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ARE ACCOUNTING STANDARDS UNDERSTANDABLE?

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AASB 2020 Research Forum

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Our Task:

To investigate whether the way in which accounting standards are written and presented impacts on the ability of the users of those standards to comprehend their meaning and requirements.

Motivation:

FINANCIAL REVIEW

Accounting standards now too complex: CFOs

Accounting standards now 'outrageously complex'

Accounting standards have become so "outrageously complex" that it is difficult for investors to understand financial statements, while the regulation of the area is "overly-complex, cumbersome and archaic".

AUSTRALIAN INSTITUTE
of COMPANY DIRECTORS

The quantum of disclosure companies have to provide is not the only issue that exists here. It is the complexity of the accounting requirements that causes some of the reliance on technical terminology, which is something for which standard setters across the globe have a lot to answer.

ACCA MEMBERS SURVEY

Complexity in Financial Reporting

This from the outset establishes standard setting as having a certain air of intellectual arrogance about it as it drives the product to more complex outcomes rather than a simplification of accounting requirements. The general body of end users and corporate stakeholders in whose name the standard setters are purportedly acting - whose interests they are supposedly protecting - have no real place in the standard setting mindset at the current time.

It is then written in language that only has a place among technicians that spend their lives interpreting the stuff rather than those that might want to actually understand what the impact the words may actually have.

Motivation:



Disclosure Initiative—Principles of Disclosure

IAASB

**COMPLEXITY UNDERSTANDABILITY SCALABILITY
PROPORTIONALITY (CUSP)**

Objective

The objective of this workstream is to develop drafting principles and guidelines to enable the writing of standards that result in the consistent and effective application of the ISAs

Understandability?

Comprehend and consistently interpret meaning and requirements of accounting standards

BUT

Ability to understand is subject to multiple factors (Farrell et al., 2014):

Specific to the reader – intellectual abilities, education, attention span, shared knowledge with author

External to the reader – size, style and colour of font, register of language used (e.g., academic, conversational, legalistic)

Prior Research:

Haswell (2006) - IASB & FASB standards

- **extreme rules**
- **densely argued definitions**
- **sometimes use 'bright lines'**
- **complicated tests for characteristics and exceptions**
- **excessive length**
- **present vague prescriptions**
- **voluminous guidance**
- **muddled definitions**
- **over-complex and poorly defined principles**
- **overly prescriptive**

Prior Research:

Measuring 'Readability'

One component of 'understandability'

Stead, 1977 – 24 US APB Opinions

Adelberg, 1982 – 15 US pronouncements

Stevens et al., 1983 – FASB Statement 33

Shaffer et al., 1993 – US GASB Statement 11

Farrell et al., 2010 – 47 AASBs, FAS13

**Readability
levels of
standards are
very difficult;
'impediment' to
understanding**

Our Approach:

Two phases:

- 1. Measure 'readability' of the suite of Australian accounting standards**
- 2. Interviews with financial statement preparers and auditors**

Phase 1 - Measuring Readability:

Flesch Reading Ease Score (Flesch, 1950)

Score derived from formula using average length of sentences and average number of syllables per word.

Applied to 65 Australian Accounting Standards as compiled at 1 January, 2020.

Flesch Reading Ease Score	Interpretation of Level of Text Readability
90 - 100	Very easy
80 - 89	Easy
70 - 79	Fairly easy
60 - 69	Standard
50 - 59	Fairly difficult
30 - 49	Difficult
0 - 29	Very difficult

