

## RELEVANCE AND CREDIBILITY OF THE INFORMATION FROM THE FINANCIAL-ACCOUNTING STATEMENTS

University Lecturer Ph.D. Marilena ZUCA  
Romanian American University, Bucharest, Romania  
[marilena\\_zuca@yahoo.com](mailto:marilena_zuca@yahoo.com)

### **Abstract:**

*The relevance of the accounting information is one of the most significant features in terms of quality and refers to its capacity to influence investors, creditors and other users of the financial statements in their decision-making. A relevant piece of information helps the user assessing present, future and past events, confirming and correcting potential past errors. The information's relevance regarding a certain element which must be acknowledged in financial statements, may not be assessed distinctly, but it must be assessed within the frame of the main objective of the financial statement, namely to provide useful information for decision-making with respect to investments, financing or exploitation. Moreover, the relevance must be taken into account within the frame of the drafting of the entire set of the financial statements and the way according to which an acknowledged element is useful in the decision-making process.*

*The credibility assumes that the accounting information does not comprise any significant error or subjectivism and it offers a faithful image of the mirrored phenomena or processes. The conceptual frames detail the elements which ensure the information's credibility equally in terms of content, but underlined in terms of wording. Thus, the accounting information must be objective (to faithfully mirror the transactions and events), must reflect the meaning and consequences of the economic events just as the legal requirements, it has to be neutral (to avoid influencing a decision or issuing a judgment for the accomplishment of a pre-determined outcome or objective), it must be complete and illustrated within the limits of cautiousness.*

*Subsequently the perusal of the argument for the two classes of opinions, we conclude that the information provided in the financial statements must be believable enough and relevant enough at the same time. Thus, the result of the display in the financial statement must comply with the cross point of these two features.*

**Keywords:** financial statements, accounting information, economic decision, the relevance, the credibility

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## **INTRODUCTION**

The professional judgment, supported by the accounting standards, allows companies to select their accounting policies regarding the ascertainment, assessment and display of financial-accounting information as long as the user's decisions are not affected.

Based on such idea, Simmons claims that the deviations, even the insignificant ones, trigger distortions of the comparability process. Hence, the need of additional certifications which ensure the users that the drafting grounds for the financial statements comply with approved standards. Moreover, it arises the high significance of a statement regarding the detailed display of the accounting policies in order to remove any trace of subjectivism upon the information's supply.

The effective use of the concept of comparability must be ascribed to the elements of materiality and subjectivism.

### **1. THE INFORMATION'S RELEVANCE. THE RELATIVE SIGNIFICANCE AND MATERIALITY BENCHMARK**

The relevance of the accounting information is one of the most significant features in terms of quality and refers to its capacity to influence investors, creditors and other users of the financial statements in their decision-making. A relevant piece of information helps the user assessing present, future and past events, confirming and correcting potential past errors. The information's relevance regarding a certain element which must be acknowledged in financial statements, may not be assessed distinctly, but it must be assessed within the frame of the main objective of the financial statement, namely to provide useful information for decision-making with respect to investments, financing or exploitation. Moreover, the relevance must be taken into account within the frame of

the drafting of the entire set of the financial statements and the way according to which an acknowledged element is useful in the decision-making process.

Example given: the ALFA Company manufactures apparel for the BETA Company, which operates a domestic retail chain. In time, BETA has become the main client, ensuring 80% of ALFA's retail market. Although, the international standards do not provide explicitly such case, the ALFA management has to provide in their financial statements, information regarding the sales' preponderance towards BETA in order to ensure the relevance of the information provided. BETA is a significant client, which may affect the future economic situation of ALFA. Therefore, failure to provide such relevant information may affect the decisions made by users based on the financial statements.

If the classification of the relevance among the qualitative features is accepted by all standards, the ways of the presentation and design of the explanatory discourse differs. Thus, the General IASB frame claims that the information's quality depends on the contribution of the information's nature and materiality benchmark to the drafting of the financial statements. The information's nature refers to the information's descriptive feature (related to a new activity segment, related to an incorporeal immobilization, etc.) and the materiality benchmark endorses the information's numerical feature (the value of the outcome achieved within the new segment, the value of the reported incorporeal immobilization, etc.).

