KPMG

Issues In Perspective

March 2016

Contents

Simplifying accounting is complicated

During the past year, the FASB devoted a significant amount of effort to its simplification initiative. The Board completed seven projects, made final decisions on two projects, and has three additional projects in the final stages.[1] But questions remain about whether the FASB is doing enough to reduce unnecessary complexity in U.S. GAAP. This publication provides our views about the challenges of the simplification initiative and suggestions for how to improve it.

We believe the FASB should develop a complexity framework to guide it in identifying, evaluating, and preventing unnecessary complexity when developing new standards and revisiting current standards. This complexity framework also should address how the FASB will prioritize its efforts to reduce unnecessary complexity while taking into account convergence with IFRS.

Key points

- So far, the FASB's simplification initiative has focused on narrow-scope projects in which the FASB believes U.S. GAAP can be simplified relatively quickly without reducing the usefulness of financial statements.
- Studies have shown that there are many causes of financial statement complexity, some of which can be avoided.
- Stakeholders have different opinions about how to reduce complexity, and some are concerned that some simplification efforts, such as alternatives for private companies, may actually increase complexity.
- Simplification initiatives may affect convergence with IFRS, and the FASB should consider whether convergence remains a priority and whether its position on convergence should influence other standard-setting initiatives.

[1] For additional information, see the FASB's Simplifying Accounting Standards topic page, available at www.fasb.org.

FASB simplification initiative

The simplification initiative is intended to reduce cost and complexity in financial reporting while maintaining or improving the quality of financial information available to the capital markets. The FASB characterizes this effort as a tightly focused initiative to make narrow-scope simplifications and improvements to accounting standards through a series of short-term projects.

Its efforts focus on evaluating dozens of potential simplification ideas from stakeholders in which complexity can be reduced without reducing relevant information.[2]

But beyond short-term simplification projects, the FASB is looking at foundational projects that it believes will reduce complexity. These projects include developing the FASB's conceptual framework chapters on measurement and presentation and creating a disclosure framework.[3] These are "long-term standard-setting goals that over time will help keep [the FASB] focused on critical issues most important to stakeholders," said Chairman Russell Golden.[4]

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KPMG observations

Although we don't believe all of the proposals meet the objectives of the simplification initiative, we continue to support the FASB's efforts to address unnecessary complexity in accounting standards.

Additionally, we believe that there are significant causes of complexity in accounting standards and financial reporting that narrow scope projects will not address. We recommend that the FASB develop a complexity framework that addresses the systemic causes of unnecessary complexity.

[2] FASB's Simplification Initiative: An Update, James L. Kroeker, FASB Vice Chairman, available at www.fasb.org.

[3] Updates on the FASB Conceptual and Disclosure Framework projects are available at www.fasb.org.

[4] Remarks by FASB Chairman Russell G. Golden at the 2014 AICPA National Conference on Current SEC and PCAOB Developments, December 9, 2014. See also "From the Chairman's Desk," Russell G. Golden, 2015 Q1 FASB Outlook article, both available at www.fasb.org.

What causes complexity?

For decades, financial and accounting professionals have discussed how to reduce complexity in financial reporting. One of the most comprehensive studies about financial reporting complexity occurred in 2008 as part of an SEC initiative.[5] An SEC advisory committee concluded that complex financial reporting makes it difficult for:

- Investors to understand the economic substance of a transaction and an entity's overall financial position and financial results;
- Preparers to properly apply standards and report their financial results to investors; and
- Auditors and regulators to fulfill their responsibilities to audit, analyze, and regulate financial reporting.

The committee cited many causes of complexity. We believe that these four are significant.

1. Complex activities resulting from the increasingly sophisticated nature of business transactions
2. Noncomparability and inconsistency of financial reporting within and across entities, which arises because of factors such as:
   - Different accounting models from one industry to another;
   - Alternative accounting policies; and
   - Exceptions to general principles.
3. Accounting standards that are difficult to apply because they reflect opposing viewpoints that were taken into account during the standard-setting process, introduce optionality or give detailed guidance for specific events, and are not created using a consistent framework
4. Information needs driven by legal risk spawn complex disclosures that make investors sort through irrelevant information

In 2013, a CFA Institute study about financial reporting complexity showed that investors believed that complexity increases when accounting standards do not reflect the underlying economics of transactions. The study also illustrated how complexity rises when disclosures do not provide information that investors need to adjust the reported financial information to apply the economic measures they find most useful (e.g., fair value).[6]

KPMG observations

It appears that some of the causes of complexity, such as the characteristics of the underlying transaction, are unavoidable. However, much complexity is unnecessary and can be avoided as new standards are set or eliminated by amending existing accounting standards.