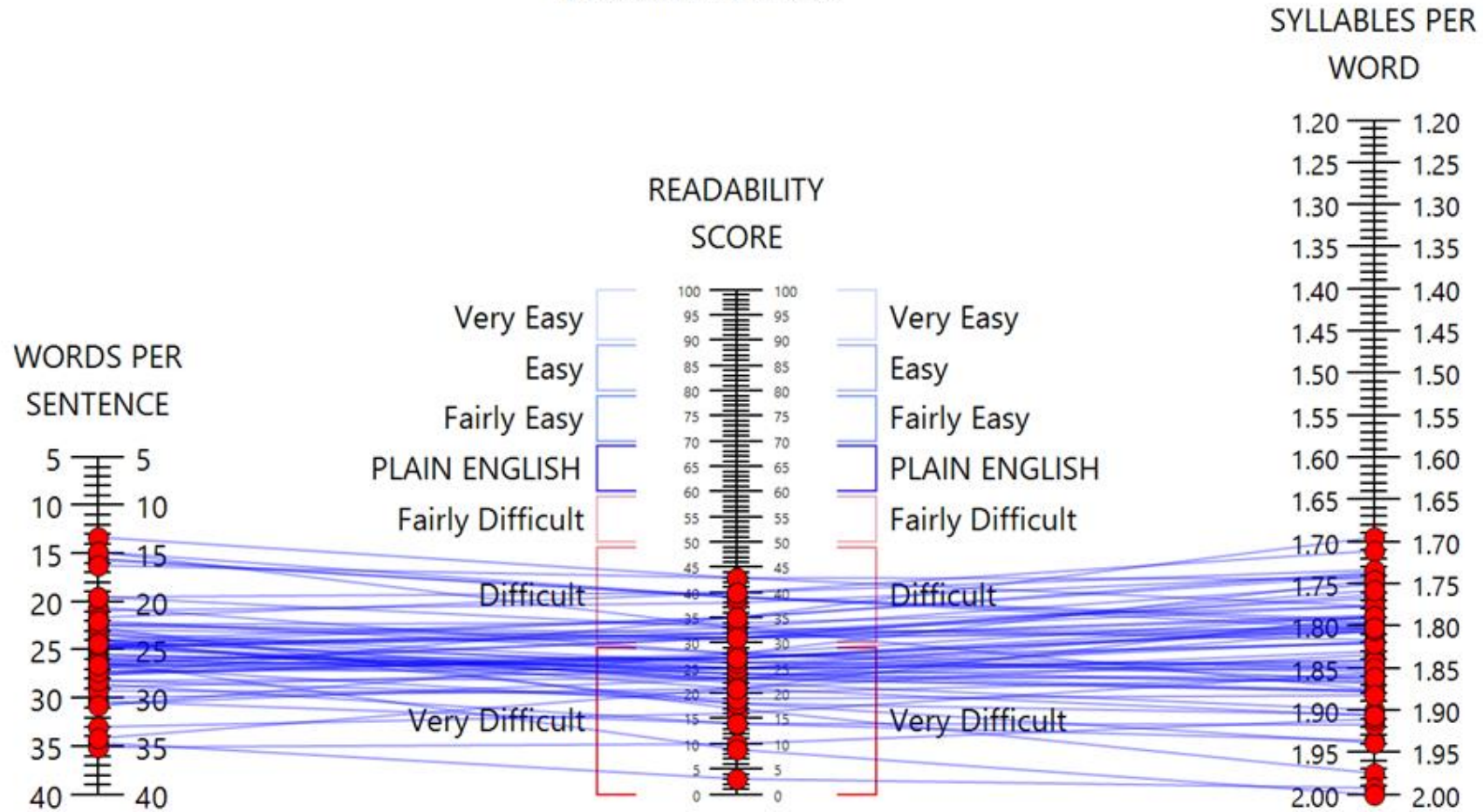
Flesch Reading Ease Score ranged from 3 to 43; average score was 27 – ‘Very Difficult’.

