

 **EFRAG**

European Financial Reporting Advisory Group ■



## Getting a Better Framework

**COMPLEXITY**

**Bulletin**



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#### Published Bulletins:

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- Reliability of financial information
- Uncertainty
- The role of the business model in financial reporting
- The role of a Conceptual Framework
- The asset/liability approach
- Accountability and the objective of financial reporting
- Complexity



This Bulletin is issued by the European Financial Reporting Advisory Group (EFRAG), the French Autorité des Normes Comptables (ANC), the Accounting Standards Committee of Germany (ASCG), the Organismo Italiano di Contabilità (OIC) and the UK Financial Reporting Council (FRC). The publication of Bulletins is part of their strategy to stimulate debate within Europe, and keep European constituents informed, as the IASB develops its Conceptual Framework. Any views expressed are tentative: the issuing bodies will develop their final views after considering responses to this Bulletin and other developments in the debate.

Further information about the work of the project partners, including regular newsletters, is available on the partners' websites.

*We welcome views on any of the points addressed in this Bulletin. Specific questions are given at the end of the document. Comments should be sent by e-mail to [commentletters@efrag.org](mailto:commentletters@efrag.org) or by post to*

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*So as to arrive no later than 30 April 2014.*

*All comments will be placed on the public record unless confidentiality is requested.*

- 1 This Bulletin addresses the issue of complexity in financial statements.
- 2 This matters because many recent reports have expressed concern that financial statements have become too complex, to the detriment of users' understanding<sup>1</sup>. These reports acknowledge that some of this complexity arises because transactions are becoming increasingly complex. However, they also note other possible causes, including problems in accounting standards. Related to this is a concern that accounting under IFRS in particular is too complex.<sup>2</sup>
- 3 The *Final Report of the Advisory Committee on Improvements to Financial Reporting to the United States Securities and Exchange Commission* (August 2008) defines complexity as:

"The state of being difficult to understand and apply. Complexity in financial reporting refers primarily to the difficulty for:

1. Investors to understand the economic substance of a transaction or event and the overall financial position and results of a company;
  2. Preparers to properly apply generally accepted accounting principles ... and communicate the economic substance of a transaction or event and the overall financial position and results of a company; and
  3. Other constituents to audit, analyze, and regulate a company's financial reporting."
- 4 The report notes that complexity can impede effective communication through financial reporting between a company and its stakeholders and that it also creates inefficiencies in the marketplace (e.g., increased investor, preparer, audit, and regulatory costs) and suboptimal allocation of capital. Hence it is important to minimise complexity whenever possible.
  - 5 The report also distinguishes between unavoidable complexity, which arises because business transactions are increasingly sophisticated and difficult to understand, and avoidable complexity, which potentially arises from poor standard-setting, regulation, education and information delivery. Similar themes emerge from other reports.
  - 6 Despite this widespread concern about complexity in financial statements in general, and the common criticism of IFRS as being too complex, the IASB Conceptual Framework does not currently include much discussion of the issue. It touches on the issue of complexity in its discussions of understandability and as part of the balance to be struck between costs and benefits, as follows.

<sup>1</sup> For example, the Final Report of the Advisory Committee on Improvements to Financial Reporting to the United States Securities and Exchange Commission (August 2008), Complexity in Financial Reporting ACCA 2009, Louder than Words, UK Financial Reporting Council 2009, Managing Complexity in Financial Reporting, Australian Financial Reporting Council 2012.

<sup>2</sup> See for example, The Future of IFRS, ICAEW 2012



- 7 Understandability is an enhancing qualitative characteristic under the Conceptual Framework, i.e. something that should be maximised to the extent possible. In its discussion of understandability, the Conceptual Framework notes, however, that 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 analyse the information diligently. And even they may need at times to seek the aid of an adviser to understand information about complex economic phenomena.
- 8 The Conceptual Framework also notes that a simpler accounting method may be less costly to apply than a more complex method and may result in information that is essentially the same as, but somewhat less precise than, information produced by a more complex method. In that situation, a balance has to be struck between the cost and the possible loss of information.
- 9 This Bulletin analyses the causes of complexity in accounting in more detail and suggests that additional discussion in the Conceptual Framework could help minimise complexity.

