manager, and hedge fund manager communities—could mitigate the current overemphasis on short-term performance.

The CFA Centre for Financial Market Integrity and the Business Roundtable Institute for Corporate Ethics thank the many commentators and participants for their contributions.

RECOMMENDATIONS

The Panel encourages corporate leaders, asset managers, institutional investors, and analysts to:

Earnings Guidance

1. End the practice of providing quarterly earnings guidance.
2. However, companies with strategic needs for providing earnings guidance should adopt guidance practices that incorporate a consistent format, range estimates, and appropriate metrics that reflect overall long-term goals and strategy.
3. Support corporate transitions to higher-quality, long-term, fundamental guidance practices, which will also allow highly skilled analysts to differentiate themselves and the value they provide for their clients.

Incentives and Compensation

1. Align corporate executive compensation with long-term goals and strategies and with long-term shareowner interests. Compensation should be structured to achieve long-term strategic and value-creation goals.
2. Align asset manager compensation with long-term performance and with long-term client interests.
3. Improve disclosure of asset managers' incentive metrics, fee structures, and personal ownership of funds they manage.
4. Encourage asset managers and institutional investors to develop processes for ensuring that the companies in which they invest use effective, long-term, pay-for-performance criteria in determining executive compensation.

Leadership

1. Endorse corporate leadership in communicating long-term strategic objectives and related performance benchmarks rather than in providing quarterly earnings guidance.
2. Support analysts and asset managers in using a long-term focus in their analyses and capital investment decisions.
3. Promote an institutional investor focus on long-term value for themselves and when evaluating their asset managers.

Communications and Transparency

1. Encourage companies to provide more meaningful, and potentially more frequent, communications about strategy and long-term vision, including more transparent financial reporting that reflects a company's operations.
2. Encourage greater use of *plain language* communications instead of the current communications dominated by accounting and legal language.
3. Endorse the use of corporate long-term investment statements to shareowners that will clearly explain—beyond the requirements that are now an accepted practice—the company's operating model.
4. Improve the integration of the investor relations and legal functions for all corporate disclosure processes in order to alleviate the current bifurcated communications that confuse, rather than inform, investors and analysts.
5. Encourage institutional investors to make long-term investment statements to their beneficiaries similar to the statement the Panel is asking companies to make to their shareowners.

Education

1. Encourage widespread corporate participation in ongoing dialogues with asset managers and other financial market leaders to better understand how their companies are valued in the marketplace.
2. Educate institutional investors and their advisors (e.g., consultants, trustees) on the issue of short-termism and their long-term fiduciary duties to their constituents.
3. Support education initiatives for individual investors in order to encourage a focus on long-term value creation.

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INTRODUCTION AND CALL TO ACTION

In 2003, former U.S. Securities and Exchange Commission (SEC) Chairman William H. Donaldson called upon business leaders at a corporate governance forum "[to] manage the business for long-term results and to get away from the attitude that you're managing the business out of a straight jacket that has been put upon you to create earnings per share on a regular basis." He further encouraged these leaders to "present to investors exactly how you are going to manage that business."[1] Expanding his concern at the 2005 CFA Institute annual conference, Donaldson cited "short-termism" as a critical issue facing the financial industry.

Similar concern is noted by corporate executives. In research conducted by the Business Roundtable Institute for Corporate Ethics, chief executive officers (CEOs) at many of the largest U.S. corporations were asked to identify the most pressing ethics issues facing the business community. "Effective company management in the context of today's short-term investor expectations" was among the most cited concerns.[2]

In a recent survey of more than 400 financial executives, 80 percent of the respondents indicated that they would decrease discretionary spending on such areas as research and development, advertising, maintenance, and hiring in order to meet short-term earnings targets and more than 50 percent said they would delay new projects, even if it meant sacrifices in value creation.[3] These results demonstrate that short-termism is a larger issue than companies simply using *accounting* actions to meet quarterly earnings expectations. These are *real* actions—asset sales, cuts in research and development, and forgone strategic investments—that corporate managers use to hit "the quarterly earnings number." Although the creation of long-term company value is widely accepted as management's primary responsibility, this research suggests that managing predominantly for short-term earnings expectations often impairs a manager's ability to deliver such value to shareowners.

These collective concerns mirror the views of the Panel gathered for the symposium series on short-termism. The Panel agrees that an obsession with meeting short-term expectations of varying constituencies too often hinders corporate managers and all types of investors from focusing on long-term value creation. The causes of this short-term fixation are multifaceted, which necessitates reforms that involve many stakeholders, including those who participated in the symposium (corporate issuers, analysts, asset managers, shareowners, institutional investors, regulators, and media representatives).

To be sure, the introduction of new information that is material to a company's health demands that investors and other market participants respond quickly. Such short-term actions actually promote market efficiency. The short-termism issue addressed in this paper, however, focuses on instances in which long-term investment decisions are made on the basis of short-term information, the most prominent of which is the "hit or miss" of quarterly earnings guidance. The Panel believes that where long-term planning and investment is called for, short-term information should factor into decision-making primarily in the context of supporting such long-term strategy.