Accounting Standard	Flesch Reading Ease Score (Arranged From Very Difficult to Difficult)
The Five Most Difficult Standards for Readability	
	3
	9
	10
	14
	14
	39
	40
	40
	43
	43

Very Difficult

Difficult

READABILITY CHART



Readability Is Not Understandability

Some counter-intuitive rankings. E.g.,

- ***AASB 139, Financial Instruments: Recognition and Measurement* ranked third most readable**
- ***AASB 133, Earnings Per Share*, ranked fifth most readable**

Phase 2 -

Interviewees:

**Conducted
via Zoom or
Skype**

Constituent Groups	Type	Number of Interviewees
Financial Statement Preparer	Large For-Profit	8
	Public Sector	3
	Not-for-Profit	1
Financial Statement Auditor	Big-4	3
	Non-Big-4	1
	Public Sector	3
Other Constituents	Professional Association	2
	Accounting Standards Draftsperson	2
	Small Practitioner	2
Total Interviewees		25

Audience for Accounting Standards?:

Financial statement preparers and auditors

Directors and analysts ('should know but don't')

- **Primarily interested in the implications for what story will be told in the financial statements**

General Observations:

Accounting standards becoming increasingly complex and harder to understand

Examples include:

- **AASB 9, *Financial Instruments***
- **AASB 15, *Revenue from Contracts with Customers***
- **AASB 16, *Leases***
- **AASB 17, *Insurance Contracts***
- **AASB 1058, *Income of Not-for-Profit Entities***

General Observations:

Older standards easier to understand than newer standards (but older standards dealt with simpler transactions)

Reasons for the increasing complexity of accounting standards included:

- **a perception that they were excessively long.**
- **they were not sufficiently reliant on a ‘principles-based’ approach but rather included too much ‘rules-based’ detail, and**
- **adopted language that was too generic for application in specific jurisdictions (e.g., AASB 17).**

The Need for Interpreters:

A deep understanding of accounting standards was perceived to exist only with a very small, select and highly skilled group; namely, technical experts in Big-4 and mid-tier audit firms, technical staff in Departments of Treasury and Finance, and auditors at departments of Auditors-General.

These elite experts played a very important and widespread role in ‘interpreting’ the requirements of standards to financial statement preparers and auditors, especially with regard to how a standard’s provisions were to be understood in the context of a given entity’s transactions.

The Need for Interpreters:

E.g.,

- **CFOs explain standards to directors/analysts**
- **Many users of standards had only a ‘working’ understanding**
- **Some topics highly specialised & outside day-to-day experience**
- **Impact of resourcing (especially small organisations & small practitioners):**
 - **Time poor; no in-house technical expertise**

The Need for Interpreters:

Coping strategies

- **Heavy reliance (by financial statement preparers & small practices) on materials/webinars produced by Big-4 and mid-tier firms**
- **More accessible and applied text and examples**
- **Public sector – guidance documents issued by Departments of Treasury/Finance, Local Govt. Associations**
- **Some parties start with these materials rather than standards**



The Need for Interpreters:

Coping strategies

- **A lot of reference to *Basis for Conclusions***
- **National and international networks of technical experts (particularly in private sector – e.g., *Emerging Accounting & Auditing Issues Discussion Group*)**
- **Small entities may rely on guidance from their auditor or external consultant**

Four Contexts in Which Standards are Interpreted:

- 1. Understanding which accounting standard applies in a given context (scope);**
- 2. Having identified the applicable accounting standard(s), understanding whether particular criteria or paragraphs apply;**
- 3. Given that applicable criteria or paragraphs have been identified, understanding how to apply the required accounting treatment to a given context; and**
- 4. Understanding the rationale for the required accounting treatment.**

1. Which Accounting Standard Applies?

Cross-cutting issues where it may be difficult to assess which standard(s) apply.

“rent concessions is really interesting; it’s scoping. You look at the scope paragraph of IFRS 9, you look at the scope paragraph of IFRS 16, we’re not sure which standard to apply; is it a lease modification or what is it? We see a lot of that.” (Non-Big-4 auditor)

Public and private not-for-profit sectors:

“you’ve got an appendix to AASB 15 dealing with not-for-profits, and then you’ve got AASB 1058 ... and then the question is ... where in the world do I start? Do I always start with 1058?” (Non-Big-4 auditor).