[5] SEC Advisory Committee on Improvements to Financial Reporting, Final Report of the Advisory Committee on Improvements to Financial Reporting to the United Sates Securities and Exchange Commission, August 1, 2008. See also the SEC staff report, Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System, July 25, 2003. Both reports are available at www.sec.gov.

[6] Financial Reporting Disclosures, Investor Perspectives on Transparency, Trust, and Volume, July 2013, available at www.cfainstitute.org.

Stakeholders disagree about how to reduce complexity

While complexity in financial reporting increases costs for preparers and users, stakeholders may have different views about what complexity is and how it can be reduced. For some preparers, reducing complexity may focus on making accounting and financial reporting standards easier to apply. For investors and other users, reducing complexity may be achieved by making financial information more understandable and useful, even if preparers must do more work or incur additional costs.[7]

KPMG observations

Balancing different perspectives while working toward improving financial reporting is a difficult task for the FASB. We believe a complexity framework would help the FASB to evaluate different perspectives.

Private company council

One of the Financial Accounting Foundation's (FAF) initiatives to address complexity in financial reporting was the establishment of the Private Company Council (PCC). The PCC's charge is to improve the standard-setting process by considering issues relevant to private companies and their financial statement users, including identifying opportunities to reduce complexity and costs of preparing financial statements. The PCC has completed many projects including accounting for identifiable intangible assets in a business combination; accounting for goodwill; applying variable interest entity guidance to common control leasing arrangements; and accounting for certain receive-variable, pay-fixed interest rate swaps (the simplified hedge-accounting approach).

The FAF recently completed a three-year review of the PCC's effectiveness, accomplishments, and future role in setting standards, and concluded that "most stakeholders expressed support for the PCC and agreed that it has been successful in addressing the needs of users of private company financial statements, while reducing costs and complexity for preparers".[8]

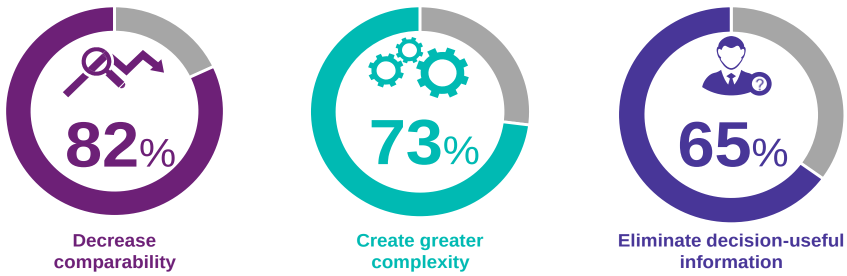
The CFA Institute provided its assessment of the PCC's effectiveness in a membership survey, *Addressing Financial Reporting Complexity: Investor Perspectives*.[9] The report showed that while some investors believe that the private company initiative addresses preparer concerns about compliance costs, the costs to investors likely will outweigh the benefits.

[7] See remarks of Robert H. Herz, Former FASB Chairman, 2005 AICPA National Conference on Current SEC and PCAOB Reporting Developments, December 6, 2005.

[8] FAF Chair Jeffrey J. Diermeier, FAF Updates Procedures of PCC To Increase Effectiveness, Improve Communication, News Release, November 18, 2015, and the Three-Year Review of the PCC, Final Report, November 2015, both available at www.fasb.org.

[9] Addressing Financial Reporting Complexity: Investor Perspectives – Separate Private Company Accounting and Beyond, available at www.cfainstitute.org.

The CFA Institute asked its members how they believe private company standards will affect their financial analysis. The top three responses follow.



KPMG observations

We believe different standards for private and public companies may be appropriate when the needs of users of private company financial statements are different from the needs of users of public company financial statements. However, the added complexity of creating options or alternatives may outweigh the benefits to the overall financial reporting system.

Although private company alternatives may make some provisions of standards easier to apply, they also may add complexity and create noncomparability among private companies, and between private and public companies. These alternatives also may introduce conceptual inconsistencies among underlying standards. For example, accounting standards require public business entities to treat goodwill as an indefinite-lived asset, while private entities have the option to treat goodwill as a finite-lived (10 years or less) asset.

Simplification initiative may affect IFRS convergence

While convergence with IFRS is a consideration as the FASB deliberates its simplification projects, it is not a primary objective of the initiative.[10]

Convergence with IFRS may increase

- Measurement of inventory at the lower of cost or net realizable value[11]
- Eliminating the concept of extraordinary items for U.S. GAAP income statement presentation[12]
- Balance sheet classification of debt, presentation of debt issuance costs, classification of deferred taxes, and accounting for the tax effects of intra-entity asset transfers[13]

Convergence may decrease

- Recognition of business combination measurement period adjustments in the period identified rather than recasting prior period financial statements. The FASB concluded that the new reporting is warranted because U.S. companies usually report quarterly while non-U.S. companies often report semiannually.