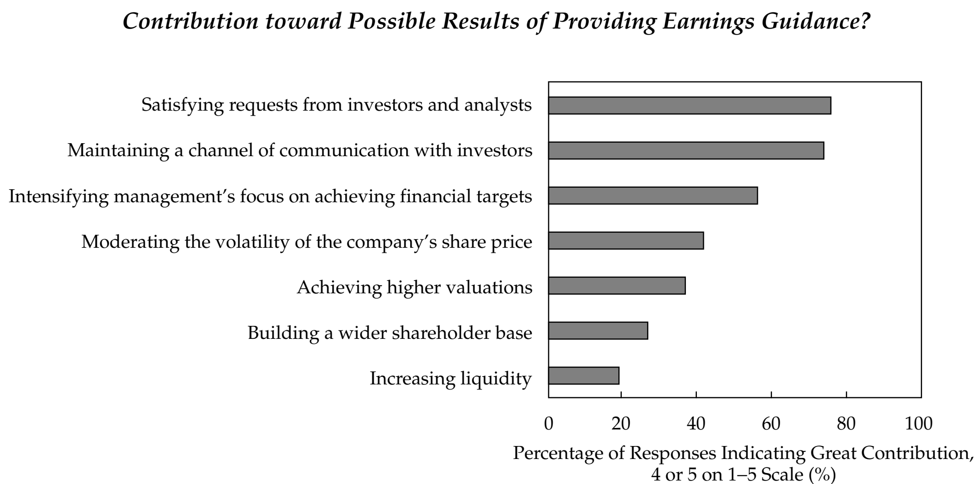
Short-termism refers to the excessive focus of some corporate leaders, investors, and analysts on short-term, quarterly earnings and a lack of attention to the strategy, fundamentals, and conventional approaches to long-term value creation. An excessive short-term focus combined with insufficient regard for long-term strategy can tip the balance in value-destructive ways for market participants, undermine the market's credibility, and discourage long-term value creation and investment. Such short-term strategies are often based on accounting-driven metrics that are not fully reflective of the complexities of corporate management and investment.

Warren Buffett, the widely respected and emulated CEO of Berkshire Hathaway, addressed the issue in his letter to shareowners in 2000 by encouraging management teams to place their attention and focus on long-term strategy, not quarterly earnings. Subsequently, companies representing significant Berkshire holdings, including Coca-Cola, Gillette, and The Washington Post Company, ceased providing quarterly earnings

guidance and, instead, opted for annual projections. More recently, Intel, McDonald's, Motorola, and Pfizer joined the growing group of companies signaling their plans to scale back focused earnings guidance. This movement away from earnings guidance reflects a growing sentiment summarized by John C. Bogle, founder and former CEO of The Vanguard Group, that "[t]he role of management should not be beating abstract numeric estimates but improving the operations and long-term prospects of organizations."[4]

Why do many companies continue to issue earnings guidance? In a March 2006 survey conducted by McKinsey & Company, a worldwide group of business executives identified the three most significant benefits of earnings guidance as (1) satisfying requests from investors and analysts, (2) maintaining a channel of communication with investors, and (3) intensifying management's focus on achieving financial targets (see Figure 1).[5] The Panel's recommendations provide a better roadmap to achieve these objectives.

Figure 1: Perceived Benefits of Issuing Guidance



Source: *The McKinsey Quarterly* (March 2006).

The McKinsey survey further indicates that the most demanding groups calling for earnings guidance are sell-side analysts, mutual/pension funds, and internal (within the company) sources—groups that were represented in our symposia. Each group does indeed share responsibility, and ultimately, each must contribute to a better model. Continuing to follow the rules of "the earnings guidance game" runs counter to the research suggesting that these behaviors can have unintended and detrimental consequences, such as destroying long-term value, decreasing market efficiency, reducing investment returns, and impeding efforts to strengthen corporate governance.

In recognition of the magnitude of short-termism and its impact, the CFA Centre for Financial Market Integrity and the Business Roundtable Institute for Corporate Ethics conducted a unique series of symposia on the topic that brought together a broad cross-section of stakeholder groups. The groups initially convened individually. Subsequently, a meeting of all participants was held to discuss and agree upon suggested principles and recommendations for broadly addressing the issue of short-termism. The Panel identified five broad categories of recommendations in response to the short-termism issue: (1) earnings guidance practices, (2) compensation and incentive practices, (3) leadership that refocuses on long-term metrics, (4) communication and transparency of long-term valuation data, and (5) improved education for all market participants.

The following pages detail each issue and describe the Panel's recommendations for breaking the short-term cycle and refocusing corporate leaders, asset managers, investors, and analysts on long-term value.

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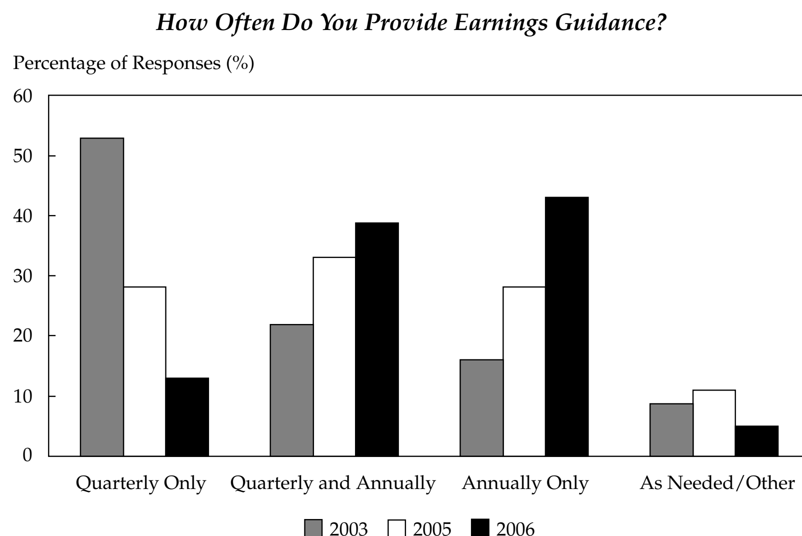
EARNINGS GUIDANCE

In a 1998 article, financial historian Peter Bernstein gently chastised the capital markets for focusing too much on measures of central tendency, such as consensus earnings estimates, as a way to measure and mitigate risk. Bernstein observed, "Simplification lures us into the trap … we set for ourselves with our demand for the 'essence' in preference to the variation, for simplification is impossible without the averages and the other measures of central tendency."[6] Indeed, the current earnings guidance landscape tends to crowd out "variations" in an effort to boil a company's complex future prospects down to its "essence," a practice Bernstein surmised might perpetuate the kind of risk market participants seek to avoid.