1. Which Accounting Standard Applies?

- **Potential lack of comparability**
- **Coping strategies:**
- **Accounting firm materials**
- **Index of cross-references (not successful)**
- **In-house materials and flowcharts**
- ***Basis for Conclusions***
- **But ability to cross-reference (both between and within standards) is valuable**

2. Understanding which Criteria or (Group of) Paragraphs Apply:

Complex transactions – potential for inconsistencies in interpretation/application

“some of the newer standards ... are quite broad, so I think in your [AASB] 16s and your [AASB] 15s and your [AASB] 9s to some extent figuring out which bits of the Standards are applying to which transactions can be a challenge.” (For-profit preparer)

2. Understanding which Criteria or (Group of) Paragraphs Apply:

Gaps in standards

“[AASB] 16 has been quite difficult to work with for a few reasons ... I think there is actually a lot missing ..., I don’t think it was ready for release. For example, just dealing with lease incentives, the more that we’ve looked, the more that we’ve discovered is not there and ... that’s not just us, that’s also feedback I’ve seen around the world.” (Public sector auditor)

2. Understanding which Criteria or (Group of) Paragraphs Apply:

Coping strategies:

- **Accounting firm materials**
- **Flowcharts very helpful in navigation around standards**

3. Understanding how to Apply the Required Accounting Treatment:

“I still think the biggest challenge is the “how” in terms of how you apply.” (For-profit sector preparer).

Most commonly measurement & disclosure

Usually the meaning of a principle was clear but there may be a lack of information or a lack of clarity about how well the specific fact situation maps to the accounting standard’s rules or principles

3. Understanding how to Apply the Required Accounting Treatment:

“you might have conflicting facts and then you’ve got to try and work out which one is more predominant than the other ... when you’re at a company the size of [listed company X], the level of complexity that they can contract into is enormous and you kind of have to sit back from that and we get a contract ... and there might any number of clauses in the contract that trigger, potentially trigger different requirements”. (For-profit preparer)

3. Understanding how to Apply the Required Accounting Treatment:

Some standards poorly written – AASB 17, AASB 1058

Coping strategies

- **Examples in standards – but tend to show the obvious, not the ‘grey’ situations**
- **Examples in accounting firm materials – more ‘applied’**

4. Understanding the Rationale for the Required Accounting Treatment:

Not a high priority for many – ‘just tell me what I have to do’

But understanding the rationale can be used to educate others about the resulting financial information – especially when outcomes may seem ‘wrong’

Importance of *Basis for Conclusions*

Different views about whether standards should say more about the rationale at the start of a standard – might just make the standards even longer!

Other Issues:

Standards-setting process:

- **Late changes without consultation**
- **Perceived lack of resources for small entities and small practitioners and perception of lack of inclusion at roundtables, etc.**

Navigating accounting standards

- **Role of technology in more effectively/efficiently navigating within and between standards**
- **Improvements to AASB website – e.g., ability to find most recent versions of standards and supplementary material**

Other Issues:

Writing for the not-for-profit and public sectors

- **IASB's 'for-profit' standards don't contemplate the 'peculiarities' of these contexts**
- **Need for more not-for-profit and public sector representation on AASB**

Conclusions:

Accounting standards perceived as:

- **Complex documents that are not easy to read or understand**
- **Complexity reflects complex transactions**
- **Increasingly too long to navigate, overwhelming (especially to those with highly limited resources)**
- **Desire for 'simplicity'**

Recommendations:

