ICAEW REPRESENTATION 54/14

GETTING A BETTER FRAMEWORK: COMPLEXITY

ICAEW welcomes the opportunity to comment on the *Getting a Better Framework* bulletin *Complexity* published by the European Financial Reporting Advisory Group (EFRAG), the French Autorité des Normes Comptables, the Accounting Standards Committee of Germany, the Organismo Italiano di Contabilità and the UK Financial Reporting Council on 10 February 2014, a copy of which is available from this link.

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MAJOR POINTS

The Getting a Better Framework initiative

1. As we have stated in our responses to previous bulletins in this series, we welcome the initiative of EFRAG and its associated national standard setters in setting up the *Getting a Better Framework* project, which has served a useful purpose in promoting discussion on issues that should form part of the conceptual framework debate. We have not responded to all of the previous bulletins as, following publication of the IASB discussion paper *A Review of the Conceptual Framework for Financial Reporting*, it seemed more sensible to focus our resources on responding to that. However, the *Complexity* bulletin raises issues on which we believe it would be helpful to comment.

Complexity

2. We agree that complexity in financial reporting is an important issue that deserves consideration and, as the bulletin points out, it is a problem that we have ourselves drawn attention to, for example in *The Future of IFRS* (2012). Greater complexity makes it more difficult for readers to understand financial reporting information and adds to preparers' costs. At the same time, as the bulletin recognises, business transactions – and, we would add, business structures – are themselves increasingly complex and this affects the complexity of financial reporting intended to reflect them. As the bulletin also recognises, different users have different capacities to cope with complex information. The bulletin also points out that preparers can help to make complex information more understandable if they present it clearly.

3. The majority of the bodies supporting the bulletin's publication propose that additional material on complexity should be added to the IASB's conceptual framework in relation to 'understandability' and the 'cost/benefit constraint' so that the question is considered explicitly as part of the standard-setting process. We believe though that, to the extent that complexity is an issue, it should already be taken into account implicitly in the IASB's considerations under the headings of 'understandability' and the 'cost/benefit constraint', and we understand that in practice it is, even if the outcomes of such consideration are sometimes more complex than we would wish. We therefore agree with the minority view expressed in the bulletin (paragraph 21) that there is no need to introduce explicit discussion of complexity into the conceptual framework.

4. The bulletin distinguishes between avoidable complexity and unavoidable complexity. While we agree that such a distinction can often be made, and we sometimes make it ourselves, we are doubtful how much weight the distinction can bear as a way of addressing the problem of complexity. There is frequently no clear dividing line between avoidable and unavoidable complexity, or between complexity and other factors affecting understandability or the costs and benefits of reported information. The issue is a grey area, rather than a black and white one, and it would, for example, be difficult to identify separately additional costs or reductions in benefits due to complexity as a discrete cause.

5. Overall, although complexity is a significant issue in financial reporting, and one that we believe standard setters should address, we do not see scope for radical reductions in the complexity of current disclosures without costs to users that would almost certainly outweigh the benefits. In particular, we do not believe that some disclosures should be omitted on the grounds that they may be too complex for ordinary users to understand. The Appendix to the bulletin is not, in our view, particularly successful in identifying current candidates for simplification; we comment below on most of its illustrative examples.

RESPONSES TO SPECIFIC QUESTIONS

Q(i): Do you think there should be explicit discussion of the different aspects of complexity in the Conceptual Framework?

6. As indicated above, we do not believe that an explicit discussion of the different aspects of complexity in the conceptual framework is warranted.

Q(ii): Are there any aspects of complexity in accounting not covered by this Bulletin that should be covered?

7. We do not believe that there are any other aspects of complexity that EFRAG and its associated national standard setters should be tackling.

COMMENTS ON ILLUSTRATIVE EXAMPLES

Example 1: Hedge accounting

8. We are not convinced that the concerns raised about hedge accounting are primarily examples of complexity. They seem to be about how best to reflect economic reality. And in the case of internal hedges, it is not clear that recognising them would either better reflect economic reality or reduce complexity. If the objective is to reduce complexity, then this could be achieved by, for example, banning hedge accounting and simply requiring companies to explain why they enter into transactions involving derivatives – not a solution that we would recommend.

Example 2: Defined benefit pension plans

9. This example raises two issues. The first, on deferred recognition, is a historical problem now dealt with satisfactorily by the IASB, and so does not seem to be worth raising at this time.

10. The second, on continuing complexity in disclosures, is indeed said to be a problem by some people, but the suggested simplification in the example – getting rid of sensitivity analyses on key assumptions – would in our view remove information that is vital to users' understanding of sponsoring company exposure when defined benefit schemes are material.

11. A more useful discussion might focus on the problems that less sophisticated users have in understanding movements in liability and asset measurements over time, and the difference between measurement for financial reporting purposes and actuarial measurement for the purposes of funding. These aspects of pensions accounting probably represent unavoidable complexity; the challenge is to find better ways of describing them to users of accounts. We believe that preparers probably hold the key here to developing ways that make these issues clearer in their financial statements, and that experimentation in this area (through mechanisms such as the FRC's Financial Reporting Lab) would be beneficial.

Example 3: Share-based payments

12. We agree that there is some concern with IFRS 2, *Share-based Payment*, and the fairly constant tinkering with the standard by the IASB and the IFRS Interpretations Committee indicates that some thought should be given to a more holistic reappraisal of the standard at some point. However, as the current debate on executive pay has demonstrated, there is a fundamental fiduciary and governance problem if companies are unable to explain the value they are giving to directors and employees for their services. It may be that there will be more focus in future on making the instruments and transactions themselves simpler and hence easier to describe and understand, ie, removing some of the 'unavoidable' complexity by changing the transaction, rather than by changing how it is reported.

Example 4: Income tax

13. The solution suggested in the example is apparently that the income tax standard should contain variations specifically tailored to fit each of the numerous tax regimes to which it might be applied. While we do not disagree in principle that IAS 12, *Income Taxes*, ought to be revisited, it is difficult to see this proposal as a simplification. It is more likely that simplification could be achieved only by taking a very different view of deferred tax, but recent attempts to tackle this have proved the intractability of the issue.

Example 5: Recognition of intangibles in a business combination

14. It is an open question whether current requirements for recognition of intangibles in a business combination are appropriate, but we believe that the real issue is the information's usefulness rather than its complexity. The post-implementation review of IFRS 3, *Business Combinations*, will, we hope, provide some insight on this point.

Example 6: Split accounting of compound financial instruments

15. Again the real question here is about how best to reflect the substance of the transaction rather than about complexity.

Example 7: Analysis of a transaction different from that provided by the entity's business model

16. Yet again, the real question here seems to be whether the required accounting treatment is appropriate; it is not primarily a question of complexity.

Example 9: Law claim with uncertain outcome

17. It is not clear why it is thought that disclosing a range of possible outcomes and the assumptions that underlie them would be less complex than disclosing a single number and the assumptions that underlie it. The proposal also seems to involve the liability's disappearance from the balance sheet, which would presumably be misleading.

18. Dealing with situations of great uncertainty, where the existence and size of potential assets and liabilities will only be determined absolutely in the future, will always be challenging to deal with in financial reporting, which deals with specific periods in the past. In our view, IAS 37, *Provisions, Contingent Liabilities, and Contingent Assets*, has established valid and understandable parameters for dealing with uncertainty, which have become fairly well understood; any proposed changes to it should therefore be considered very carefully.