Although there may be certain benefits to providing earnings guidance, the costs and negative consequences of the current focused, quarterly earnings guidance practices are significant, including (1) unproductive and wasted efforts by corporations in preparing such guidance, (2) neglect of long-term business growth in order to meet short-term expectations, (3) a "quarterly results" financial culture characterized by disproportionate reactions among internal and external groups to the downside and upside of earnings surprises, and (4) macro-incentives for companies to avoid earnings guidance pressure altogether by moving to the private markets. Corroborating research identifies the most significant costs of issuing guidance to be management time (which 53 percent of respondents identified as very costly), a focus on short-term earnings (42 percent), and employee time (35 percent).[7] Additionally, earnings guidance contributes to an illusion of complete business predictability, a faulty premise for both companies and their investors.

Recent evidence suggests that companies are indeed addressing the shortcomings of the current earnings guidance landscape. The trend is to shift from quarterly to annual guidance and, in some instances, to withholding guidance entirely. According to research conducted by the National Investor Relations Institute (NIRI), the number of companies providing quarterly guidance decreased from 75 percent in 2003 to 52 percent in 2006. The number of companies providing annual guidance has increased to 82 percent from 38 percent over the same period, and the percentage of companies that now provide *only* annual guidance is 43 percent (see Figure 2).[8]

Figure 2: NIRI Survey on Earnings Guidance Practices

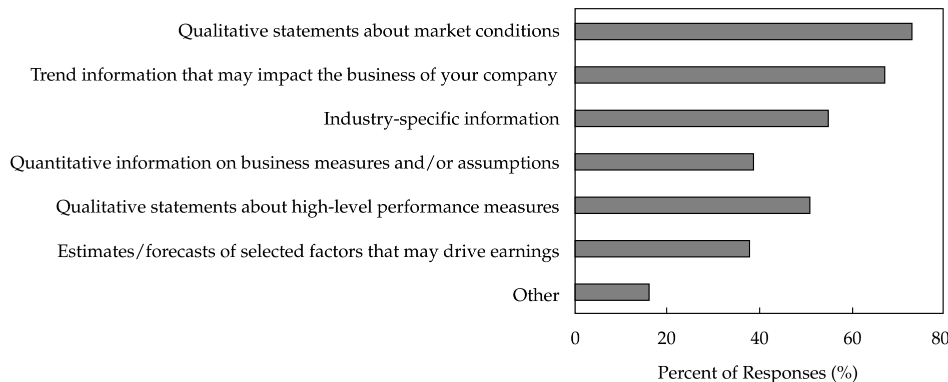


Source: National Investor Relations Institute.

Discontinuing the practice of earnings guidance does not imply discontinuing communication. Indeed, the NIRI participants who do not provide earnings guidance note a lengthy list of quantitative and qualitative information that they do provide to assist analysts and the broad investment community (see Figure 3).

Figure 3: NIRI Survey on Earnings Guidance Practices

Do You Provide Nonearnings Guidance That May Assist Analysts in Arriving at Their Estimates?



Source: National Investor Relations Institute.

These survey results should encourage corporations to examine their own guidance practices and consider whether they are indeed following "leading practices" for informing shareowners and others about their businesses.

Although a majority of panelists supported a recommendation for companies to discontinue providing quarterly earnings guidance, there was recognition that such a bold step might not be appropriate for all companies. Accordingly, one framework suggested by the Panel (the second recommendation in this section) is a matrix of evolving practices based on both company size and industry life-cycle characteristics.

Efforts by corporations to adjust earnings guidance practices will require significant cooperation and communication with the analyst and asset manager communities to gain support for reforms. Analysts are increasingly recognizing that earnings guidance "creates an echo chamber that drowns out investor debate and distills what should be a complex message about a company's operations and performance into a single number—dictated by the company itself," according to the head of global securities research at Merrill Lynch & Company. The Merrill Lynch position, she added, is that "it would be in the best interests of investors if companies dropped quarterly earnings guidance."[9]

A broad base of financial professionals is also supportive of such a change. In a CFA Institute survey of its membership, which includes a large contingent of asset managers and analysts, 76 percent of respondents supported companies moving away from quarterly earnings guidance. Of those supporters, 96 percent further agreed that companies should provide additional information on the fundamental, long-term drivers of the business (see Figure 4).[10] Discontinuing earnings guidance would offer skilled analysts and asset managers an opportunity to differentiate themselves and add value by conducting insightful research and building superior valuation models for their clients.

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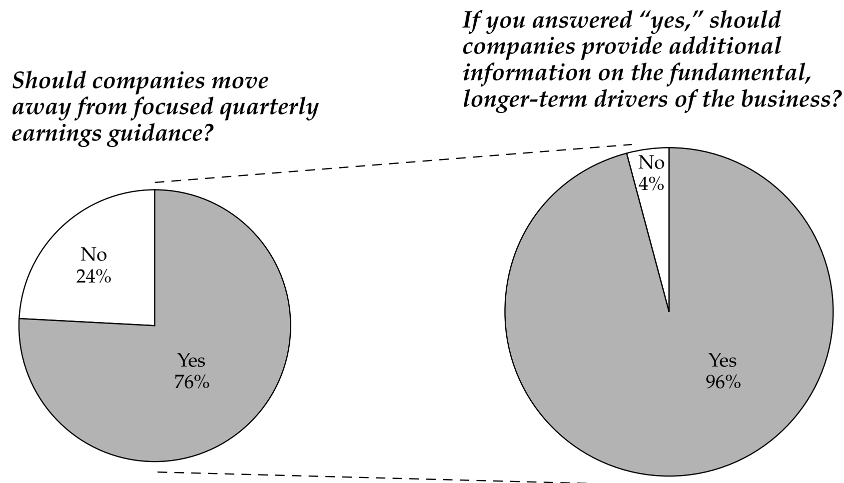
Figure 4: CFA Survey of Earnings Guidance



Source: CFA Institute (2006).

The recommendations made by the Panel for reforming earnings guidance aspire to refocus attention on the reality of business complexities. Focusing on key assumptions, business drivers, and overall strategic objectives will lead to more valuable and insightful disclosures, analysis, investment, and decision making.