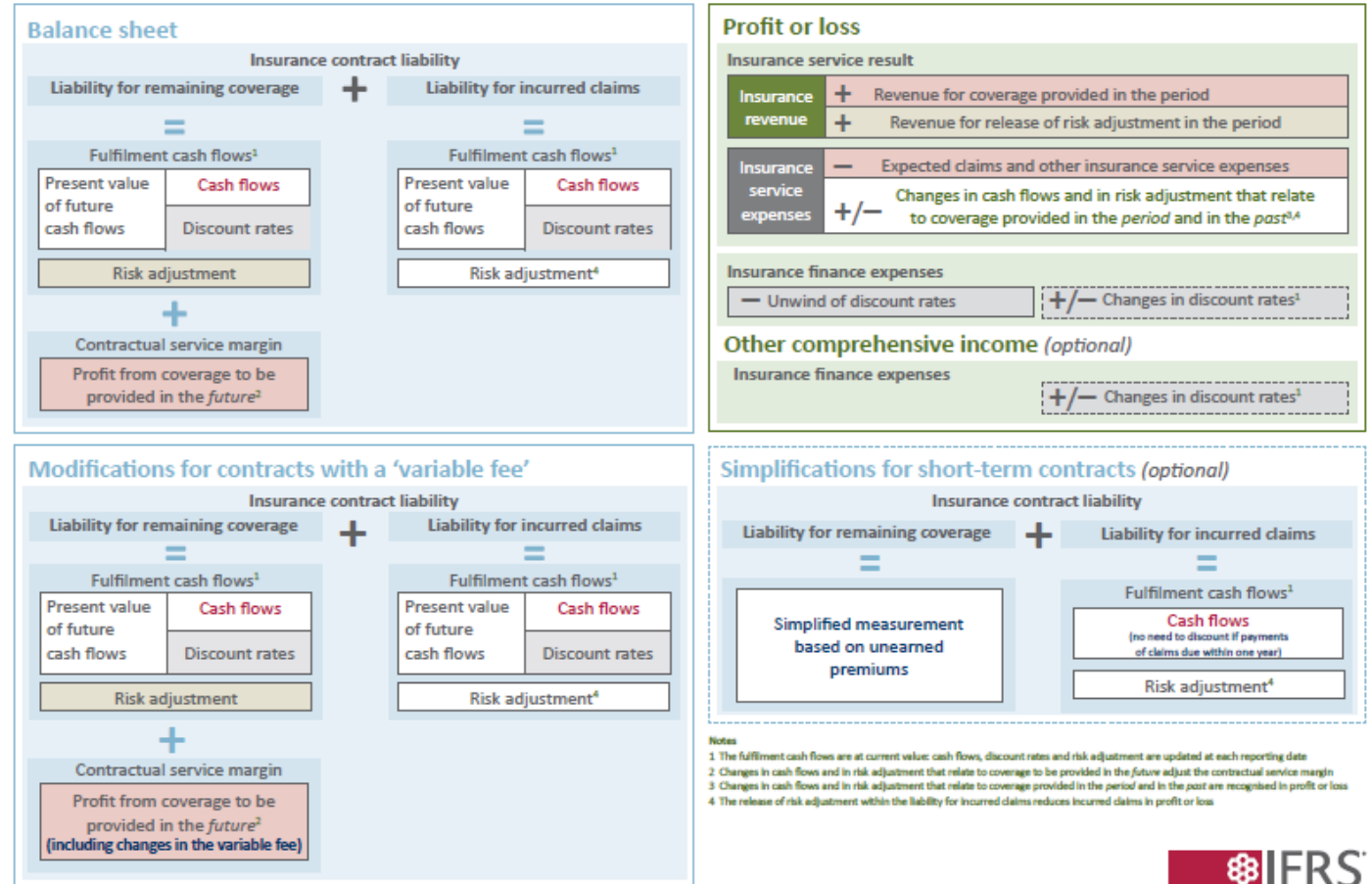
- 1. Develop interactive e-versions of standards (e.g., cf. IAESB's recent efforts)**
- 2. Provide more 'advanced' examples (but breadth of relevance and how many is enough?)**
- 3. Increased use of flowcharts and other visual aids/templates**

Power of Flowcharts? AASB 17, *Insurance Contracts*

**Standard of 84
pages
+
Basis for
Conclusions of
68 pages**

VS

IFRS 17 *Insurance Contracts*—the accounting model in one page



Recommendations:

- 4. Reforms to the standards-setting process (e.g., other means of engaging with non-experts; improvements to due process such as ‘road testing’ in local conditions, no last-minute changes without consultation)**
- 5. AASB to reconsider its ‘education’ objective**
- 6. AASB to redesign website – e.g., easier to identify most recent versions of standards; increased awareness of ‘extra’ material**

Thank You for Your Attention