## UNAVOIDABLE COMPLEXITY

- 10 As noted above business transactions are increasingly sophisticated and difficult to understand. This results, to some extent, in unavoidable complexity in financial statements. The onus is on the standard-setters and preparers to account for transactions, and any links between the resulting assets and liabilities, in a manner that makes the financial statements as transparent and understandable as possible. The way in which information is presented can reduce complexity – with careful thought it is possible to give a clear overview of complex transactions.
- 11 Nonetheless, there will always be a balance to be struck between presenting unduly complex information and losing information. There are two aspects to this balance:
  - a. The cost of accounting complexity for preparers: the cost to the preparers of implementing complex accounting requirements needs to be balanced against the benefits to the users of the resulting relevant information. There is also a question of how lengthy and detailed accounting standards should be. The greater the detail, the more complex they become to implement, but if the standards are kept relatively short and at a high-level, non-authoritative guidance may be developed to fill the gaps, adding even more complexity to the process; and
  - b. The understandability of reported information by users: the need for balance here arises because of the diversity of users. More complex information may be relevant, but understandable only by a limited number of highly knowledgeable users. In these cases the benefit to that limited number of users needs to be balanced against not only the costs to preparers but also against the needs of other users. These other users could be reasonably well-informed generally but lack the very high level of knowledge necessary to understand the information in question. As a result the information is not relevant to them and could potentially confuse and mislead them.

Examples 3, 4, 5 and 6 in the Appendix illustrate where some believe this balance has been misjudged.




## AVOIDABLE COMPLEXITY

- 12 As well as unavoidable complexity arising from the increased sophistication of transactions and the business environment, some think that IFRS add to the problem by requiring unnecessarily complex accounting or disclosure requirements.
- 13 Some argue that the Conceptual Framework itself adds to the problem by setting objectives for financial reporting that increase complexity. For example:
  - a. Some argue that the Conceptual Framework focuses on the statement of financial position rather than on financial performance. This perspective creates obstacles to considering financial performance in the most straight-forward and transparent way;
  - b. Some also believe that providing useful information for the wide range of users currently regarded as primary users is inherently difficult and inevitably adds complexity. These users are diverse, and have different and sometimes conflicting information needs; and
  - c. Finally, some think that the removal of reliability as an important characteristic of financial information could lead to the recognition of assets and liabilities with very high levels of measurement uncertainty, such that the disclosures necessary to support the amount recognised are too complex to provide the most useful information.
- 14 In addition to concerns about the Conceptual Framework, some note problems caused by the standard-setting process. They argue that sometimes:
  - a. Complexity arises when new concepts are introduced in standards which then require additional guidance as their consequences emerge over time. Examples of this might include the use of fair value, other comprehensive income and rights of use assets;
  - b. The reasoning in a standard based on many details can make it difficult to understand the overall principle or objective of the accounting;
  - c. The way in which standards are phrased (for example complex sentences, inconsistent wording, a mix of narration, description and requirements) make it difficult to identify the principles and make the standards difficult to interpret and translate; and
  - d. The almost continuous flow of new standards, changes to standards and new interpretations of standards creates instability that is costly for constituents and adds to the complexity of financial reporting (it is necessary to check which standards have been applied in any particular set of financial statements).



- 15 Some also point to specific standards where they believe the accounting and/or disclosure requirements add unnecessary complexity. Examples are given in the Appendix. There are two important points to note about the examples:
  - a. All the examples in the Appendix that illustrate instances of what some would regard as avoidable complexity also involve unavoidable complexity because the transactions themselves are complex. Avoidable complexity seems to arise when standard-setters are deemed to have misjudged how to deal with unavoidable complexity; and
  - b. Not everyone would agree that all the examples cause unnecessary complexity. Whether a prescribed method of accounting or disclosure is too complex is a matter of judgment and perspective. Some may think it is necessary to properly reflect the complex nature of the underlying transaction, others may think that the accounting is over-complicated and a more straightforward method would give a clearer representation.
- 16 Although the assessment of whether the accounting or disclosure adds unnecessary complexity is a matter of judgment, some common themes do arise from the examples. Avoidable complexity is often regarded as arising when:
  - a. The standard requires classifications that some regard as arbitrary, for example the ineligibility of some transactions for hedge accounting in IAS 39 *Financial Instruments: Recognition and Measurement* and the distinction between market and non-market vesting conditions in IFRS 2 *Share-based Payments*;
  - b. The standard includes anti-abuse measures, for example the effectiveness tests for hedge accounting under IAS 39;
  - c. The standard departs from the underlying economics of the transaction, for example the deferred recognition of actuarial gains and losses allowed in the past under IAS 19 *Employee Benefits*;
  - d. The standard assumes that one approach fits all transactions in the scope of the standard, for example the temporary difference approach in IAS 12 *Income Taxes* and the identification of revenue-generating activities in the revenue recognition proposals;
  - e. The standard includes exceptions to principles, for example the classification of debt and equity under IAS 32 *Financial Instruments: Presentation*; and
  - f. The standard requires recognition of estimates that some regard as too subjective to be reliable, for example the recognition of a lawsuit with highly uncertain outcomes under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.



