point of

view

April 2015

FASB aims for simpler GAAP
Why changing the status quo is easier said than done

pwc

Simplifying accounting guidance may change financial statements in more-than-insignificant ways. That's when simplification becomes not so simple.

- The objective of the FASB's simplification initiative is to reduce cost and complexity while maintaining or improving the usefulness of the information required to be reported in the financial statements. That seems like a cause that most people would get behind. But a few of the FASB's early proposals have been met with some resistance.

- Why the resistance? Because change is hard. And simpler accounting standards don't mean that determining *how* to simplify the standards will be easy, or that the impacts will be inconsequential.

- Many of the simplification topics will present a challenge for the FASB: How do you reduce complexity in one topic without creating complexity elsewhere, while still maintaining the relevance of all of the information being impacted by change? Fortunately, making changes to accounting standards isn't new territory for the FASB. Its robust due process enables it to carefully consider all feedback received to ensure that each proposal is, in fact, meeting the objectives of the simplification initiative: minimizing complexity and reducing cost, while maintaining useful information in the financial statements.

- We encourage the FASB to continue the simplification journey, even if some of the proposals initially seem unpopular. In the short term, some changes will result in preparers having to update systems and controls, and having to explain the impacts to users. And users, in turn, will need to update their models. However, over the long term, eliminating exceptions or other unnecessary complexities in GAAP will minimize the possibility of inconsistent or incorrect application and help make the guidance easier for a broad range of preparers to apply and for users to understand. In addition, changes that reduce potential diversity in practice can increase comparability.

Even when many agree an issue exists, finding a solution can be hard

Business transactions are more complex today than they were a decade or two ago. So it's no surprise that accounting for certain transactions is not as straightforward as it used to be. But evolution in business is not the sole reason for today's complicated accounting.

Accounting guidance has become complicated because of new ideas, shifts in strategic priorities, and targeted fixes that address one problem but inadvertently lead to others.

Over time, practitioners and auditors developed wish lists — ones that aggregated all of their "it-would-be-so-much-simpler-if-GAAP-just-said-this-instead" items. In 2014, the FASB asked for these items to help it identify the areas that may be ripe for change. This marked the beginning of the FASB's simplification initiative.

What is simplification?

The purpose of the FASB's simplification initiative is to make improvements to specific standards through narrow changes. The goal is to maintain or improve the usefulness of financial information, while reducing costs and making the guidance simpler to understand and apply.

Minimizing complexity is a FASB priority. Complex standards are more difficult to understand, implement, and tend to require more interpretation (which can lead to inconsistent application and decreased comparability). The impact they have on companies' financial statements may need more explanation. This leads to increased costs for all stakeholders.

The costs and benefits of simplifying accounting can take various forms. For example, in some instances, stripping out complexity may come with a trade-off of more volatility in financial results. Although the financial results may be easier to understand, constituents may conclude that this "cost" of volatility exceeds the benefit of simplicity. In other situations, making the guidance more useful for preparers and users in the long term may result in more costs or effort in the short run. For example, preparers may need to explain why their financial performance looks better or worse in the year of adoption even though their operations didn't change.

Where's the easy button?

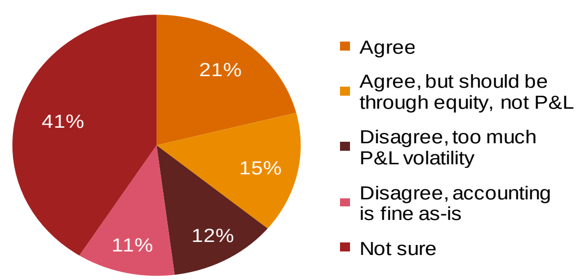
The FASB's initial agenda of simplification topics included those that appeared on the wish lists of multiple constituents — indicating that there is at least some level of agreement that these items should be addressed, and indeed could be addressed in such a targeted fashion. However, behind that façade of agreement lies the hard reality: most people don't like change.

Consider the FASB's proposal for simplifying one aspect of the income tax accounting for stock-based compensation. The current method of tracking so-called "windfalls" and "shortfalls" was a head turner when the guidance was originally issued back in 2004. The recordkeeping is complex and the accounting is not very intuitive.

So it seems like the perfect candidate for simplification, right? That remains to be seen. Comments are still coming in on the FASB's proposal to eliminate the windfall/shortfall concept and instead have companies record all tax effects from stock compensation through the income statement. However, early indications (see Figure) suggest that there may be some pushback because the proposed simplification may add some volatility to companies' effective tax rates, and therefore to their bottom lines. Companies may prefer to retain the complexity they're used to, or may suggest that any differential income tax effects upon option exercise be recognized in equity instead of income. How should the FASB address these conflicting perspectives?

Source: PwC Q1 2015 Current Accounting and Reporting Developments webcast, approx. 6,200 respondents

Do you agree with proposal to eliminate windfalls/shortfalls through the P&L?



For another example, consider the FASB's efforts to simplify inventory valuation. The proposal, which has to do with the concept that inventory should not be carried at a value above "market," is generally expected to be a non-event for most companies. However, for a subset of companies using the last-in, first-out (LIFO) method, particularly those in the retail sector, the initial adoption of the FASB's proposal could have some material, and perhaps unusual or counterintuitive, impacts on their financial statements.

Staying true to mission, priorities should guide FASB forward

So should the FASB move forward with this proposal, make an exception for companies using LIFO, or just abandon the project?

A slightly different twist on familiar questions

The FASB faces several challenges in deciding how to proceed with these specific examples and others on its simplification agenda. Should it only change the guidance if an overwhelming majority of commenters believe the proposal is simpler? Should the positive effects of the proposed simplification be measured in immediate terms or over the long haul? If the proposal will significantly change reported financial metrics, should that give the FASB pause?

