point of view

June 2011

Reducing complexity

Our proposal to address this challenge

Highlights

- Complexity imposes costs on both investors and companies for information that is often neither easily understood nor particularly useful.
- Opportunities exist to maintain, or even increase, the quality of accounting standards while reducing complexity.
- A standing advisory committee to the board should be created. Its objective should be to advise the board on how to reduce complexity while maintaining quality and improving the usefulness of financial reporting for investors.

Accounting standards are often too complex

- Many U.S. accounting standards are more complex than necessary to meet the standard-setter's objective of issuing high-quality standards. Complicated scope provisions, exceptions to general principles, and sometimes just overly detailed guidance often make standards difficult to understand, interpret, and apply. Simply put, many standards are unnecessarily complex.
- Investors are affected adversely when accounting standards are too complex. Unnecessarily complex standards may result in economically similar transactions being reported differently from company to company; reducing an investor's ability to compare companies. When the financial reporting is not easily understood or there are extensive disclosures that are difficult to navigate or not decision useful, investors will look elsewhere for information.
- Processes, controls, and systems are needed to apply accounting standards. If standards are unnecessarily complex, companies incur compliance costs that may not be commensurate with the reporting benefits. The effort to gather data, continually track information, perform the accounting, and report the results takes time and resources.
- Unnecessary complexity has long been a topic of conversation and debate. More recently, the Financial Accounting Standards Board (the board) has demonstrated a greater commitment toward trying to address the issue of complexity. Despite this, no formal process has been established to reduce unnecessary complexity in current and future standards. Without such a process, complexity may continue to be introduced and possible simplification of standards may not be achieved.

pwc

Reducing complexity will benefit investors

Some standards result in accounting that is difficult to understand, or increasingly detailed disclosures that are not often used by investors.

Certain overly complex standards may actually misrepresent the economics of transactions and confuse investors.

The goal of accounting standards should be to provide high-quality, decision-useful information to investors and other financial statement users (investors). Standards that produce information that faithfully reflects the economics of transactions and is easily understood by investors achieve this goal. But standards should also be operational for preparers and balance some investors' desire for increasingly detailed disclosures with the cost of preparation.

Recently, the board has been actively looking for opportunities to reduce complexity. The current goodwill impairment proposal and certain changes to the lease and revenue proposals are good examples. But more could still be done.

What we mean by "too complex"

Some complexity in financial reporting is unavoidable. Transactions are often complex. Sometimes that means the accounting needs to be too in order to reflect the economics. When we refer to complexity in this document, we mean complexity that is unnecessary because the resulting information is not sufficiently meaningful for investors to justify the preparation costs.

Complexity takes many forms, including complicated or conflicting scope provisions, exceptions to general principles, overly detailed guidance, excessive disclosures, and bright lines that sometimes fail to reflect the economics of transactions, thereby confusing investors. For example, when debt contracts are modified or replaced, minor differences in cash flows can create dramatically different results even though the economics may be virtually identical.

How complexity affects investors

Complexity negatively affects investors in many ways. Complex standards may produce information that at times many investors don't want or can't understand easily. Also, too much disclosure makes it harder for investors to find key information that would be useful in their decision making. Some investors then look outside of the financial statements for needed information.

Some believe that standard setters at times have sought a high level of perfection in reporting the economics of transactions. Such perfection may be more than is necessary to achieve high-quality standards, and more than most investors want or need. The accounting involved to achieve this, though, is often complex. And, it may not be sufficiently flexible to allow for varying provisions in otherwise similar transactions to be reported in a manner that appropriately reflects the economics. The result is that minor differences between what are, in substance, economically identical transactions can result in vastly different financial reporting outcomes. Comparing companies then becomes more difficult for investors.

Generally, the more complex an accounting standard, the more difficult it is to apply and the more prone companies are to not getting the reporting right. Inevitably, some financial statements will get restated. Restatements are serious matters for investors. Some, such as those that impact revenue and other key measures, are of greater importance to investors. Other restatements have less impact on investors' views of future performance. The complicated, rules-driven manner in which the income tax provision is allocated between continuing operations, discontinued operations, and components of equity is a good example of a potential restatement area that may have less impact. Further, regardless of the reason for a restatement, investors may be kept in the dark while the reporting is adjusted.

Complexity is costly for preparers

Gathering and reporting new information to properly comply with a new standard often requires significant changes to a preparer's systems, processes, and controls. Information gathering and reporting, as well as monitoring, also must occur on an ongoing basis. The costs for these activities get built into companies' reporting systems. Investors ultimately bear these costs.

Analysis

Our proposal to reduce complexity

The standard setting process would benefit from clear principles for determining when complexity is necessary.

Reducing complexity requires a dedicated focus.

Establish principles

One of the hardest challenges in accounting standard setting is striking the right balance. Balance between the desire to achieve a perfect portrayal of economics and the complexity required to do so is an example. Balance between excessively detailed disclosures and reasonably summarized information is another. Finding presentations that meet the needs of most investors is a third. Striking the right balance is hard, but it is possible.

