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The Relevancy Concept in Accounting

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The studies and recommendations published in the period 1971-73 by several major public accounting firms and the Study Group on the Objectives of Financial Statements renewed interest and discussion concerning the objectives of financial reports. Each group recognized that the accounting function is or should be utilitarian and made some attempt to identify the anonymous "user" of financial data and his using habits.

Pressures brought by regulatory agencies, court rulings, and changes in attitudes and social and economic conditions require that the accounting profession sharpen its focus in regard to who is to be the recipient of accounting data and how that data is to be used. Much of the debate on how to bring about changes in accounting practice involves the question of utility and problems of measurement. In this regard, accountants must recognize that the utility of and approach to measurement of accounting data are dependent on the relevancy of the data to the user.

Relevancy is not an idle word nor a pennant hung from the ramparts of the academician's ivory tower. Relevancy is the primary criteria by which the value of accounting data should be evaluated. This paper incorporates an analysis of the concept of relevancy and a review of its importance to accounting.

Relevancy as a Concept

Accounting is generally described as a service activity which provides quantitative information about an economic entity that is useful in making economic decisions. Financial statements are the means by which the information is communicated to those who make decisions related to an economic entity. It is generally believed that the financial statements are designed to serve the needs of a variety of users which includes owners and creditors.[1] Based on need identification, the accountant selects data that is critical and prepares abstractions of data for decision models. What criteria does the accountant use in the selection, formulation, and communication of financial data? It would appear that whatever the criteria used, it should provide reasonable assurance that the accounting data will be recognized as having the quality of utility.

Most accountants would likely identify generally accepted accounting principles as the criteria used to select data necessary for fair financial reporting. More specifically, the entity concept, continuity, realization, objectivity, cost, consistency, matching, full disclosure, materiality, etc., would be the principles named as criteria for data selection and reporting. However, the thread which binds each of these principles, and provides for a measure of acceptance, and compromise when they conflict, is the concept of relevance.

Relevant means that the proposition is to the point or pertinent to the matter being considered. Pertinent, germane, and material are considered by many to be synonymous with relevant. To be relevant, the proposition must be logical and have a precise bearing, closely related to the problem, and required to complete or solve the problem. The 1961 Management Accounting Committee of the American Accounting Association stated that:

> *Relevance* focuses upon the end use to be made of reported information. Accounting information is relevant if it is useful for the purpose for which the report has been designed. Releveant data may be objective data or subjective data or a combination of the two.[2]

In the American Accounting Association's, *A Statement of Basic Accounting Theory*, relevancy is identified as a standard which requires that information be usefully associated with results desired or actions which it is expected to facilitate. To apply this standard, it is of prime importance that the information needs of potential users be known or can be assumed.[3]

In the *Statement of the Accounting Principles Board, No. 4*, relevance is identified as a qualitative objective.

Relevant information is identified as that which bears on the economic decisions for which the information is used.[4] The concept of relevance is so important that data not meeting the test cannot be considered useful and should be considered misleading.

The relevancy concept is most visibly associated with management accounting as a criteria by which data inputs are selected and measured for decision models. Relevancy is often referred to in management accounting as a concept, principle, or standard. The term, relevancy, is much less often used or referred to in financial accounting practice or literature. Perhaps the reason is found in the view expressed that data reported within general purpose financial statements are not intended to be relevant for every use a reader might wish to make of them. Therefore, relevance is not as important in selection and adjustment of externally reported data as it is for internal reporting.[5] However, it should be clear that published financial data are evaluated on the basis of relevancy. Some recent publications indicate that accountants are more concerned with the relevancy of financial reports than in the past. It is observed that surrogate terminology such as utility and materiality may have been used in financial accounting rather than relevancy.