By means of an original disposition, the British standard presents the materiality benchmark as a self-contained feature and more over the most significant feature. This significance arises from the fact that failure to provide insignificant information leads to complicated financial state ments, which limit the audibility of the other information provided. Two factors are under analysis for making the decision regarding the removal of insignificant information:

- a) The value of the element perused both taking into account the entire set of financial statements and the availability of the user's assessment.

And

- b) The nature of the provided element, mirrored by means of the transaction and events carried out, by means of their consequences, by means of the identity of the involved parties or by means of the class where such element is acknowledged.

The two positions regarding the reasoning ascribed to the materiality benchmark regarding the qualitative features are blended in the American frame. This defines the materiality benchmark distinctly from the qualitative features, but closely related to relevance and credibility. For instance, the decision to not provide certain information may be made due to the fact that investors (main users according to the American definition) do not need such information (it is not relevant) or the involved elements are too small (both in nature and value) to be provided (the information is not significant).

Exceeding these details regarding the approach and wording, the actual content displays the double role played by the information's relevance:

1. Foreknowledge role: the information regarding the financial status and the performance are used by management for forecasts regarding the company's ability to react in the future and to avoid unfavorable situations;
2. Confirmation role: the information from the financial statements is used to peruse previous forecasts and to define the company's management control (to confirm or correct previous assessments and forecasts).

The assessment of the past event's consequences mixed with present information generate information which represents the raw material for reshaping previous forecasts and for establishing new scenarios with respect to future activity.

We illustrate hereby the relevance's double role by means of an **example** based on the case of a company, which invests its moneys in order to obtain income from interests.

We start from the fact that the company keeps during the year if 200X, in a deposit, 20,000 u. m. with a rate of interest of 10%. The company's investing of the moneys would benefit to the company an interest of 13% for the year of 200X. We already have information regarding the

confirmation role of the information, namely the actual value of the moneys which may be invested and the actual interest rate. Therefore, the confirmation value allows the company to compare the amount of 20,000 u. m. from the beginning of the year of 200X with 22,000 u. m. that could be available at the end of the year of 200X. However, taking into account the forecasts, we may detail our perusal by orientation towards the future. Future pessimistic forecasts show an interest rate for investments to 12% and the optimistic ones to 15%. Forecasting an investment on term, the amount of 22,000 u. m. from the end of the year of 200X may bring to the company an overall gain of 2,860 u. m., taking into account the interest rate at the beginning of 200X, or a gain of 2,640 u. m., according to the pessimistic forecast, or a gain of 3,300 u. m., according to the optimistic forecast. Detailing further such information, the company may develop evolution scenarios, ensuring a significant basis for the decision-making process.

Providing in the financial statements such detailed information bestows relevance for users, as they narrow the decisions' diversity field and, implicitly, decreases the probability for erroneous construal, thus ensuring a guide of construal. In literature, we find various suggestions for information display. An alternative claims that it is highly significant to offer past information over present information, based on the fact that it offers the possibility to peruse the trend, which activates the information's usefulness in decision-making. Another alternative suggests that the financial statements should detail and the management's forecasts and synthesize the present values. Such display of the information helps the users to supersede the border arising from the lack of economic and accounting training and allows them to issue judgments regarding the managing performance. However, these arguments do not support the removal of present information, but they claim that such information should be illustrated within a past/future frame.

The study of Sterling illustrates an interesting association of present -past by analogy with navigation. The author sees the reported elements by means of the two coordinates of a watercraft's position: latitude and longitude and supports the idea that the present position is the one generated a future position. The optimal choice for reaching its destination may not be achieved in the absence of possible alternatives. The possible alternatives to be achieved in the future are defined according to the present position and the targeted destination.

Moreover, the present position is the result of the distances run in the past, seen by means of gains (the correct path) or losses (deviations from the correct path) generated by better or worse decisions. Thus, the present decision is the result of a past position and the distances run in the past. According to the same logic, the author claims that the present information arises from the past information and from the decisions made in the past. This information becomes ground for the future together with extrapolations of the past forecasts corrected with the past and present reality or related to forecasts built on future reality. In this respect, the present financial position (as the moment's image) and the past overall outcome (as reflection of the time period) reflect starting points in the achievement of the forecasts regarding the financial position and the performance, which bestow forecasting value to such information. If we bring the future into present, the present financial position and performance are the consequences of the forecasts made based on past information, which bestow confirmation value to such information.

