

Relevance and Reliability

By L. Todd Johnson



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The FASB's goal in setting standards is to enhance the usefulness to investors and creditors of the information that entities report in financial statements and other financial reporting. In assessing whether the usefulness of information would be enhanced, the FASB considers the "qualitative characteristics" that make accounting information useful to investors and creditors.

FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, identifies those qualities, defines them, and explains how they interact with one another.

Concepts Statement 2 explains that the primary qualities of accounting information are relevance and reliability, and that to be useful, information must possess both of those qualities. However, information may possess those qualities to differing degrees, which requires the Board to make trade-offs between relevance and reliability in reaching decisions about standard-setting issues.

Trade-Offs between Relevance and Reliability

Some FASB constituents have questioned certain of the trade-offs between relevance and reliability that the Board has made in setting accounting standards. Specifically, they have questioned the appropriateness of the trade-offs that the Board has made in requiring financial statement measures that reflect fair values rather than historical costs. Their underlying presumption seems to be that historical costs, while perhaps not as relevant as fair values, are clearly more reliable. In those instances, they assert that the trade-off between relevance and reliability should favor historical costs rather than fair values.

Some who question the Board's trade-offs seemingly believe that reliability should be the dominant characteristic of financial statement measures. Others appear to interpret reliability as having a meaning that differs in at least certain respects from how that term is defined in the conceptual framework. To analyze those views, it is instructive to consider what the conceptual framework says with regard to making trade-offs between relevance and reliability and the meaning of reliability.

The pertinent conceptual guidance for making trade-offs between relevance and reliability is provided by Concepts Statement 2. It provides guidance for the Board and others in

making standard-setting decisions aimed at producing information useful to investors and creditors.

Concepts Statement 2 states:

The qualities that distinguish "better" (more useful) information from "inferior" (less useful) information are primarily the qualities of relevance and reliability. . . . The objective of accounting policy decisions is to produce accounting information that is relevant to the purposes to be served and is reliable. [paragraph 15]

Paragraph 15 adds that there are gradations of relevance and reliability and notes that problems may arise if trade-offs between them are necessary.

Objectives of Making Trade-Offs

In discussing those trade-offs, Concepts Statement 2 acknowledges that different FASB constituents (and different groups of those constituents) may have different views about what the trade-offs between relevance and reliability should be. That is because they attach different importance to one quality as opposed to another and, for that reason, their willingness to trade one quality for another also will differ.

For example, preparers are likely to place greater importance on the reliability of measures in financial statements in order to pass audit scrutiny. Similarly, auditors are likely to place greater importance on the reliability of measures in the financial statements that they audit because of their legal exposure. In contrast, investors might place greater emphasis on the relevance of those measures in forecasting the entity's future earnings or financial position.

Concepts Statement 2 concludes that even though considerable agreement exists about the qualitative characteristics that "good" accounting information should have, no consensus can be expected about their relative importance in a specific situation because different constituents have or perceive themselves as having different needs and, therefore, different preferences. Accordingly, it should not be surprising that some constituents might have different views about the trade-offs that should be made between relevance and reliability than the Board. That is because the Board's objective—providing guidance that results in the provision of accounting information that is useful to investors and creditors—may differ from their objectives.

Whether Reliability Should Dominate Relevance

As noted above, Concepts Statement 2 states that, to be useful, financial information must be both relevant and reliable and acknowledges that information may possess both characteristics to varying degrees. However, it cautions that neither characteristic can be dispensed with entirely.

Concepts Statement 2 addresses the importance of reliability in financial statements in the context of information that is conveyed

by financial statements and information that is conveyed outside of financial statements:

Although there seems to be considerable support for the view that reliability should be the dominant quality in the information conveyed in financial statements, even at the expense of relevance, while the opposite is true of information conveyed outside the financial statements, that view has in it the seeds of danger. Like most potentially harmful generalizations, it does contain a germ of truth: almost everyone agrees that criteria for formally recognizing elements in financial statements call for a minimum level or threshold of reliability of measurement that should be higher than is usually considered necessary for disclosing information outside financial statements. But the remainder of the proposition does not follow. If it were carried to its logical conclusion . . . the end would be that most really useful information provided by financial reporting would be conveyed outside the financial statements, while the audited financial statements would increasingly convey highly reliable but largely irrelevant, and thus useless, information. [paragraph 44]

Concepts Statement 2, therefore, rejects the view that reliability should be the dominant characteristic of financial statement information and suggests that relevance should have at least an equal standing.

What Reliability Means

As noted above, some who have questioned the Board's trade-offs seemingly interpret the meaning of reliability differently than how that term is defined in Concepts Statement 2. Some seem to equate reliability with *precision*, and others view it principally in terms of *verifiability*. Analyzing those views requires considering what reliability means (and does not mean) in the conceptual framework.