EARNINGS GUIDANCE RECOMMENDATIONS

1. **End the practice of providing quarterly earnings guidance.**

The widely held consensus of the Panel is that publicly traded companies should end the practice of providing quarterly earnings guidance. The Panel believes that such guidance inadequately accounts for the complex dynamics of companies and their long-term value drivers.

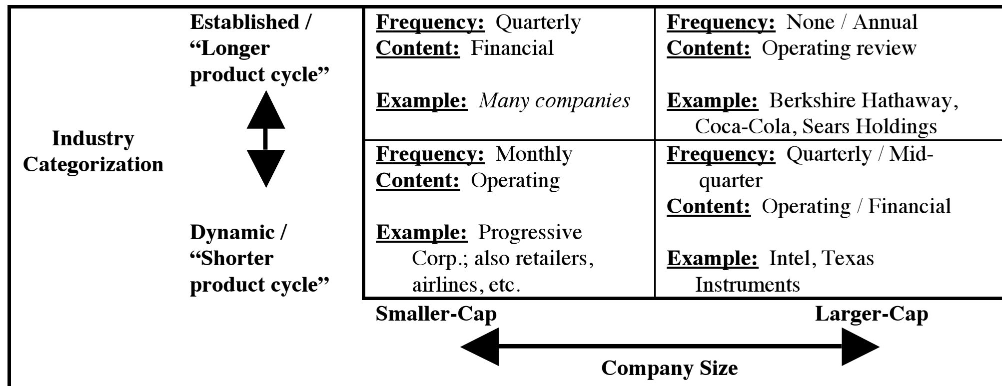
By proactively moving to change a culture that has become overly obsessed with meeting a quarterly earnings number, companies would also motivate analysts to effectively differentiate themselves and their analyses, thereby encouraging a long-term outlook by both the institutional and individual investment communities.

2. **However, companies with strategic needs for providing earnings guidance should adopt guidance practices that incorporate a consistent format, range estimates, and appropriate metrics that reflect overall long-term goals and strategy.**

In recognition of the difficulty some companies may encounter in abruptly ending quarterly earnings guidance, the Panel introduced the concept of an "earnings guidance life cycle" as a method to replace the current "one-size-fits-all" quarterly guidance model and allow companies to improve the quality of their disclosures on the basis of company-specific and industry characteristics. The "earnings guidance life cycle" is depicted in Figure 5.

Earnings Guidance

Figure 5: Guidance Practices Framework



The life-cycle concept also supports a process for companies to ultimately end focused earnings guidance. For example, an early-stage, small-capitalization company with a shorter-term product/service cycle is likely to be covered by few analysts and may need to raise capital from the financial markets over a regular time frame (e.g., every two to three years). In today's capital markets, such a company may not have the strategic option of providing less than quarterly guidance. As the company grows and/or diversifies its products, services, and markets, however, it can tolerate potential fluctuations in volatility and investor sentiment that may occur with less frequent earnings guidance. Still later in the corporate life cycle, the company may have matured to the point of focusing on managing the business for the long term and have little need to provide earnings guidance to outside sources.

From a tactical perspective, a company could notify users of its financial data of a planned change in what guidance it considers appropriate according to the earnings guidance life-cycle model by stating, for example, "… when we meet the current guidelines we have communicated [perhaps including market-cap, market share, yearly revenue, and sales targets], we intend to begin providing less earnings guidance [or will cease to give quarterly earnings guidance]. We intend to provide monthly operating data on our website to help investors understand our business and provide them the information necessary to value our company."

Our panelists noted that several companies that have stopped providing quarterly earnings guidance now offer *more* information (such as monthly operating data) that is also of a higher quality and less susceptible to manipulation than earnings. These companies thus still provide analysts with the information they need to complete their analyses and run their valuation models.

3. **Support corporate transitions to higher-quality, long-term, fundamental guidance practices, which will also allow highly skilled analysts to differentiate themselves and the value they provide for their clients.**

Asset managers, institutional investors, and analysts should use their increasing influence to support reformed corporate earnings guidance and communications practices directed at long-term performance. Highly skilled analysts and asset managers should view a decrease in corporate earnings guidance as an opportunity to differentiate themselves and to add value by doing more direct research and creating superior valuation analyses and models.

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INCENTIVES AND COMPENSATION

Much attention is currently directed at corporate executive compensation, but a more thorough approach to addressing short-termism requires appropriate incentive policies and practices for corporate executives, asset managers, analysts, and others.

Although the current median tenure for CEOs of Fortune 500 companies is approximately five years,[11] the actions and decisions of these CEOs often have much longer consequences. To be properly structured, incentives should reflect the upside potential *and* downside risk of management actions and should align management interests with those of shareowners. One way companies can encourage long-term value creation is by basing the *majority* of executive compensation on long-term performance measures, even if such terms extend beyond the tenure of the executives themselves. (The definition of "long term" varies largely by industry, and therefore, incentive measures should reflect specific industry operating characteristics. Typically, in this context, long-term is considered to range from three to five years and should not be less than two years.)

Progress in long-term "pay for performance" is being made. In 2006, 57 percent of Business Roundtable companies indicated that the use of performance criteria has increased as a component of overall executive compensation. This is a notable increase from 49 percent in 2005 and 40 percent in 2004. Moreover, among the companies placing greater emphasis on performance, 20 percent use primarily long-term goals, 73 percent use a mix of long-term and short-term goals, and only 7 percent emphasize only short-term targets.[12] The Panel's recommendations seek to advance this progress.

In January 2006, the SEC proposed new guidelines for executive compensation that would greatly enhance the disclosures U.S. listed companies must make concerning the compensation of their highest paid executives. Greater disclosure should allow asset managers and all investors to better understand whether corporate executive compensation packages provide the proper incentives to manage for the long term. The Panel encourages asset managers and institutional investors to develop rigorous processes for the thorough review of corporate executive compensation packages.