Accounting as a Utilitarian Function

Utilitarian pertains to or associates with utility, stresses the value of practical qualities and the quality of usefulness. If accounting is to be utilitarian, the nature of the utility must be determined. Usefulness of financial information is necessarily of a subjective quality. It changes over time and varies within the context of the enterprise and its environment,[6] the user or composition of users, and the decision models to which the financial information will serve as input. "The utility of information lies in its ability to reduce uncertainty about the actual state of affairs of concern to the user."[7]

Arthur Andersen & Co. indicated the importance of utility in this statement:

> Financial statements are strictly utilitarian. A fundamental consideration, therefore, in seeking to define the objectives of financial statements and in resolving individual accounting questions is what is most useful on the broadest possible basis for users of financial statements. While some have argued that usefulness is obvious and not helpful as a criterion, it has nevertheless been too often ignored and too easily forgotten. Extensive literature has been written developing complex accounting structures, arguing points to an ultimate of logic and consistency, with little apparent attention being given to whether the results are useful to those who need financial information.[8]

Accounting has been described as a language, a communication system, and a service function to management. Regardless of the description, it is the intelligent and conscious use of accounting data that justifies the accounting process. Accounting data required by management for decision models are relatively easy to determine because the users and problem can be defined with greater definity, and direct communication between producers and users is possible. The same can be generally said for financial reports provided for a specific purpose and user outside of the enterprise. The problem is, however, more pronounced in the case of general published financial statements because the users and their decision problems are diverse and less definable with a degree of certainty. As a result, certain assumptions about users and their data needs must be made by the accountant.[9]

Published financial reports are often referred to as general all-purpose statements. Price Waterhouse & Co. has stated that "there is no such thing as all-purpose financial reporting. Financial statements require a specific orientation."[10] The historical orientation of financial reporting has been toward the collective owners of the enterprise. Much of the current dissatisfaction with financial reports has resulted from overreaction to new business conditions and changing mores. Halfway departures from the historical thrust of financial reporting have confused accountants and businessmen.[11]

> ...The utility of financial statements oriented to the investor's well being doesn't have to be established. The cause for the present criticism is failure to reaffirm that concept and a failure to stick to that concept.[12]

Financial reports are the principal means of communicating financial information about an enterprise. If communication is to be effective, it is essential that the message be sent to the proper user(s), that it contain data relevant to user(s) needs, and that the user(s) understand the message. General or all-purpose financial statements may fail to communicate simply because they cannot be all things to all people. Such statements may represent only chaotic listings of bits of data. Effective communication cannot occur without a target.

Generally accepted accounting principles are the acknowledged criterion for preparation of fair financial reports.

Relevancy is not an idle word nor a pennant hung from the ramparts of the academician's ivory tower.

Recent efforts by the Accounting Principles Board and now the Financial Accounting Standards Board to develop such accounting principles appear to be directed toward a legalistic codification of a body of inflexible and at times conflicting rules and procedures. The introduction of rigidity resulting from attempts to refine financial data will reduce the usefulness of the data.

The elements of indisputable fact within financial statements are relatively few. Acknowledgement that, even under the rigid concepts of today, financial statements are essentially based upon opinion and judgment would be helpful. The clinging to completely "objective" data which is irrelevant can only be harmful to the profession.[13]

> ...Only as accountants acknowledge with forthrightness that the measurement of economic data involes uncertainties, estimates and judgments will they release themselves from the rigid grip of "objecticity" and move toward relevance and, hence, usefulness.[14]

The recipients of financial information need relevant information. This requirement takes precedence over all other characteristics associated with the information. The selection of concepts, principles, rules, and methodology must meet the test of relevance.

Materiality is a modifier of relevance and not a substitute for it.

...surrogate terminology such as utility or materiality may have been used in financial reports rather than relevancy.

An operational application of relevancy requires the specification of the information required by the user in decision-making. Specification of relevant information can be derived from normative or descriptive decision models. It is neither possible nor desirable to present all the relevant information because of measurement problems and user constraints. Where information is provided for specific users and purposes, the concept of relevancy can be implemented with greater definition and measurement.[15] Much of the operational refinement has come from management accounting.