Thus, the relevance, meant to ensure that the information provided is correct in order to make proper decisions, accomplishes its objective by means of the two values:

- a. Forecasting value - it uses past and present information to guide future decisions, and
- b. Confirmation value – ensures the grounds for comparing the effects of past decisions based on the information from the forecasting financial statements with the decisions to be made based on present statements.

## 2. INFORMATION CREDIBILITY OR FEASIBILITY. FAITHFUL IMAGE

The credibility assumes that the accounting information does not comprise any significant error or subjectivism and it offers a faithful image of the mirrored phenomena or processes. The conceptual frames detail the elements which ensure the information's credibility equally in terms of content, but

underlined in terms of wording. Thus, the accounting information must be objective (to faithfully mirror the transactions and events), must reflect the meaning and consequences of the economic events just as the legal requirements, it has to be neutral (to avoid influencing a decision or issuing a judgment for the accomplishment of a pre-determined outcome or objective), it must be complete and illustrated within the limits of cautiousness.

The faithful display of transactions and events is a primary element which ensures the credibility of the information provided in financial statements, as it ensures a balance between the information provided numerically and descriptively and the information's inductive phenomenon. Thus, the existence of an event or transaction is compelling in order for faithful information to be generated. This feature is embodied upon the level of the Balance sheet with regard to the display of the elements concerning the company's assets, debts and own capital according to the acknowledging criteria.

### Example

A company stipulates, in its financial statements, a piece of information regarding a doubtful debt in amount of 50,000 u. m. In order to ensure the faithfulness of the statement, it is necessary to check if:

- There is a sales transaction with due date which generated a debt in the past;
- The due date has been exceeded without being postponed by means of a payment tool;
- The assessment of the debt to 50,000 u. m. is believable (there are documents or rational and acceptable arguments);
- The probability of cashing in to future the amount of 50,000 u. m. is confirmed or it is necessary to re-assess it.

The description of transaction and event in the financial statements depends on the rights, obligations and economic resources, on their ascribed significance, on the assessment grounds and on the display techniques used to recognize them in the financial statements.

The credibility of events and transactions by means of faithful display is directly related to the display of the economic phenomena which affect the company's resources. The transactions' economic reality is comprised by the economic benefits generated by each transaction, which benefits enter or exit the company, ensuring, together with their believable assessment, the fulfillment of the criteria for the elements' ascertainment in the financial statements. Thus, the transactions' economic reality may ensure, in the absence of a complete legal form, a believable and useful display of information in the financial statements.

Moreover, a piece of information is believable if it is not influenced. Such neutrality is ensured when, by means of information selection and display, the decisions made or the judgments chosen by the management are not influenced in order to shape the outcomes.

The neutrality requirement refers not only to the possibility to choose between various accounting methods, which would generate differences regarding the information's display, but to the regulation gaps which allow the accountants to involve into the information's contents and to shape them in order to comply with the achievement of a pre-determined outcome. This limit must not be mistaken for an exclusion of the existence of a purpose governing the drafting of the financial statements or an exclusion of the professional judgment. It mainly refers rather to the limitation of the trend regarding the selective display of information.

It is very difficult to ensure the information's credibility because of the incertitude which features certain events and circumstances of the company. Such incertitude must be displayed in terms of nature and value and assessed based on cautiousness. By means of cautiousness, we understand that there must be taken into account a sort of cautiousness degree in the assessment issued under incertitude circumstances, thus the outcomes are not overestimated (the assets and incomes must not be overestimated and the debts and expenses must not be underestimated), but there must not be displayed highly cautious values as they affect the neutrality.

The limit up to which the cautiousness may reach in order to ensure all the other qualitative features is highly sensitive, especially due to the fact that cautiousness has always been seen as a means of permanent underestimation of the outcome. When the information held by the company leads to the same probability, namely an amount of money is lost or gained, the cautiousness tends to confirm the loss. However, if the probabilities are not equal, for instance, the possible alternatives generate losses, but with different values, the cautiousness does not compel the choice of the most pessimistic alternative.