Similarly, evaluating the performance of asset managers against a quarterly benchmark is counterproductive to conditioning them as long-term investors. When asset managers are evaluated and compensated primarily on the basis of quarterly metrics, they may pressure companies into the same short-term thinking or increase volatility by regularly trading in and out of company securities in an effort to capture short-term profit. The Panel thus believes that a significant portion of incentive pay for asset managers should be measured by long-term (three to five years) metrics similar to those used at the companies in which they invest. To confirm this longer-term focus, asset management firms should provide investors with more information about their incentive structures.

INCENTIVES AND COMPENSATION RECOMMENDATIONS

1. **Align corporate executive compensation with long-term goals and strategies and with long-term shareowner interests. Compensation should be structured to achieve long-term strategic and value-creation goals.**

Although proposed SEC requirements on executive compensation will provide shareowners with greater transparency as to the components of management compensation, it is ultimately up to the companies themselves, their boards, and their shareowners to make sure that the interests of management are aligned with those of shareowners. All three panels identified executive incentives that focus disproportionately on short-term objectives as a key driver of short-termism.

Additionally, stock ownership guidelines should require all executives and directors to hold a *meaningful* amount of equity in the company at which they serve. "Meaningful" in this context can be defined as an amount that makes it economically material to the individual that a company succeed in the long-term.

2. **Align asset manager compensation with long-term performance and with long-term client interests.**

Evaluating asset managers quarterly almost ensures that many will fall short of the benchmark because of unpredictable short-term events, near-term stock market swings, and transaction fees that ultimately penalize returns to investors.

As much as possible, incentive pay for asset managers should be measured by long-term metrics in order to promote a long-term investment horizon. The Panel recommends that asset managers investigate ways to link asset manager pay to performance—in much the same way the Panel encourages corporations to rethink corporate executive pay to better reflect long-term performance. An example would be tying manager incentives to multi-year performance. By creating more transparent links between asset manager pay and long-term performance, asset management firms will help ensure fund shareowners that asset managers are paid for performance, not asset gathering.

Asset managers should also be encouraged to commit a *meaningful* portion of their own wealth to the funds they manage in order to tie their compensation directly to the wealth they create for fund shareowners.

3. **Improve disclosure of asset managers' incentive metrics, fee structures, and personal ownership of funds they manage.**

Asset managers and investors have long called for more transparency from the companies they evaluate and in which they invest, especially in the areas of executive compensation. Similar incentive disclosures are severely lacking in the managed funds industry.

The Panel calls on asset management firms to more closely link incentive compensation to long-term performance. Because most investors in mutual funds have a long-term investment horizon, asset management firms should strive to provide investors with more information concerning asset manager incentive metrics and incentive structures. Greater transparency concerning the incentive structures of asset managers will go a long way toward reassuring investors that the interests of asset managers run parallel to their own.

Although hedge funds do not fall under the same regulatory rubric as mutual funds, hedge fund managers should strive to assure long-term investors (e.g., those that agree to lock up their funds for a prolonged period of time) that the fund managers are fairly compensated on the basis of long-term results through use of incentive fees and other methods of tying fees to long-term performance.

4. **Encourage asset managers and institutional investors to develop processes for ensuring that the companies in which they invest use effective, long-term, pay-for-performance criteria in determining executive compensation.**

The new SEC guidelines for executive compensation disclosures should provide all shareowners with better tools for evaluating whether corporate executive compensation packages properly link pay to performance and provide executives with the incentives to manage for the long term. The Panel encourages asset managers and institutional investors to closely examine corporate pay packages to ensure that incentive plans are aligned with the long-term interests of shareowners.

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LEADERSHIP

Several panelists claimed that the short-termism mindset among certain investors is correlated with an overall loss of trust in corporate leaders. Those investors who have become distrustful of business leadership and its commitment to long-term value creation may have opted to seek short-term profits instead of long-term growth in value.

TIAA-CREF, one of the largest financial services organizations in the United States, has published a principle that "sound corporate governance contributes significantly to long-term corporate performance."[13] Believing that reform efforts should be focused throughout the business and investor community on regaining the public trust, the Panel endorses a similar philosophy. Companies as a group, as well as their investors, would better demonstrate corporate leadership by concentrating their attention on the long-term business strategy of their companies.

One symposia participant summarized, "Companies get the shareowners they deserve." The corollary is also true: Shareowners get the companies they deserve. In other words, long-term shareowners need to act like the owners they are and demand proper long-term stewardship of their capital assets. This is a two-way relationship. Investors should expect greater influence but must exhibit true ownership behavior and generally commit to acting like *owners* (e.g., holding longer, trading less). Similarly, companies should expect longer capital commitments—but only if they provide investors with high-quality communications and a fair voice in governance.

A company can make an active effort to seek a base of shareowners whose investment horizons mirror the company's strategy for long-term economic growth by focusing its communications and disclosures on the long-term strategy, operations, and viability of the business. Moreover, the company should resist the pressures of shareowners who simply clamor for short-term results (see the following section on "Communications and Transparency" for further discussion). Put another way, leading companies and their shareowners need to coalesce around the appropriate long-term value creating strategies.

Currently, many companies encounter significant short-term pressures from a more transient investor base. The annual turnover ("churn rate") for shares of New York Stock Exchange–listed companies has increased dramatically from a range of 10 percent to 30 percent during the 1940–80 period to more than 100 percent in 2005 (see Figure 6). Certainly, such a churn rate imposes costs on companies and their investors, not the least of which are higher transaction fees and possible internal company trade-offs against long-term strategic investments.

In contrast, a group of *Fortune* magazine's 2006 Most Admired Companies specifically recognized in the category of "Long-Term Investment" had an average turnover rate of approximately 60 percent in 2005.[14] These results suggest that, instead of short-term shareowners or speculators applying undue pressure, a core base of long-term shareowners allow these companies to make sound long-term investments.

Leadership

Figure 6: NYSE Turnover Rate, 1940–2005

Source: New York Stock Exchange Fact Book (2006).

