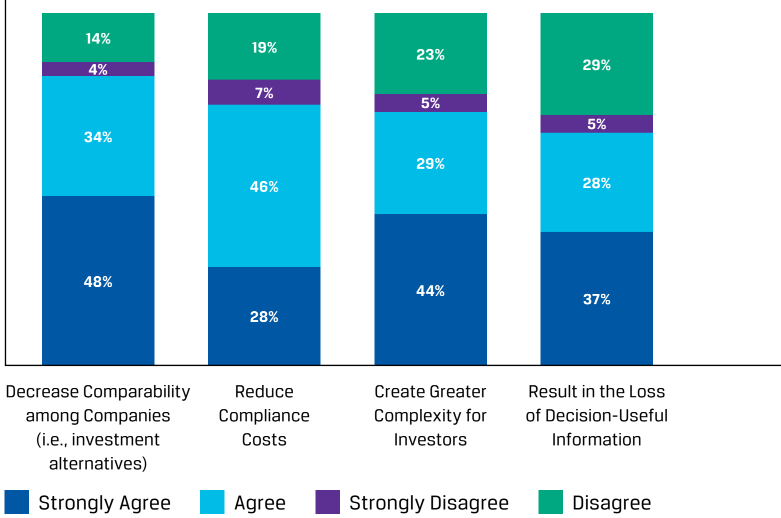
Private Company Reporting: What Investors Need

By Rhea Wessel

Efforts to reduce the complexity and compliance costs of financial reporting for private companies appear poised to have a negative impact on those for whom the reports are compiled: investors. For the first time, investors' opinions of these efforts have been made known, and they overwhelmingly say that the moves will make it more difficult to conduct financial analyses.

A report published by CFA Institute showed that some 82% of investors surveyed say moves for reduced requirements, or differential standards for private companies, will decrease comparability, 73% foresee greater complexity, and 65% say efforts will lead to a loss of decision-useful information about private companies. Titled *Addressing Financial Reporting Complexity: Investor Perspectives*, the report was released in May 2015.

Impact of Private Company Accounting Standards on Investor Analysis



Note: Responses to the survey question: "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?" For details, see the full report *Addressing Financial Reporting Complexity* (www.cfapubs.org).

INVESTORS AND COMPLEXITY

The implications are clear, according to the report's author, Mohini Singh, director of Financial Reporting Policy at CFA Institute. "The report clearly shows that investors' views of complexity are very different from those of corporate managers," says Singh. "Investors do not want separate private company reporting. Instead, they believe that the issue of financial reporting complexity should be addressed for all types of companies. Furthermore, they think some sources of complexity are unavoidable, such as those related to complex transactions. But other avoidable sources can be reduced, particularly those complexities created by inadequate accounting standards and inadequate communication."

For years, people involved in financial reporting have been talking about reducing reporting requirements for private companies. Organizations behind the efforts, including the IASB (the International Accounting Standards Board), which has developed separate standards for small and medium-sized enterprises, and the FASB (the Financial Accounting Standards Board), which is working on US private company standards, are responding to companies' concerns about rising compliance costs. The IASB and FASB approach of developing reduced requirements, however, has a serious impact on investors' ability to compare reports and get useful information, and it could lead to higher capital costs for private companies, the study showed.

"If the FASB continues to push for differential standards," says Singh, "it should develop them on a very limited basis—for instance by reducing the disclosures about items that are recognized and measured in the financial statements or by giving private companies more time to adopt new requirements if they have limited resources."

Overall, the underlying assets and liabilities of an entity do not change based on the type of entity or its legal structure. Similar items should therefore be recognized and measured similarly, according to Singh.

REDUCING COMPLEXITY

Standard setters could work to reduce two key sources of complexity: inadequate accounting standards and inadequate communication.

Problems of inadequate accounting standards include, for example, decreased comparability because of optionality and exceptions to principles.

The optionality available in current accounting standards can result in widely different financial statements, making it difficult for investors to make comparisons, which is a critical part of the decision-making process. If standard setters increase reporting options through the creation of separate private company standards, investors will face even more complexity when performing analyses.

Likewise, exceptions to principles add complexity to financial reporting. Financial reports should provide information that helps investors decide whether to invest (i.e., reports need to reflect the underlying economics of transactions and events). Exceptions to principles suggest that there is a lack of consensus on the economic substance of a transaction.