The cautiousness triggers a difference regarding the approach of the qualitative features under different standards. Thus, if on international level, due to European influence, the cautiousness is defined as the credibility's grounded justification, the American standard, although not excluding the cautiousness in the information's display, deals with it critically, trying to bring into discussion its limits, under present circumstances, of convergence in the accounting regulation. The topics regarding the reassessment of the Conceptual frame underline the support of a flexible cautiousness.

Another element which ensures the information's credibility, sustained by all the accounting standards, is entirety (completeness), which implies the complete display of information, within reasonable limits, ensured by the materiality benchmark and the ration cost/benefit arising from the procurement of such information. Such limits are justified by means of the practical impossibility to display accurately the elements or consequences arising from transactions, especially in terms of their magnitude. The incertitude characteristic to the value's assessment, the specific of the professional judgment of various experts or even of the same expert at different moments, the permanent fluctuations of the factors used in mathematical calculations, on which the assessment is based, are elements which shape and explain the reasonable limits of the entirety of the information's display in the financial statements.

Such features of believable information are stipulated under each standard, but the display method differs. For instance, the American standard deems that a piece of information is believable if it is faithfully displayed, if it may be checked and if it is neutral. If the faithful display and neutrality are met under the requirements of the General IASB frame, the capacity to be checked is not defined as such, but it may be said that it is implicit.

The verifiability is the process by means of which independent observers issue assurances regarding the relevance and credibility of the information provided in the financial statements, by confirming the correspondence between the displayed image and the purpose perused for the events and transactions carried out. This quality is embodied by means of the accomplishment of an agreement between observers and of a correspondence between the economic and accounting aspects, but, also, between the direct and indirect verification of the displayed information. Thus, the information assessed by an evaluator may be deemed believable if it may be confirmed by another expert. This agreement presents various accomplishment degrees according to the nature of the displayed phenomenon or element. For instance, it is significantly easier to ensure an agreement for the presentation of a building than of a provision for disputes.

The need to ensure correspondence between economic and accounting aspects arises from the reality of erroneous construal made intentionally or unintentionally and which distorts the provided information. Such construal errors may be limited by direct control (quantitative inventory, confirmations debtors/creditors, confirmation of market values) or by indirect control (reassessment of inputs and recalculations of outputs, using the same methods). Examples of directly controllable information are those which mirror the transactions carried out on the market between various companies and examples of indirectly controllable information are those arising from costs' allotment arising from mathematic calculations, such as the calculation of the input cost as amount between the purchase price and the costs directly allotted to purchase or the calculation of the value recovered by means of amortization.

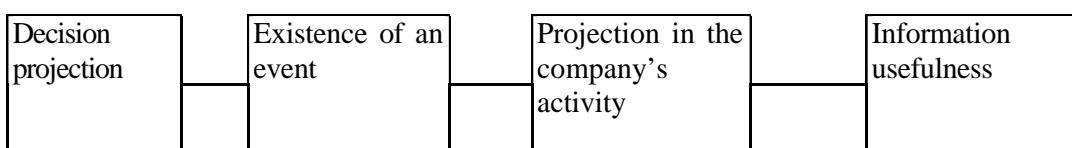
The *American frame* ascribes to credibility, features such as the appropriateness of the information's display or the ratio cost/benefit, which elements, according to the British or

international concepts are dealt with within the limits of the display of qualitative information and not among proper features.

### 3. CONCLUSIONS. THE CROSS-POINT RELEVANCE-CREDIBILITY IN THE FINANCIAL-ACCOUNTING STATEMENTS

In order to justify the features ascribed to credibility, it must be taken into account together with relevance. The usefulness of the provided information is carried out when both requirements are met. Although, the starting point is the idea that a relevant information may be as believable (or the opposite) as it may generate errors in the decision-making process, we deem that the two requirements must be met, without trying to decide if a better credibility supplies a lower relevance or the opposite. They are clearly defined features, which complete each other mutually, without intersecting. Thus, the relevance refers to the accomplishment of the connection between the economic phenomenon and the decision made for the company while the credibility describes the connection between the economic phenomenon and its display in the financial statements, both descriptively and in terms of value.

