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Transaction Complexity and the Movement to Fair Value Accounting

- **Our global economy has pushed the complexity of business transactions to a new level, as companies now employ sophisticated contracts and financial instruments**
- **Our findings suggest that complex transactions result in complex accounting guidance, making the standards difficult to read and understand**
- **However, the use of fair value accounting might be a solution to the challenges arising from transaction complexity**
- **Our study informs regulatory bodies, investors, creditors, and public companies that are increasingly concerned about the state of financial reporting standards, which arguably have become very costly to implement yet less effective in communicating the economic substance of complex transactions**

The knowledge economy has increased the complexity of business activities. Business transactions have evolved from simple exchanges of goods and services to exchanges involving sophisticated contracts and financial instruments. The proliferation of complex securities and derivatives, where dramatic uncertainty and contingencies exist, makes it difficult even for the profession and practice of law (Lipshaw 2005). Furthermore, organizations have become interdependent, since they engage in integrating and coordinating business processes (Ketchen, Crook, and Craighead 2014; Larsen, Manning, and Pedersen 2013). Increased transaction complexity follows from intertwined business relationships (Zhou 2012; Ding, Dekker, and Groot 2013).

Yet, it is unclear how current accounting and reporting standards anticipate the new complexities and uncertainties of business transactions. On the one hand, complex transactions

demand that accounting standards become increasingly complex as well (see, e.g., Thornton 2016). Importantly, the history and development of accounting thought, theory, and standards have been intertwined with broad economic development in a reciprocal linkage. Accounting is considered one of the oldest human recordkeeping systems and is designed to support commerce.2 Accounting is arguably an economic institution that always evolves in response to market forces (Waymire and Basu 2008; Watts and Zuo 2016). As such, accounting practices and standards are expected to adapt to transaction complexity.

On the other hand, Dye, Glover, and Sunder (2015) aptly argue that formulating complex accounting standards in response to transaction complexity can be problematic. They assert that it is not feasible for accounting standard-setters to incessantly promulgate complex rules in order to win the "arms race" against the development of transaction complexity. Innovations in transaction complexity escalate rapidly because sophisticated financial experts continuously engineer transactions to keep up with modern economies (Glode, Green, and Lowery 2012). In contrast, new accounting rules take years to develop. The development of accounting theory combined with financial reporting standards due to changes in the level of complexity underlying business transactions and activities has been somewhat simultaneous, with both theory and standards usually lagging behind the development in commerce. Accordingly, to some extent, accounting has always been playing catch-up with the underlying business transactions.

Dye, Glover, and Sunder (2015) also point out that the desire to constantly update standards may lead standard-setters to write overly detailed and complex rules that, ironically, result in suboptimal financial reporting. In a similar vein, Lev and Gu (2016) claim that accounting regulation has grown excessively complicated in response to the complexity of the business environment. They describe this phenomenon as "the Lev-Gu law of the dynamics of regulation," which means that "regulatory systems strive to be even more complex than the structures or institutions they were charged to regulate" (2016, 221). Lev and Gu argue that the escalation of accounting complexity is a major reason for the deterioration of usefulness in accounting information. The increase in accounting complexity makes accounting information difficult to decipher. At the same time, the information is losing its relevance because accounting standards are unable to capture all the nuances of business complexity (Lev and Gu 2016).

The first objective of our study is to find empirical evidence that the complexity in the underlying transactions is manifested in the complexity of the authoritative guidance used in the affiliated reporting standards.3 Our investigation draws upon a fundamental notion in systems theory, which dictates that all control mechanisms, including accounting regulation, require a

more complex mechanism than the process or activity being controlled.[4] Our findings support this argument. Next, our study examines the economic consequences of accounting complexity. Specifically, we show that an audit fee premium is placed on complex transactions. In addition, we conjecture that the use of fair values for financial accounting and reporting is more effective than overly complex accounting standards to cope with the increase in transaction complexity. Supporting our hypothesis, our study suggests that the audit fee premium is mitigated when using fair values instead of complex authoritative guidance. Drawing on this finding, our study provides insights into the development of accounting standards moving toward a fair value approach.