Corporate directors are one influential group that must take a leadership role in engendering a longer-term focus. In March 2006, *Directors & Boards* magazine asked its *eBriefing* subscribers, "Should companies end the practice of giving earnings guidance?" Almost 74 percent of respondents answered "Yes." Equally intriguing was the overall interest in the question, which resulted in "the highest response rate and additional comments [of any question] to date," according to the magazine's editor.[15] Recently, the directors of Coca-Cola addressed shareowner concerns about short-termism in a unique manner. The board adopted an "all-or-nothing" compensation plan in which all director pay consists entirely of equity-based share units payable only when longer-term company performance targets are met. The initial performance period is three years.[16]

Leadership can also come from institutional investors willing to make a long-term commitment to strategy. Institutional investor equity holdings increased to $8 trillion in 2005, representing 60 percent of outstanding equity in the United States.[17] With such influence, institutional investors have the opportunity to become a major advocate for supporting long-term, value-creating corporate strategies.

Leadership commitments from public companies, asset managers, and institutional investors to long-term strategy, investment, and ultimately, value creation will contribute to improved long-term performance for all market participants.

LEADERSHIP RECOMMENDATIONS

1. **Endorse corporate leadership in communicating long-term strategic objectives and related performance benchmarks rather than in providing quarterly earnings guidance.**

The Panel believes that companies gain little from participation in the current practice of providing quarterly guidance and can better serve themselves and their shareowners by concentrating attention on the long term.

Companies that discontinue providing earnings guidance can take the lead in demonstrating the long-term benefits of devoting less of their valuable resources to providing guidance.

Leading companies can focus attention on the long term by embracing enhanced reporting that concentrates on cash flows and a broad range of operating metrics. These companies can take the lead in "changing the conversation" to a focus on the long-term growth prospects that are ultimately more important to continued success than pennies per share in a quarterly earnings forecast.

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2. **Support analysts and asset managers in using a long-term focus in their analyses and capital investment decisions**.

It will take leadership from analysts and investment firms to focus more on the long term and align their incentive structures with a long-term mandate. But without such leadership, it is doubtful that such changes will happen.

Such panelist comments as "the quality of analysts has declined in recent years" support the need for CFA Institute to continue emphasizing long-term measures, including discounted cash flow (DCF) valuation models, over short-term asset valuation models in its curriculum. CFA Institute will continue to espouse the virtues of such long-term valuation models and will revisit its curriculum to determine if and where undue emphasis is being given to short-term investment strategies that are detrimental to the creation of long-term shareowner value.

Additionally, the current "consensus earnings" culture places significant pressure on analysts whose estimates differ from company guidance, thereby promoting analyst conformity. CFA Institute supports bringing about a market in which the hard work, expertise, and independent assessment of the best analysts are rewarded.

3. **Promote an institutional investor focus on long-term value for themselves and when evaluating their asset managers.**

Some panelists cited the actions of institutional investors and pension funds as part of the short-termism problem. Members of our institutional investor panel stated that many pension funds are focusing too closely on the same quarterly performance data that they criticize companies and analysts for following. These pension funds sometimes evaluate asset manager performance based heavily on quarterly results—thereby exacerbating the very short-termism issue they bemoan and reinforcing the short-term-driven quarterly rating cycle.

The Panel encourages pension fund managers to evaluate their asset managers on a long-term basis and develop incentives based on a long-term measurement period (three to five years). The Panel believes that institutional investors would be better served by focusing their efforts on asset allocation and cost containment to meet their long-term return goals.

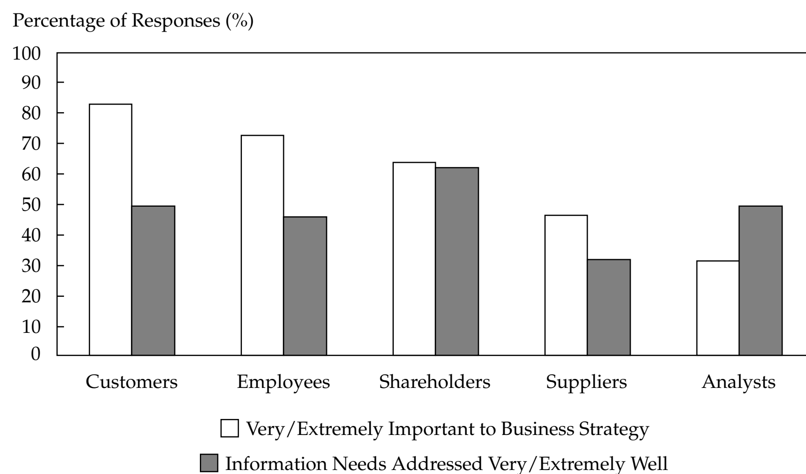
Institutional investors ultimately control an influential proportion of global equity and are in a position to encourage long-term thinking by supporting resolutions dealing with compensation, corporate planning, and other corporate actions that foster a long-term perspective.

COMMUNICATIONS AND TRANSPARENCY

All investor groups that participated in our symposia called for meaningful communication and performance reporting that goes beyond the current calls for transparency and understandable language in disclosures. When the SEC approved Regulation Fair Disclosure (Regulation FD, adopted in August 2000), the explicit intent was to ensure that analysts, asset managers, and institutional investors would no longer receive privileged corporate information. Our symposia discussions suggest that an unintended consequence has been a decrease in the quality of information exchanged between companies, investors, and analysts. The Panel recommends bridging the gap between the information that companies believe is being requested and the information that investors, analysts, and other stakeholders really need.

A recent PricewaterhouseCoopers survey of business executives illustrates the gap between the quality of information companies provide and what their key stakeholder groups seek (see Figure 7). According to those surveyed, only the shareowner and analyst groups are being provided the information they consider important for understanding the company's overall strategy. However, even the group whose needs are best met—shareowners—are receiving only 62 percent of the information they need.[18] This research supports panelist recommendations for improved communication of information that allows all investors and analysts to better understand companies' long-term value drivers.