In order to provide a believable and relevant piece of information in the financial statements, the professional judgment must follow the following path:



The high generalization degree of the relevance concept triggers its layout in the decision-making frame in order to check the information's relevance. For instance, the assertion, according to which the supply of information regarding own capitals is relevant for investors' attraction, has quite another representation than the assertion, according to which the supply of information regarding own capitals is relevant. Identifying the decision which must be made based on the provided information must be placed within the frame of an event, transaction or phenomenon which may be related to the company's activity. Thus, the assertion, according to which reporting information regarding the provisions for disputes is relevant in order to establish the risk degree, which describes the company has a completely different meaning than reporting information regarding the provisions for disputes is relevant.

Detailing further, we may say that placing the decision within an event characteristic for the company triggers relevance for the information only if such information may be described. A piece of information, although relevant for the company, may be believably displayed (the control of the generated economic resources belongs to the company and the assessment of such resources provides a justifiable and acceptable value) or may not ensure credibility. Resuming the aforementioned example, the display of the provision in the financial statements, although relevant by means of the fact that it helps the company with the control of the result's allotment and it arises from a dispute regarding the trial's loss, is not high enough or the value of probable losses may not be assessed related to reality.

Starting from such mutual assessment between the relevance and credibility of a piece of information provided in the financial statement, the regulators have brought into discussion a comparison of the significance of the two features for the guidance of the professional judgment.

For instance, the decision to provide the information in historical costs or real values is ascribed to the significance that the two features have in the endorsed alternatives. As mentioned in the first chapter, at present the regulators' trend is to leave the assessment in historical costs in the detriment of the one in real values. One explanation is that real values ensure a higher relevance than historic costs, although they are not as believable as the historic costs. However, the opinions differ. Certain experts assert that a higher credibility justifies the supply of less relevant information while

other experts place relevance before credibility. In this respect, those who draft financial statements incline to give a higher importance to the supply of believable information, although it is not relevant enough, while auditors incline to place on first position the information's relevance and then to check if the relevant information is believable, as well.

Subsequently the perusal of the argument for the two classes of opinions, we conclude that the information provided in the financial statements must be believable enough and relevant enough at the same time. Thus, the result of the display in the financial statement must comply with the cross point of these two features. Using mathematic rapports, we are able to build a function of the provided information, such as:

$$\text{Provided information} = f(\text{relevance and credibility})$$

The comparability endorses the need of users to compare the information provided in financial statements in time, for the same company, and in space, for different companies and to extract trends regarding the companies' financial positions and the performances. The purpose for the assurance of this feature is that of perceiving and explaining the differences and similarities between certain information provided in the financial statements. For this point of view, the comparability involves the existence of common features for the compared elements. In this respect, it is necessary:

- a. Display of the accounting policies used for drafting the financial statements and their changes and the consequences of such changes;
- b. To ensure the consistency of the display in time and space by keeping the chosen accounting policy as long as possible, without distorting the resulted information.

However, the comparability must not be mistaken for the information's equality and, at times, it may be better mirrored by means of the perusal of differences than similarities'. Therefore, it is necessary to supersede the consistency's inflexibility (the methods' permanence) by waiving certain accounting methods which do not ensure the supply of relevant and believable information given the display of all information regarding the respective change. The comparability's quality is preserved if different accounting methods are used and even if there are adjusted, given that there are displayed comprehensibly, believably and relevantly all the consequences arising from such situations.

The comparability between companies and the consistency of the accounting policies in time ensure the increase of the informational value of the economic opportunities and performances and the information's meaning, especially the qualitative one, depends on the user's ability to relate it to certain standards.

J. K. Simmons underlines in his article *A concept of comparability in financial accounting*, the significant role played by the endorsing of the financial statement of a Conceptual frame. Given the absence of such frame, the concept of comparability may not be applied and the comparisons of two companies which do not use the same accounting frame on specific elements do not have informational usefulness. Simmons defines comparability by means of the economic substance and claims that we may speak about comparability when there are similar reflections of the information's economic substance, which allows establishing differences and similarities.

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