Mixed results

- Eliminating the requirement that an entity retroactively adopt the equity method of accounting for previously held investments because its ownership level increased would be more consistent with IFRS. The FASB staff is currently exploring other ways to improve the equity method of accounting. The IASB also has a research project to address application issues related to the equity method. However, the Boards are currently embarking on separate, rather than coordinated projects, which could hamper convergence.[14]

KPMG observations

We believe the FASB should evaluate whether convergence with IFRS remains a priority, and if so, how that priority should influence the direction of its standard-setting activities, including the simplification initiatives. It would be desirable for the FASB to develop, communicate, and implement clear protocols to specify how convergence will affect its decisions about issues in ongoing projects to simplify accounting. The FASB should consider:

- If convergence is a priority, in what circumstances does it take precedence over other considerations such as simplifying U.S. GAAP?
- When, if ever, should standards be revised to converge with IFRS if those revisions would be of comparable quality but would not necessarily result in higher-quality U.S. standards?

[10] FASAC meeting, June 17, 2014.

[11] IAS 2, Inventories.

[12] IAS 1, Presentation of Financial Statements.

[13] IAS 1; IAS 32, Financial Instruments: Presentation; IAS 12, Income Taxes.

[14] The IASB has a research project to address application problems with the equity method of accounting in IAS 28, Investments in Associates and Joint Ventures. Updates on the IASB's project are available at www.ifrs.org.

The way forward

Accounting standards are not complex because standard-setters intended them to be. Instead, the complexity was expected to improve financial reporting. Those standards were subject to due process, including exposure for public comment and redeliberations. In some cases, the FASB responded to stakeholders' requests, with increased complexity as an outcome. Other changes reduced complexity for preparers, but also reduced the information available to users thereby increasing the cost for users to more broadly compare financial information. While some changes might have brought U.S. GAAP closer to IFRS, others created additional differences.

KPMG observations

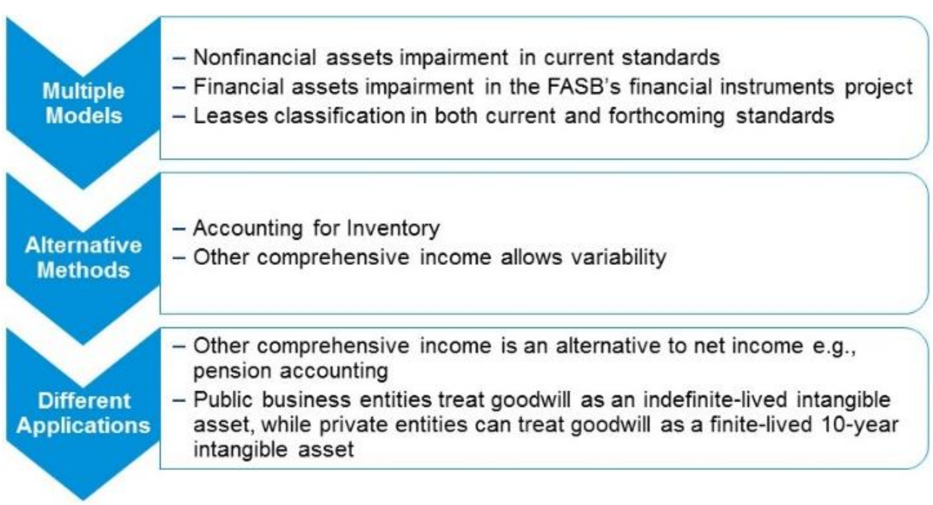
The FASB's simplification initiative is a first step to reducing unnecessary complexity in accounting standards. However, we believe the causes of unnecessary complexity in accounting standards and financial reporting are broader than the specific provisions within standards that the FASB targeted. To substantively reduce complexity, we believe the FASB needs a complexity framework to address unnecessary complexity in all of its standard-setting activities. As an initial step, we believe the FASB should review existing studies and conduct more research on the underlying causes of complexity in accounting standards and financial reporting.

A complexity framework should address how to:

- Make financial reporting more useful and relevant for financial statement users;
- Arbitrate different views on cost and complexity; and
- Where appropriate, preserve and / or increase comparability between U.S. GAAP and IFRS.

Unless the FASB undertakes a broader effort to reduce unnecessary complexity, financial statements likely are to continue to have unnecessary complexity. The absence of a complexity framework also will create difficulties for the FASB as it weighs different perspectives about what complexity is necessary.