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- 17 These themes highlight some underlying reasons why standards might sometimes be regarded as adding complexity, including:
- a. A lack of trust between standard-setters, preparers and regulators, leading to a perceived need for detailed rules and anti-abuse measures; and
  - b. A lack of consensus on the economic substance of a transaction. This may lead preparers to want exceptions from principles identified by the standard-setter.
- 18 Hence it can be seen that not introducing unavoidable complexity is not a matter for standard-setters alone. All parties involved in financial reporting need to be aware of the pressures that could lead to overly complex standards.

## Our tentative views



- 19 Some transactions are complex, and give rise to a complex set of elements to be recognised. Users of financial statements are not helped by false simplifications of transactions. However, determining the best way to present complex transactions involves difficult judgments to be made, weighing up the costs of preparing the information and the benefits of that information to different types of user.
- 20 Given this, the ANC, EFRAG, FRC and OIC believe that it would be helpful for the Conceptual Framework to include additional discussions on complexity, so that it becomes an issue that standard-setters, and their constituents, explicitly consider. Although it is mentioned in the current Conceptual Framework, these partners do not think that it is given sufficient prominence as a matter that needs to be actively assessed. They suggest that the discussion should fall under the following aspects of the Conceptual Framework:
  - a. Understandability: the presentation and disclosure of information should be as simple as possible to achieve a faithful representation of relevant information. This too should be used as a quality check by the standard-setter, and borne in mind by those responding to standard-setters on proposals. In making this judgment, the benefit to some of detailed complex information needs to be balanced against its understandability by other users of financial statements. It could be argued that general purpose financial statements cannot be regarded as general purpose if they are only capable of being understood by a small number of experts; and
  - b. Cost/benefit constraint: the required accounting should be as easy as possible to achieve a faithful representation of relevant information. This should be used as a quality check by the standard-setter, and borne in mind by those responding to standard-setters on proposals.
- 21 The ASCG acknowledges complexity as an important issue for setting financial reporting standards. Nevertheless, it considers that the revised Chapter 3 of the Conceptual Framework, with reference to the qualitative characteristics of financial information and the general cost constraint on useful financial reporting, includes sufficient tools for the IASB to address complexity issues. By way of example, explicit references to complexity issues are already included in the Basis for Conclusions of nearly all new IFRSs.



## Questions for respondents

We would welcome your views on any aspect of this Bulletin. In particular:

- (i) Do you think there should be explicit discussion of the different aspects of complexity in the Conceptual Framework?
- (ii) Are there any aspects of complexity in accounting not covered by this Bulletin that should be covered?

Comments should be addressed to: [commentletters@efrag.org](mailto:commentletters@efrag.org), so as to be received before 30 April 2014.

# Appendix: Illustrative examples

## EXAMPLE 1: HEDGE ACCOUNTING

- 1 Entities enter into hedging transactions to mitigate risks. Hedge accounting acknowledges the role the transaction plays in reducing risk by applying different recognition and/or measurement requirements to those that would apply were the transaction not a hedge. Hedge transactions can be complex, and reflecting their risk-reducing role in the accounting adds complexity to the accounting. This complexity is unavoidable in presenting relevant information about hedging transactions.
- 2 However, many argue that the hedging requirements in IAS 39 *Financial Instruments: Recognition and Measurement* added complexity that could be avoided. They regard the requirements as rules-based, including arbitrary classifications and anti-abuse measures that divorced the accounting from the risk management objective of the hedges. In particular:
  - a. In some cases, preparers could not designate as “hedged items” those which were actually economically hedged;
  - b. The assessment of the hedge ineffectiveness did not appropriately consider the way risks were managed (for instance situations where preparers had voluntarily decided to under-hedge exposures from a portfolio); and
  - c. Internal derivatives were not eligible as “hedging instruments” although they are widely used as such within the banking industry.
- 3 These problems have been acknowledged by the IASB, which has moved to an approach that more closely reflects an entity’s risk management activities.

## EXAMPLE 2: DEFINED BENEFIT PENSION PLANS

- 4 Defined benefit pension plans result in an entity being exposed to a complex set of assets, liabilities and risk. Not recognising these assets and liabilities would result in a substantial loss of information for users of financial statements. Hence, they give rise to unavoidable complexity.
- 5 However, many argued that the accounting for defined benefit plans in the past added avoidable complexity. The options for deferred recognition of some gains and losses were unnecessarily complex and led to the presentation of misleading information. These problems were acknowledged by the IASB, which removed the deferral options, resulting in simpler accounting and more transparent information.