Figure 7: Analysis of Stakeholder Information Needs



Source: PricewaterhouseCoopers (2006).

Clearly, companies need to focus efforts on meeting the unsatisfied information needs of their most important stakeholder groups—customers, employees, shareowners, suppliers, and analysts. Perhaps one of the most important responsibilities of company executives is to communicate and act on their corporations' values and to embed those values in the long-term strategy and "value proposition" of the company. Short-term earnings goals are inherently volatile and susceptible to significant fluctuations and are a hurdle to corporate leadership in communicating a company's long-term value prospects. An executive overly focused on and driven to respond to short-term objectives may diminish and discourage long-term commitment from employees, investors, and other important groups.

For shareowners and analysts, such communications should occur predominantly in plain language (not accounting or legal language) to encourage accurate analysis and a clear understanding of the business. These groups will rely less on the quarterly earnings guidance from companies if appropriate, high-quality performance metrics are provided on a frequent basis.

Public companies that wish to step off the earnings guidance treadmill may be able to do so by sharing more of the high-quality performance metrics they themselves use for internal planning. One panelist indicated that his company does not provide quarterly

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earnings guidance but, instead, discloses on its website the same monthly operating data used internally for long-term planning. The company managers can then focus their efforts on educating analysts as to the business drivers of both the industry and the company. This communication strategy removes the drain on resources required by providing separate earnings guidance, and it provides more frequent information focused on how the company is managing for the long term.

COMMUNICATIONS AND TRANSPARENCY RECOMMENDATIONS

1. **Encourage companies to provide more meaningful, and potentially more frequent, communications about strategy and long-term vision, including more transparent financial reporting that reflects a company's operations.**

The Panel believes that companies should strive to increase the understanding of their businesses by those in the financial community. A company can engender a long-term outlook in the financial markets by providing highly transparent financial statements that clearly communicate that company's financial position and long-term, value-creating prospects.

For example, by including both a condensed balance sheet and statement of cash flows in each quarterly earnings release, companies allow shareowners to easily reconcile the income statement items, always included in a quarterly earnings announcement, with the directly related balance sheet or cash flow statement items. Regular quarterly earnings releases should also provide expanded discussions of the balance sheet and cash flow impacts so that shareowners are given a clearer sense of companies' long-term value drivers.

In addition, the Panel believes it would be beneficial for companies to provide supplemental shareowner value information for investors. A large body of literature on shareowner value attempts to provide ways to improve communications with investors through robust tools that measure changes in shareholder value. An example discussed by symposia participants is the "Corporate Performance Statement" developed by Alfred Rappaport of Northwestern University's Kellogg Graduate School of Management, which would provide shareowners with more meaningful corporate performance measures than they currently receive and help the markets move away from over-reliance on earnings-based valuation models.[19] Rappaport argues that, although many market participants agree that DCF is the correct model for equity valuations, such models are more time-consuming than are the immediate share price reactions offered by earnings-based models. Unfortunately, both corporate managers and short-term investors often forget that earnings-based valuation models are, in reality, DCF models with a large number of implicit assumptions, including future growth rates, margin trends, and reinvestment rates. These assumptions should be explicitly stated through a DCF-driven model, where accounting that may obscure true performance must be clarified.

2. **Encourage greater use of *plain language* communications instead of the current communications dominated by accounting and legal language.**

One panelist spoke for many in suggesting that "… currently, the proxy statement is looked upon as a legal document, as a liability document. It should be a communications document."

The Management Discussion and Analysis (MD&A) narrative that accompanies financial statement filings is widely perceived to not meet the broad purpose of informing investors as originally intended. A study by the SEC in 2001 of the agency's review of annual reports filed by Fortune 500 companies revealed that "[the SEC] issued a significant number of comments generally seeking greater analysis [where] companies simply recited financial statement information without analysis or presented boilerplate analyses that did not provide insight into … business prospects."[20]

Financial documents and other corporate communications should not be written predominantly in boilerplate or legal language. The Panel believes that investor uncertainty would lessen if such documents were written in plain language.

3. Endorse the use of corporate long-term investment statements to shareowners that will clearly explain—beyond the requirements that are now an accepted practice—the company's operating model.

In each Berkshire Hathaway annual report, CEO Warren Buffett does a great service to Berkshire's investors by providing insight into the state of the company and its long-term outlook. Over the decades, Buffett has also educated his shareowners about the virtues of long-term investing and helped create a long-term investor base—in part, because their CEO focuses his company and communications on the long term.

The Panel encourages company managers to follow this example and communicate more about the long-term investment outlook for their companies. Currently, the typical letter to shareowners spends a significant amount of time describing what the company did *right* in the past year and gives limited space to miscalculations or disappointments. The rest of the letter is likely to address expectations for the coming year, with vague references to a long-term mandate for "building shareowner value."

Investors would be better served by this letter if it discussed with shareowners why the company should serve them well as a long-term investment. The Panel acknowledges that not everyone can write on the virtues of long-term investing as well as Buffett (although this is a hard proposition to prove because so few have tried.) Nonetheless, company managers owe it to shareowners to make the effort.

4. Improve the integration of the investor relations and legal functions for all corporate disclosure processes in order to alleviate the current bifurcated communications that confuse, rather than inform, investors and analysts.

Our panelists noted that the corporate communications process has become split between investor communications created and distributed by a company's investor relations (IR) department and a large number of communications, including the annual report and proxy statement, that consist largely of boilerplate and legal language.

The Panel believes that by serving on a company's corporate disclosure committee, an executive from a company's IR department can help develop disclosure language that communicates the company's corporate message better than the current boilerplate/legalese writing that dominates disclosure-related communications.

5. Encourage institutional investors to make long-term investment statements to their beneficiaries similar to the statement the Panel is asking companies to make to their shareowners.

Although several of the improvements to communications the Panel recommends pertain to *corporate* communications, the institutional investors on the Panel admitted that they also need to do a better job of communicating their long-term investment strategies to their beneficiaries.