As a first step, standard setters should develop key principles to help evaluate the trade-offs that are needed. For example, we believe that exceptions to broad standards and bright lines should be used only if it can be demonstrated that investors would find the resulting information more useful. Similarly, disclosures should be driven by what most investors actually want and can realistically absorb. Additional principles should be developed in an effort to guide the provision of valuable information at a reasonable cost to preparers and investors.

Advisory committee

Though the board is very aware of this issue and clearly has been trying to reduce complexity, their attention and time have been limited by the demands of the convergence agenda. Reducing complexity requires a dedicated focus. The best way to accomplish this is for the Financial Accounting Foundation (the Foundation) to establish an advisory committee (the committee) to the board for the purpose of focusing on this challenge. The committee should include investors, preparers, auditors, regulators, and a representative of the board. It could be structured similarly to the Emerging Issues Task Force, though its goals would be different. Staff should be assigned to help it achieve its objectives. Its mandate would be to advise the board on sources of complexity in existing accounting standards, and to propose balanced solutions that improve the quality of information for investors while reducing complexity. In other words, the board would have a standing group of experts to help it develop alternatives to address the ongoing challenge of reducing complexity.

Input on reducing complexity

Initially, the committee should conduct a survey of investors, preparers, auditors, and regulators to identify existing areas of complexity in financial reporting. It likely won't be difficult to find these. The committee also would consider any complexity-related suggestions from the Foundation's new post-implementation review process and the SEC's planned Financial Reporting Series of round tables. Identified areas would be prioritized, possible solutions discussed, and proposals to reduce complexity sent to the board. A process to obtain and address ongoing input also should be established.

The board also would use the committee as a resource to identify ways to simplify standards under development. Doing so would likely result in less complex exposure drafts, which may speed the standard development process.

International convergence

We observe that the current uncertain path toward convergence with, or possible adoption of, international standards represents a major challenge. Some may question why the complexity issue should be addressed at this time. To us, too much complexity already exists in both sets of standards. This means that focusing attention on developing a systematic process for addressing this issue and getting started now are important. Also, a number of standards are already converged and additional standards are in the process of being converged. It seems to us that an advisory committee, no matter where located, dedicated to suggesting high quality, economic, less complex accounting in both existing and developing standards, would provide valuable input for both the U.S. and international boards to consider.

In conclusion

Complexity has long been a concern of investors, preparers, and auditors. Yet, no systematic approach exists to address this concern. By establishing this committee to focus on reducing existing complexity and providing advice as new standards are developed, we believe that financial reporting for investors can be improved and preparation costs can be reduced.

Questions and answers

Q: Aren't detailed standards necessary?

A: Some suggest that the detail and complexity included in accounting standards is necessary to ensure consistent application and comparability among companies. We agree that a reasonable level of detail helps to explain the intent of the standards and increase the consistency of application. However, in many cases overly complicated rules have forced accounting treatments that are not aligned with the underlying economics of transactions. We believe that many U.S. standards could be improved by simplifying certain provisions and eliminating much of the associated detail that exists today.

Q: How is your approach different from previous recommendations to reduce complexity? What about the board's existing advisory groups?

A: In 2008, the SEC's Advisory Committee on Improvements to Financial Reporting provided a number of recommendations to the SEC about reducing complexity and improving financial reporting. Our proposal, while consistent with the spirit of those recommendations, is different because it focuses on establishing a sustainable mechanism to address both existing complexity and potential complexity through involvement early in the standard-setting process. We believe that our proposal addresses the necessary mechanism, process, and resources to help achieve the goal of reducing complexity.

The board's existing advisory groups do not focus primarily on complexity, and in some cases have limited mandates, such as the private company committee. Our proposal establishes a committee with an ongoing mandate to suggest opportunities to reduce complexity while maintaining quality. Its output would benefit all companies.

Q: Can you give some examples of accounting standards that may not align with the underlying economics?

A: There are many. For example, whether a transaction is a recapitalization or a business combination is form driven and can impact whether the acquired company's entire balance sheet is remeasured. Derivatives accounting also is highly form driven and contains great detail, numerous exceptions, and special provisions for unique circumstances. In both cases, minor details in a transaction or the standard, may result in transactions with similar economics being reported differently.

Q: Are you suggesting that the board is purposely including unnecessary complexity in accounting standards?

A: No. The board does not intentionally make standards more complex than is necessary. In fact, additional detail and complexity are often added as the board attempts to address concerns of various constituents, including preparers, investors, and auditors. In addition, application questions on standards are often posed to the board that may result in amendments that include more detailed guidance and complexity. Without a process in place to reduce unnecessary elements, this will likely continue in the future.

Contact Information

To have a deeper discussion about our point of view on complexity in accounting standards, please contact:

Dave Kaplan
Co-leader, Accounting Services Group
U.S. National Office
Phone: 973-236-7219
Email: dave.kaplan@us.pwc.com

Doug Parker
Partner
U.S. National Office
Phone: 973-236-4707
Email: douglas.t.parker@us.pwc.com