- 6 Nonetheless, some still argue that information disclosed in financial statements about defined benefit pension plans is too complex. In addressing this, the two aspects of complexity need to be considered separately. A faithful representation of the assets and liabilities resulting from participation in a defined benefit pension plan will inevitably seem complex to some. The question on unavoidable complexity is how much disclosure (and of what) is necessary to convey an adequate understanding of the impact of the plan on the entity. For example, are sensitivity analyses on key assumptions helpful, or do they simply become a confusing overload of information? The question on avoidable complexity is how can standard-setters develop requirements that do not add complexity, e.g., by avoiding arbitrary distinctions between different types of benefits.



### EXAMPLE 3: SHARE-BASED PAYMENTS

- 7 Share-based payments are frequently cited as being a cause of complexity in financial statements. As with defined benefit pensions, they are inherently complex transactions involving difficult valuations. So their accounting gives rise to unavoidable complexity. However, many would argue that the balance has been misjudged between the provision of detailed information about the complex transactions on one hand and the cost to preparers and understandability by users who are not experts in the subject on the other.
- 8 Further, many also argue that the requirements in IFRS 2 *Share-based Payments* add unnecessarily to the complexity of the accounting, for example in requiring a distinction to be made between different types of vesting conditions.



### EXAMPLE 4: INCOME TAX

- 9 Unlike the previous examples, income tax cannot be regarded as an exotic or esoteric transaction. However, users criticise IAS 12 *Income Taxes* as being a 'black box' that produces amounts that are difficult to understand and not helpful. Preparers also criticise IAS 12 as difficult and complex to apply.
- 10 Much of the problem in accounting for tax arises because of the wide range of different tax regimes around the world and the very entity-specific nature of tax. To that extent, income tax is indeed a complex matter and hence will inevitably result in complex accounting. However, some argue that the model adopted in IAS 12 does not fit all aspects of the tax regime in their jurisdiction, and hence its application creates complexity that could be avoided under a model developed with their tax jurisdiction in mind. Other problems arise from the number of exceptions to the basic principles in the standard.



## EXAMPLE 5: RECOGNITION OF INTANGIBLES IN A BUSINESS COMBINATION

- 11 IFRS 3 *Business Combinations* requires an entity to recognise identifiable intangible assets separately from goodwill. Some argue this adds complexity to the accounting for a business combination, because of the difficulty in identifying and valuing such intangibles. Here the existence of the intangibles is part of the unavoidable complexity of the transaction, but some would argue that the cost of identifying them separately outweighs the benefit of the resulting information.



## EXAMPLE 6: SPLIT ACCOUNTING OF COMPOUND FINANCIAL INSTRUMENTS

- 12 If a financial instrument contains both a liability component and an equity component, IAS 32 *Financial Instruments: Presentation* requires the components to be accounted for separately. Compound financial instruments are more complex than financial instruments that are pure debt or equity and hence some argue that the complexity arising from the split accounting is unavoidable complexity. However, others question whether the right balance has been struck between the cost to preparers and the understandability of the information for a wide range of users on the one hand and the loss of information if the financial instrument were presented in a less complex way on the other.



## EXAMPLE 7: ANALYSIS OF A TRANSACTION DIFFERENT FROM THAT PROVIDED BY THE ENTITY'S BUSINESS MODEL

- 13 The proposals in the IASB revenue recognition project require an entity to separately identify different revenue-generating components in a contract. Sometimes the proposals result in activities being accounted for as generating revenue, even though that is not how they are viewed in the context of the entity's business model. The IASB argues that the separate identification faithfully depicts the transfer of goods or services to the customer, i.e. reflects the complexity of the transaction. Others argue that analysing a transaction in a manner inconsistent with the way the transaction fits into the business model introduces artificial complexity into the financial statements, presenting the business activity as if it were something different. They do not think that the same approach to identifying revenue-generating components should be applied to all entities, regardless of their different business models.



## EXAMPLE 8: CLASSIFICATION OF FINANCIAL INSTRUMENTS AS LIABILITIES OR EQUITY

- 14 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.



## EXAMPLE 9: LAW CLAIM WITH UNCERTAIN OUTCOME

- 15 IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* requires an entity to recognise a liability for a provision if it is probable that the settlement of the obligation will require an outflow of economic benefits and a reliable estimate of the obligation can be made. IAS 37 goes on to state that except in extremely rare occasions an entity will be able to make a sufficiently reliable estimate.
- 16 Consider a legal claim for compensation for illness and death of former employees arising from exposure to asbestos. The outcome of the case is highly uncertain, both in terms of whether the entity will be found liable, and if so the amounts involved. Estimating the amount of the obligation is complex and subjective, leading to complex disclosures that explain how the amount recognised was determined.
- 17 Some argue that recognition of any single amount provides no useful information and results in unnecessarily complex disclosures. Disclosure of the nature of the case, the number of claimants involved, and perhaps a range of values under differing scenarios would provide more useful information. In other words, requiring the recognition of a single amount adds avoidable complexity to financial statements.





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