Materiality and Relevancy

"The concept of materiality has long been considered a fundamental and integral part of the financial accounting and reporting process."[16] Materiality basically means that only those factors having significance need by considered. A factor is considered significant based on its relationships, both quantitatively and qualitatively, with other factors and with the environment in which decisions are to be made. The factor is not necessarily considered material or significant because of its basic nature. It is this distinction which differentiates between relevancy and materiality. Relevancy determines those factors which have an inherent relationship to the decision, whereas materiality directs the sorting and identification of only those factors which are of sufficient magnitude, qualitative as well as quantitative, to have significant impact on the decision results. Materiality is a modifier of relevancy and not a substitute for it. It appears that materiality is used as a substitute in practice.

Pattillo and Siebel stated that "relevance" and "materiality" are not synonymous terms and should not be treated as such by information providers or users. Relevance determines whether an item should be considered, whereas materiality indicates how important the item is to the user.[17]

Paul Grady listed ten basic concepts drawn from current experiences and views to which accepted accounting principles are oriented. Materiality was listed, relevancy was not. Each of the concepts were justified as providing qualitites of usefulness and dependability to accounting information.[18] Grady offered the following definition:

> A statement, fact, or item is material, if giving full consideration to the surrounding circumstances, as they exist at the time, it is of such a nature that its disclosure, or the method of treating it, would be likely to influence or to "make a difference" in the judgment and conduct of a reasonable person. The same tests apply to such words as significant, consequential, or important.[19]

Materiality is necessarily a matter of judgment concerning proportions. An unrealistic attachment to exactitude has caused much confusion over materiality. Some have erroneously elevated materiality to the status of a basic accounting concept. And, unfortunately, some rather suspect accounting practice has been hidden behind the cloak of immateriality.[20]

Importance of Relevancy to Accounting

Most accountants would likely agree that the modern accounting system should be a multi-purpose integrated information system flexible enough to achieve management's information needs. The distinction between financial and management accounting is primarily that of distinguishing the user and purpose for which the information is processed. The concept of relevancy is fundamental to both financial and management accounting. If this concept is disregarded or ineffectively implemented, the service rendered to management and other users will be inadequate and/or misleading.

The management accountant provides many information services, of which, income determination is one. It is imperative that the accountant be able to distinguish the relevant from irrelevant data. The quality of relevancy is an indispensable tool of information service to management.[21]

The American Accounting Association identified relevance as one of the four basic standards (relevance, verifiability, freedom from bias, quantifiability) for accounting information. Information which does not adequately meet these criteria collectively is unacceptable. Primary importance was attributed to relevance.[22]

> The standard of relevance is primary among the four recommended standards. Although not sufficient as a sole criterion, it represents a necessary characteristic of all accounting information. None of the other standards has this position of primacy...[23]

In statement No. 4 of the Accounting Principles Board, it was noted that a set of seven qualitative objectives aid in determining what and how resources should be measured and reported to make the information most useful. Of the seven qualitative objectives, relevance is primary.[24]

> The objective of relevance helps in selecting methods of measuring and reporting in financial accounting that are most likely to aid users in making the types of economic decisions for which they use financial accounting data...Relevance is the primary qualitative objective because information that does not bear on the decisions for which it is used is useless, regardless of the extent to which it satisfies the other objectives.[25]

The importance of relevance is not whether it is a standard or objective, but rather the conscious use of the concept by accountants in fulfilling their role. The resort to legalism and the inappropriate and overzealous use of generally accepted accounting principles can only result in continued criticism as a result of what Abraham Briloff has termed "creeping irrelevance."[26] Perhaps, it is best to view relevancy as a criteria by which accountants can better select appropriate data for various decision models.