In its glossary of terms, Concepts Statement 2 defines reliability as the quality of information that assures that information is reasonably free from error or bias and faithfully represents what it purports to represent. With respect to measures, it states that “[t]he reliability of a measure rests on the faithfulness with which it represents what it purports to represent, coupled with an assurance for the user, which comes through verification, that it has that representational quality” (paragraph 59). Thus, the principal components of reliability are *representational faithfulness* and *verifiability*.

Representational Faithfulness

Concepts Statement 2 describes *representational faithfulness* as follows:

Representational faithfulness is correspondence or agreement between a measure or description and the phenomenon it purports

to represent. In accounting, the phenomena to be represented are economic resources and obligations and the transactions and events that change those resources and obligations. [paragraph 63]

For example, the representation of receivables in a balance sheet at a specified dollar amount, net of any allowance for bad debts, purports that the stated number of dollars is collectible. However, if the allowance is too small and many more of the receivables are uncollectible, that depiction would not be reliable because it would not be representationally faithful of the number of dollars that is collectible.

What sometimes is overlooked is the requirement that, to be representationally faithful, accounting measures or descriptions must reflect *economic phenomena*—economic resources and obligations and the transactions that change them—and not simply accounting notions. Consider, for example, so-called “deferred charges” or “deferred credits” sometimes seen in balance sheets. If deferred charges do not reflect economic resources that are assets, and if deferred credits do not reflect economic obligations that are liabilities, those depictions are not representationally faithful. For that reason, those depictions would not be reliable and, hence, not useful.

Verifiability

Concepts Statement 2 states that “the purpose of verification is to provide a significant degree of assurance that accounting measures represent what they purport to represent” (paragraph 81).

Verifiability has three key aspects:

1. Consensus among observers
2. Assurance of correspondence to economic things and events
3. Direct verification versus indirect verification.

Consensus among Observers

Verification requires consensus among observers. Accounting measures that are determined by one measurer must be confirmed or substantiated by other measurers that reach essentially the same result from measuring the same phenomenon. In that regard, there may be more consensus among observers about some measures than others. For example, measures of cash by different observers are more likely to be clustered together than their measures of receivables (net of the allowance for bad debts), in part because of differences in views about the collectibility of those receivables.

However, consensus among observers cannot be assessed in isolation. Rather, it must be assessed in the context of both correspondence to economic things and events and direct verification versus indirect verification, as discussed below.

Assurance of Correspondence to Economic Things and Events

Concepts Statement 2 states that “the *purpose of verification* is to provide a significant degree of assurance that accounting measures represent what they purport to represent” (paragraph 81, emphasis added). That is, the purpose of verification is to provide assurance as to the correspondence of accounting information to real-world economic phenomena.

Accounting information may not correspond to economic things and events because of measurer bias, measurement bias, or both. *Measurer bias* may be unintentional (for example, because of lack of skill) or intentional (for example, because of lack of integrity), which may be evidenced by misapplication of the measurement method. *Measurement bias* results from using a measurement method that is unlikely to produce a result that represents what it purports to represent, such as a method that consistently produces results that understate or overstate the item in question.

Direct Verification versus Indirect Verification

With *direct* (or *separate*) *verification*, the accounting measure itself is verified, such as by counting cash or observing quoted prices for marketable securities. Another example of direct verification is counting inventories to verify their *quantity*.

With *indirect verification*, the accounting measure is verified by checking the inputs and recalculating the outputs, using the same accounting methodology. An example is the carrying amount of inventory, which is indirectly verified by verifying the inputs (quantities and costs) and recalculating the ending inventory using the same cost flow assumption (that is, LIFO, FIFO, etc.). Consensus among measurers with indirect verification is unlikely unless the measurers include the same inputs (costs) and use the same accounting methodology, because otherwise there likely will be a wide dispersion in their results.

Direct verification tends to minimize both measurer bias and measurement bias. In contrast, indirect verification tends to minimize only measurer bias and not any measurement bias from the selection of accounting or allocation methods. Thus, even though there is consensus among measurers, an indirectly verified measurement may not be reliable if the accounting method results in a measure that does not correspond to the economic phenomena that it purports to represent.

Examples of measures that are directly verifiable are those that reflect exchanges in the marketplace between independent entities. Examples of measures that are only indirectly verifiable are those that result from allocations. That is because allocation methods interpose calculations (or other means of assigning costs to particular items or particular time periods) between the original inputs that are based on marketplace transactions that the entity engaged in and the accounting outputs. While the inputs and calculations may be verifiable, the resulting outputs are not, except by recalculating and applying the same procedures.

Because the representational faithfulness of accounting measures that involve calculations and allocations cannot be directly verified, the reliability of many accounting measures may be considerably lower than is commonly assumed. As Concepts Statement 2 notes, “[m]ore than one empirical investigation has concluded that accountants may agree more about estimates of the market values of certain depreciable assets than about their carrying values. Hence, to the extent that verification depends on consensus, it may not always be those measurement methods widely regarded as ‘objective’ that are most verifiable” (paragraph 85).