Problems of communication include, for example, management that has a lack of understanding or a lack of intent to disclose certain items, such as the risks and uncertainties faced by the business. Another problem is poor financial statement presentation that does not allow users to link income statement and cash flow captions, making statements more complex for investors to analyze.

According to a 2012 report published by CFA Institute titled "Financial Reporting Disclosures: Investor Perspectives on Transparency, Trust, and Volume," standard setters could require improved communication to investors, including enhancing the style and presentation of information. Ideas include an emphasis on matters of importance during a reporting period, a greater integration of information within the financial statements and between the financial statements and management commentary, and entity-specific information.

Given the investor view that it is these areas of avoidable complexity that need to be addressed, and the clear statement of investors that current efforts by standard setters to create separate private company standards will actually increase complexity, it's clear that standard setters still have work to do to find a balance between the needs of companies to cut their compliance costs and the needs of investors to receive valuable, usable information.

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Intentional Accidents

WHAT IS THE DRIVING FORCE BEHIND INTERNET FINANCE IN CHINA?

By Alan Lok, CFA

Ever since Alibaba and Tencent secured commercial banking licenses from the China Banking Regulatory Commission (CBRC) in September and July 2014, respectively, the internet big boys' entrance to the financial industry arena has been nothing short of spectacular. And with both companies going a step further in gaining clearance from the CBRC to establish their consumer credit rating operations in January 2015, their presence may prove revolutionary. Already, some in the Chinese capital markets predict the eventual obsolescence of traditional financial intermediaries there.

Indeed, internet financing in China has been touted by some of its hardcore supporters to be the key move toward establishing a more convenient payment mechanism (and the mechanism that has the least informational asymmetry). With the rise of internet financing, according to these supporters, traditional intermediaries (such as banks, security houses, and financial exchanges) will gradually lose their relevance, leading to a great reduction in the cost of capital for every stakeholder within the ecosystem. (In this connection, one should consider the investor protection issues CFA Institute has raised in regard to crowdfunding.)

Beneath all these seemingly grand capital market benefits foreseen from internet financing, however, lurks a slow, strong, agenda-driven undercurrent: the Chinese government.

A school of thought has attributed the recent success of Alibaba and Tencent to loopholes within the legal framework. By the time regulators caught up to them, their financial business operations had surpassed the point at which they could be contained. This "too big to fail" argument might sound plausible on the surface, but to those with a better understanding of the Chinese legal, cultural, and political systems (where nothing happens by chance), it barely holds water.

First, when it comes to legal enforcement in China, the interests of the country and political party override everything. Regardless of whether the regulatory framework is robust enough to deal with such innovative evolution as described here, the Chinese government still possesses the power to veto anything it deems unfavorable. Such an action might be unthinkable in the West, but it is common practice in this part of the world.

Second, most of the banks with sizable balance sheets in China are state owned. That includes the Bank of China (BOC), the Agricultural Bank of China (ABC), and the Industrial and Commercial Bank of China (ICBC). Together, these banks make up the supporting pillars for the Shanghai and Shenzhen stock exchanges and, to a certain extent, the Hong Kong Stock Exchange. As such, without the inherent blessing from the Central Politburo, it is next to impossible for both Alibaba and Tencent to throw their punches directly at these state-owned operations.

Third, Alibaba and Tencent are Chinese-owned enterprises. One of the best ways to tackle the inefficiency and complacency within state-owned banks is to create external competition. But national interest still takes top priority. To strike a balance between safeguarding national interests and injecting competition into the finance industry, encouraging home-grown enterprises, such as Alibaba and Tencent, is the preferred solution.

Need more convincing? Think about this. The Chinese government did not question Alibaba's or Tencent's entrance into the consumer credit market. Why not? In fact, both the CBRC and Xinhua news agency (China's official voice of the Central Politburo) were effectively silent when all these activities were going on in the background. Also, when Alibaba and Tencent made their initial encroachments into the banking sector, the moves occurred during a series of banking reforms specifically directed to tackle the complacency and inefficiency within state-owned banks.

Internet financing is something truly unique to China and has no context in other parts of the world. Witnessing its evolutionary development within the Chinese capital markets is exciting, and continued analysis of it in the next five years will be instructive.

Alan Lok, CFA, is director of capital markets policy at CFA Institute. A version of this article originally appeared on the CFA Institute *Market Integrity Insights* blog.

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