This recommendation originated when a panelist observed, "Maybe one answer (to the lack of long-term vision by fiduciaries) is to have fiduciaries make a long-term investment statement so that beneficiaries have a better understanding of how their money is being managed for the long term." Such a statement should focus on long-term liabilities faced by the institution and on that institution's strategic investing plan to match long-term assets to those liabilities.

Additionally, the Panel encourages institutions to use this long-term investment statement to educate their beneficiaries about the costs of short-term thinking (turnover, trading costs, and manager replacement costs) that can erode long-term returns.

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EDUCATION

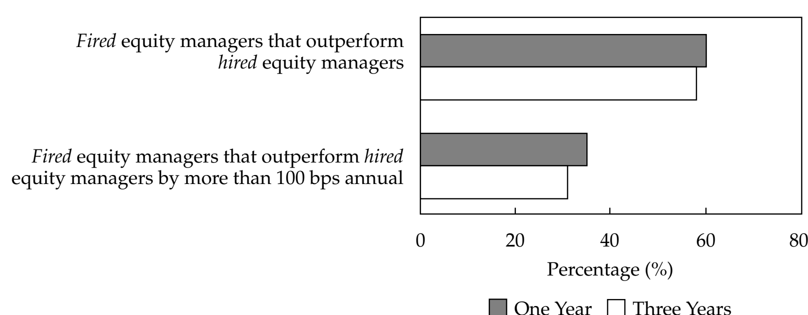
Some panelists in the asset manager group stated that too many corporate managers misinterpret how the market values their companies, and therefore, they focus too much attention on short-term valuation measures such as earnings per share. These panelists suggested that many public companies overestimate the influence of hedge funds, perhaps because of the heightened coverage these funds receive in the business media. Our panelists agreed that greater education of all significant parties—corporate leaders, investors, analysts, regulators, and the media—is a necessary element to address the complex nature of short-termism.

Institutional investors on the Panel specifically noted the need for better education of pension fund plan sponsors and pension fund trustees. This perspective was endorsed by a pension fund consultant, who suggested that some pension fund trustees may not possess the financial background necessary to adequately fulfill their fiduciary duties to fund beneficiaries in relation to a number of issues, not only short-termism.

Panel participants voiced concern that the true costs of hiring and firing asset managers may not be adequately understood by all pension funds and their trustees. They noted that an over-reliance on recent past performance may be indicative of a short-term mindset that ill serves the interests of the pension funds and their ultimate beneficiaries.

In an analysis of their clients, Cambridge Associates, an investment consulting firm to foundations, endowments, and other large institutions, found that 92 institutions in the period from 1996 to 2001 indicated that the decision to switch asset managers, often on the basis of short-term criteria, usually resulted in the destruction of value.[21] This analysis found that the *fired* equity managers outperformed the *hired* equity managers in 58 percent of the switches in the next year and in 60 percent of the switches over the next three years. Furthermore, the study found that if companies required new equity managers to beat their replacements by at least 100 basis points annually (to justify the costs and disruptions associated with switching managers), only 35 percent of the changes would be labeled a success after one year, and only 31 percent after three years.

Figure 8: Performance of Hired and Fired Equity Managers



Source: Cambridge Associates (2003).

A similar study published in 2006 by Watson Wyatt, a worldwide consultancy, reinforces these findings. The report found that pension funds and insurers often fire asset managers just before performance improves and often hire managers immediately before performance declines.[22]

Finally, panelists observed that more financially educated individual investors who better understand the consequences of focusing on the short term to the detriment of the long term would help alleviate the short-termism problem. A more knowledgeable investor would be better equipped to understand long-term business and investment strategy and could reinforce a focus on long-term horizons by corporate leaders, fund managers, and institutional investors.

Unfortunately, the overall financial education level in the United States and around the world is low. Only 8 of 50 states currently require a course with personal finance content to be taught in high school, and only 9 states test personal finance knowledge.[23] The Panel thinks that investor education efforts such as requiring more financial literacy programs in schools would help, although simply requiring such courses would be but one step in addressing the short-termism problem. A population armed with practical personal finance knowledge is likely to make for more patient future investors who are not as easily swayed by short-term influences.

EDUCATION RECOMMENDATIONS

1. **Encourage widespread corporate participation in ongoing dialogues with asset managers and other financial market leaders to better understand how their companies are valued in the marketplace.**

The disconnect between perception and reality regarding how investment professionals value companies causes many corporate managers to focus on short-term metrics, such as earnings per share, instead of focusing on running their businesses for the long term.

Influential organizations, including CFA Institute and the Business Roundtable Institute for Corporate Ethics, can play a role in providing publicly traded companies with better information about how they are valued by sponsoring educational seminars for company executives or by bringing the asset management and corporate issuer communities together in forums to facilitate understanding. Such meetings would comply with Regulation FD because company managers would be listening to their asset management and hedge fund counterparts—a role reversal the Panel suggested many company managers would welcome.

2. **Educate institutional investors and their advisors (e.g., consultants, trustees) on the issue of short-termism and their long-term fiduciary duties to their constituents.**

The need for pension fund trustee education came up on multiple occasions in the symposia discussions. Trustees who understand the market forces that produce short-termism will be better equipped to do their part to stop it.

The Panel encourages pension funds to make use of educational programs and materials already available to their trustees so that trustees can gain the knowledge required to adequately serve the long-term interests of beneficiaries.

3. **Support education initiatives for individual investors in order to encourage a focus on long-term value creation.**

Individual investors would make fewer decisions that are counter to their long-term investing goals and would be less tolerant of behavior destructive to long-term value (by executives or investment professionals) if the individuals were better students of the financial markets and better long-term investors.

CFA Institute will work with appropriate partners to expand its educational efforts and aid in financial educational initiatives that serve the investing public. CFA Institute will also work to facilitate investor education through the sponsorship of investor forums and other events that aim to educate the investing public.

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