

RESEARCH SUMMARY



Transaction Complexity and the Movement to Fair Value Accounting

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As technology rapidly improves, businesses have become more complex and accounting standards more difficult to understand. Accounting standards that define what, when and how information is measured become more difficult for more complex transactions. Do accounting standards need to match the complexity of business transactions? No.

Rusli, Zhao and Ziebart find that it is possible to write simpler accounting rules that do not have to determine the what, when and how but rather rely on the market to determine those answers by using the price an asset would receive in the market—market valuation.

BACKGROUND

Information and technology allow businesses to become more interconnected and transactions more complicated. What used to be a simple exchange of goods and services between two entities now often includes sophisticated contracts, financial instruments and multiple intertwined entities. These complicated exchanges may lead to complicated accounting standards. Unfortunately, as accounting becomes more complex the usefulness of accounting information may deteriorate and may be costly for investors and companies.

Rusli, Zhao and Ziebart analyze transaction complexity compared to the readability of accounting rules. The authors rank transaction complexity using a survey of peers. The readability of the associated accounting standard is measured using the Flesch-Kincaid Grade Level Formula, which is used in education to express the grade level needed to understand a text.

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The authors then study one accounting standard that regulates fair value measurements (which often rely on market valuations), SFAS No. 157. They test whether relying on observable market values simplifies accounting standards. They also analyze an explicit cost of accounting standards—auditing fees. They compare audit fees for underlying transactions that can be measured using market values to those that are measured using promulgated accounting measurement standards.

FINDINGS

Complex business transactions result in accounting standards that are difficult to read and understand. Rusli, Zhao and Ziebart find that transaction complexity encourages standard setters to pass accounting rules that are increasingly difficult to read. Figure 1 graphs the education grade needed to read the accounting standard for each group of business transactions. An ideal reading score for the general public is usually around eight. The reading scores for the accounting standards of the business transactions in this study varied from just under 13 to more than 16.

Fair value accounting allows standard setters to write simple accounting rules for complex transactions. However, when fair value measurements rely on explicit authoritative guidance in situations where no fair values (market values) are available, fair value accounting is no longer able to “tame” transaction complexity.

Simpler fair value accounting standards reduce auditing fees. However, a reliance on more authoritative guidance that provides what to measure, when to measure and how to measure leads to higher auditing fees.

The authors recommend using market valuation in accounting standards with a caveat. The benefit of market valuations could be outweighed by deterioration in other accounting properties. Standard setters should examine these trade-offs before establishing financial reporting rules. For example, fair value accounting does not force reported earnings and cash flows to converge over a reasonable time horizon.

Figure 1: Plot of Transaction Complexity versus Accounting Complexity