Making targeted changes to accounting standards is not new territory for the FASB. But doing so in this manner—addressing a large number of varied and narrow topics at once, moving quickly to come to resolution, and focusing primarily on minimizing complexity—is unprecedented. Luckily, the FASB has an effective due process for decision-making already in place.

What guides the path forward?

The FASB's mission is focused on providing decision-useful information to users of financial statements. The goal of the simplification initiative is to reduce cost and complexity—concepts that would be beneficial to all constituents, including users.

> **...we are seeking to consider only those [simplification topics] where complexity can be reduced without sacrificing relevance.**
>
> *Russell Golden, FASB Chairman, December 9, 2014*

Measuring the costs and benefits of new standards is not an exact science. The benefits are often intangible: would the new guidance produce financial statement information that is more relevant, unbiased, understandable, and/or easier to use? They also vary by stakeholder. The costs can often be more tangibly measured, making it difficult to know how to reasonably compare the benefits to the costs.

In many cases, the costs and effort of implementing simplification changes would be consistent with what happens when any new accounting guidance is issued.

It's also important to realize that the FASB views the financial statement impact of new guidance as separate and distinct from costs and benefits. That's because the role of financial reporting is to provide information needed to make well-informed decisions.

Ultimately, the FASB's deciding factor will likely circle back to a fundamental question: Does a proposed simplification maintain the decision-usefulness of the information provided to users of the financial statements in a cost-beneficial manner?

A word of caution

The FASB may need to be careful not to try and alleviate stakeholder concerns around certain proposals by expanding the scope. Scope "creep" could result in simplification topics growing into full-fledged standard setting. This would be contrary to the goal of identifying narrow-scope, short-term projects.

The FASB's due process may identify some proposals that don't actually result in simplification. However, we are confident that if the FASB stays true to its mission, priorities and due process, it will recognize when a proposal needs to go back to the drawing board, or even be removed from its agenda altogether.

Conclusion

The FASB's simplification efforts are timely, worthwhile, and the related goals achievable. Generally, there is a collective will among board members and constituents to achieve results, even though the path may be a bit rocky.

Complex standards can be costly for preparers. But beyond the obvious opportunity to reduce the cost of compliance, there are numerous other benefits to reduced complexity. Standards that are easier to read and interpret make it easier for preparers to comply with them and users to understand the resultant financial information.

Reducing potential variability in interpretation may enhance comparability. Preparers can also be more confident that they are getting the right answer the first time.

By maintaining a decision-making approach that is aligned with its mission and its priorities, we believe the FASB will be able to issue simplified guidance that reduces cost and complexity while maintaining or improving the information available to financial statement users.

Questions and answers

Q: Has the FASB completed any simplification projects?

A: Yes. The FASB removed the concept of extraordinary items from GAAP. Since the bar to achieve "extraordinary" presentation was so high, preparers were rarely able to conclude that gains or losses were extraordinary. However, they still had to go through the assessment, so removing the concept reduced their effort without affecting the relevance of information available to financial statement users.

The FASB is also close to finalizing a practical expedient for employers that sponsor defined benefit plans that have fiscal year-ends that do not fall on a calendar month-end date. The expedient would permit those employers to measure defined benefit plan assets and obligations as of the month-end that is closest to the entity's fiscal year-end.

Lastly, the FASB has issued new guidance related to the balance sheet presentation of debt issuance costs. It will require that debt issuance costs be presented as a direct reduction in the carrying amount of the debt liability, consistent with the presentation of debt discounts or premiums.

Q: What is the relationship between the simplification agenda and proposals by the Private Company Council (PCC)?

A: The two are not formally linked, but in many instances the PCC has acted as a springboard for efforts to reduce complexity in GAAP for all companies, not just private companies. The FASB considers whether any GAAP alternative proposed by the PCC may also apply to companies other than private companies.

For example, the FASB's new guidance on development stage entities, which is applicable to all companies, evolved out of a PCC recommendation. In addition, the FASB has added several other projects to its agenda based on feedback from the PCC and other stakeholders. The projects are aimed at reducing complexity, and include topics such as intangible assets, goodwill, and stock-based compensation.

Q: What are some of the topics currently on the FASB's simplification agenda other than those already discussed?

A: The FASB continues to consider whether to add additional topics to its simplification agenda. However, some of the more significant topics currently on the agenda include:

Accounting for income taxes — Under the proposal, all deferred taxes would be classified as noncurrent. In addition, current and deferred tax consequences associated with an intra-entity transfer would be recorded when the transfer occurs, eliminating a long-standing exception in the literature.

Balance sheet classification of debt — The FASB's goal is to reduce cost and complexity by replacing the fact-pattern-specific guidance in GAAP with a principle to classify debt as current or noncurrent based on the contractual terms of a debt arrangement and a company's current compliance with debt covenants.

Stock-based compensation — The FASB's proposal would allow entities to withhold an amount up to the highest applicable marginal tax rate, without causing liability classification of the award. In addition, the FASB is proposing changes to accounting for forfeitures, classification of awards with put rights, and several other proposed changes that would only be available to private companies.

Contact Information

To have a deeper discussion about our point of view on FASB simplification initiatives, please contact:

Beth Paul
U.S. Strategic Thought Leader, National Accounting Services Group
Phone: 973-236-7270
Email: elizabeth.paul@us.pwc.com

Pat Durbin
U.S. Leader, Standard Setting, National Accounting Services Group
Phone: 973-236-5152
Email: pat.durbin@us.pwc.com