Summary

As a concept, relevancy is difficult to define in an operational sense. Nonetheless, its importance to the accounting process cannot be overstated. Utility and materiality are used as surrogates for relevancy in financial accounting. This, too often, results in emphasis being misplaced. If accounting information does not meet the criteria of relevance it cannot have the quality of usefulness. Materiality is considered by

many accountants to be synonymous with relevancy. However, it is important to recognize that an item is relevant if it is inherently related to the use of the data, and material if it is important enough to be considered.

FOOTNOTES

[1]**Accounting Principles Board of the American Institute of Certified Public Accountants,** *Statement of the Accounting Principles Board, No. 4, Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises,* (New York: The American Institute of Certified Public Accountants, 1970), p. 6.

[2]American Accounting Association, "Report of the Management Accounting Committee," *The Accounting Review,* XXXVII, No. 3 (July, 1962), p. 532.

[3]American Accounting Association, *A Statement of Basic Accounting Theory* (Evanston: American Accounting Association, 1966), p. 7.

[4]*Statement of the Accounting Principles Board, No. 4,* p. 36.

[5]American Accounting Association, "Report of the Management Accounting Committee," p. 533.

[6]*Objectives of Financial Statements for Business Enterprises* (Chicago: Arthur Andersen & Co., 1972), p. 7.

[7]American Accounting Association, *A Statement of Basic Accounting Theory,* p. 8.

[8]*Objectives of Financial Statements for Business Enterprises,* Arthur Andersen & Co., p. 7.

[9]Study Group on the Objectives of Financial Statements, *Objectives of Financial Statements* (New York: American Institute of Certified Public Accountants, 1973), p. 13.

[10]*The Objective of Financial Statements* (New York: Price Waterhouse & Co., 1971), p. 3.

[11]Ibid., p. 3, 17.

[12]Ibid., p. 17.

[13]*Objectives of Financial Statements for Business Enterprises,* Arthur Andersen & Co., p. 12.

[14]Ibid., p. 12.

[15]Eldon S. Hendriksen, *Accounting Theory,* Revised Edition (Homewood: Richard D. Irwin, Inc., 1970), pp. 105-06.

[16]FASB Discussion Memorandum, *An Analysis of Issues Related to Criteria for Determining Materiality* (Stamford: Financial Accounting Standards Board, 1975), p. 24.

[17]James W. Pattillo and Jerry D. Siebel, "The Concept of Materiality," *Financial Executive* (October, 1973), p. 28.

[18]Paul Grady, *Inventory of Generally Accepted Accounting Principles for Business Enterprises,* Accounting Research Study, No. 7 New York: American Institute of Certified Public Accountants, Inc., 1965), p. 24.

[19]Ibid., p. 40.

[20]*Objectives of Financial Statements for Business Enterprises,* Arthur Andersen & Co., p. 40.

[21]Richard M. Lynch, *Accounting for Management: Planning and Control (New York: McGraw-Hill Book Company, 1967), p. 11.*

[22]*American Accounting Association, A Statement of Basic Accounting Theory,* pp. 7-9.

[23]Ibid., p. 9.

[24]*Statement of the Accounting Principles Board, No. 4,* pp. 35-36.

[25]Ibid., p. 36.

[26]Abraham J. Briloff, *Unaccountable Accounting* (New York: Harper & Row, Publishers, 1972), p. 7.

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Correction

Paragraph Four, Column One, Page Twelve of the January issue incorrectly defines the hour of continuing professional education as it relates to Kansas. The Kansas State Board of Accountancy in its register of laws and regulations for the year ending June, 1977, states under Article 9, Continuing Education:

"A (1) Credit is to be counted in full hours only.

(A 50-minute period will be considered as being equal to one hour.)"

Omission

Exhibit III was inadvertently omitted from the article appearing in the January 1977 issue entitled "Continuing Professional Education Requirements for National Accounting Organizations," by Glenda E. Ried, CPA. Copies of the exhibit will be sent upon receipt of a request addressed to the Editor.

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