That may be illustrated by the carrying amounts of inventory. Suppose that the cost of goods sold in a period is determined to be \$17 million under a FIFO cost flow assumption, \$26 million under a LIFO cost flow assumption, and \$22 million under average cost. Suppose further that a reported profit of \$5 million would result from a FIFO assumption, a \$4 million loss from a LIFO assumption, and zero profit or loss from average cost. All of those amounts are equally verifiable, but only indirectly, yet they differ significantly from one another. Such differences raise questions about their reliability.

What Reliability Does Not Mean

Accountants presently use a wide array of accrual and deferral methods (which include allocation and amortization methods) in preparing financial statements. Those methods are essentially mathematical constructs and applying those methods results in outputs of dollar amounts that are quite precise. However, that precision reflects the precision of mathematics rather than the precision of the depiction. And even though those outputs are precise, they may not faithfully represent the economic thing or event that is being depicted in the financial statements. That is, the outputs might depict the wrong assets or liabilities or mismeasure those assets and liabilities.

Most measures of real-world phenomena are imprecise to a degree. As Robert R. Sterling notes:

*Accountants who continue to seek more precision are to be admired and encouraged. However, those who seek absolute precision might be instructed by considering what has been learned in the so-called “exact” sciences. Einstein . . . drew a sharp and clear distinction between the certainty of calculation and the uncertainty of representations of phenomena: “As far as the laws of mathematics refer to reality, they are not certain; and as far as they are certain, they do not refer to reality.” The same is true for accounting: as far as the mathematical methods used in accounting refer to reality, they are not certain; as far as they are certain, they do not refer to reality.*¹

Depreciation accounting is an example. Given the input of the cost of the item, an accountant can readily calculate with great precision the depreciation of that item for a particular period and

its net carrying amount at the end of the period. Moreover, that calculation can be replicated by another accountant, provided that he or she uses the same cost, the same expected useful life, the same expected residual value or fair value, and the same depreciation method, as the first accountant did. Absent any procedural error or computational error, the two accountants would be expected to calculate precisely the same income statement and balance sheet amounts. But would those measures faithfully represent the economic magnitude of the asset and its depreciation during the period?

The accounting profession has responded to such questions by adopting definitions like the following one that was adopted by the Committee on Accounting Terminology of the AIA (the AICPA's predecessor) in Accounting Terminology Bulletin No. 1, *Review and Résumé*:

Depreciation accounting is a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not of valuation. [paragraph 56]

. . . a cost or other basic value is allocated to accounting periods by a rational and systematic method and . . . this method does not attempt to determine the sum allocated to an accounting period solely by relation to occurrences within that period which affect either the length of life or the monetary value of the property. Definitions are unacceptable which imply that depreciation for the year is a measurement, expressed in monetary terms, of the physical deterioration within the year, or of the decline in monetary value within the year, or, indeed, of anything that actually occurs within the year. [paragraph 54]

That definition of depreciation specifies the real-world phenomena that depreciation accounting *does not* purport to represent, but fails to specify what it does purport to represent. Lacking that specification, the representational faithfulness of the outputs of depreciation accounting cannot be determined because the correspondence of those calculated measures to real-world economic phenomena cannot be assessed. Those accounting outputs cannot be directly verified, but rather only indirectly verified by recalculations.

Even though the *precision* of calculated measures such as those in depreciation accounting is not open to question since they can be calculated down to the penny, the *reliability* of those measures is open to question. Precision, therefore, is *not* a component of reliability under Concepts Statement 2. In fact, Concepts Statement 2 expressly states in paragraph 72 that reliability does *not* imply certainty or precision, and adds that any pretension to those qualities if they do not exist is a negation of reliability.

Concluding Comments

The Board has required greater use of fair value measurements in financial statements because it perceives that information as more relevant to investors and creditors than historical cost information. Such measures better reflect the present financial state of reporting entities and better facilitate assessing their past performance and future prospects. In that regard, the Board does not accept the view that reliability should outweigh relevance for financial statement measures.

In adopting such requirements, the Board has been mindful of reliability concerns associated with fair value measures, particularly when such measures may not be able to be observed in active markets and greater reliance must be placed on estimates of those measures. However, the Board has observed that present-day financial statements are replete with estimates of monetary amounts that are viewed as being sufficiently reliable. Indeed, present-day measures of many assets and liabilities (and changes in them) are based on estimates, for example, the collectibility of receivables, salability of inventories, useful lives of equipment, amounts and timing of future cash flows from investments, or likelihood of loss in tort or environmental litigation. Although some constituents may perceive those measures as being more precise than fair value measures, others might disagree; in any event, in the conceptual framework, reliability is about faithful representation and verifiability, not precision. Moreover, many present-day financial statement measures are not more—and may be less—representationally faithful of the economic phenomena being depicted than fair value measures. Additionally, many present-day financial statement measures are not as verifiable as many believe because those measures can be verified only indirectly, not directly.

¹ Robert R. Sterling, *An Essay on Recognition* (1985), p. 28.