Sources of complexity



KPMG observations

Problems addressed by a complexity framework

Although not inclusive, we believe that a complexity framework should identify how the FASB will minimize or eliminate unnecessary complexity that may result from:

- *Optional or elective methods* and alternatives in accounting for the same transaction;
- *Multiple models* to account for similar transactions, assets, or liabilities that allow different reporting for similar economic events and transactions;
- *Standards that are inconsistent* with the FASB's conceptual framework;
- *Standards that are not clear about what principles* they are based on, lack of clarity about how to determine when exceptions to principles are appropriate, and outcome-specific standards that create an exception to the general principles of the standard;
- *Multiple transition alternatives* including extended required effective dates, grandfathering of existing transactions, and early adoption elections; and
- Different accounting standards used by different companies.

We believe the complexity framework should provide the FASB a basis for consistently deciding whether complexity is necessary while allowing stakeholders to provide useful input during the comment process.

We believe a FASB complexity framework should be subject to the Board's due process and coordinated with its other activities and priorities. For example, a complexity framework must address how the FASB intends to prioritize efforts to reduce unnecessary complexity while making information reported under U.S. GAAP more comparable with IFRS. Those efforts need to be considered within the overall objective of improving the usefulness and relevance of financial statements. Once completed, the complexity framework should be used to review current standards and to evaluate decisions when new accounting standards are developed.

Completed projects

Measurement of inventory	Changes the measurement principle for inventory from the lower of cost or market to the lower of cost and net realizable value
Extraordinary items	Eliminates the concept of extraordinary items
Presentation of debt issuance costs	Reported as a reduction from the related debt liability
Measurement date of an employer's defined benefit obligation and plan assets	Provides a practical expedient for employers with fiscal year-end dates that do not fall on a calendar month-end to measure pension and postretirement benefit plan assets and obligations as of the calendar month-end date closest to the fiscal year-end
Simplifications for employee benefit plans	Eliminates the requirement for plans to measure fully benefit-responsive investment contracts (FBRICs) at fair value
Measurement-period adjustments	Eliminates the requirement for an acquirer in a business combination to retrospectively adjust its acquisition accounting
Balance sheet classification of deferred taxes	Requires all deferred income tax assets and liabilities to be classified as noncurrent

Forthcoming projects

Share-based payments	Changes tax accounting and withholding requirements, forfeiture policy election, and cash flow classification
Equity method accounting	Eliminates the requirement to retrospectively apply the equity method when an increase in ownership triggers equity method accounting

Ongoing projects

Balance sheet classification of debt	Debt would be classified as noncurrent only if certain criteria are met as of the balance sheet date
Equity method of accounting	FASB staff is researching alternatives for improving the equity method of accounting
Accounting for income taxes	Recognition of the current and deferred income tax consequences of an intra-entity asset transfer would be required when the transfer occurs

Keeping you informed

For additional information on the topics discussed, see these KPMG publications, which are available at www.kpmginstitutes.com.

Simplification initiative

Issues In-Depth, December 2014, 2014 AICPA National Conference on Current SEC and PCAOB Developments

Disclosure framework

Defining Issues No. 15-42, FASB Proposes Changes to Materiality for More Effective Disclosures

Defining Issues No. 14-52, FASB Continues Discussion on Disclosure Framework

Defining Issues No. 14-16, FASB Proposes Disclosure Framework

U.S. GAAP and IFRS Convergence

Defining Issues No. 15-35, *IFRS in the U.S. – Current Status and Outlook*

Measurement of inventory

Defining Issues No. 15-33, *FASB Changes Measurement Principle for Inventory*

Extraordinary items

Defining Issues No. 15-2 *FASB Eliminates Extraordinary Items Concept*

Presentation of debt issuance costs

Defining Issues No. 15-14, *FASB Changes Presentation of Debt Issuance Costs*

Measurement date of an employer’s defined benefit obligation and plan assets

Defining Issues No. 15-17, *FASB Issues Practical Expedient for Measurement Date of an Employer’s Defined Benefit Plan*

Simplifications for employee benefit plans

Defining Issues No. 15-36, *FASB Issues Simplifications for Employee Benefit Plans*

Measurement-period adjustments and other business combination issues

Defining Issues No. 15-56, *FASB Proposes to Clarify the Definition of a Business*

Defining Issues No. 15-43, *FASB Simplifies Measurement Period Adjustments in Business Combinations*

Share-based payments

Defining Issues No. 15-28, FASB Proposes to Simplify Accounting for Share-based Payments

Equity method of accounting

Defining Issues No. 15-24, *FASB Proposes Changes to Equity Method Accounting*

Accounting for income taxes

Defining Issues No. 15-55, *FASB Changes Balance Sheet Classification of Deferred Taxes*

Defining Issues No. 15-3, *FASB Proposes Changes to Accounting for Income Taxes on Intercompany Transfers and Deferred Tax Classification*

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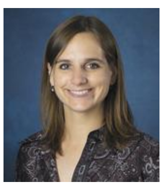

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