

2.1: Creating a Portrait of an Organization That Can Be Used by Decision Makers

Learning Objectives

At the end of this section, students should be able to meet the following objectives:

1. Explain the comparison of financial accounting to the painting of a portrait.
2. Understand the reasons why financial accounting information does not need to be exact.
3. Define the term “material” and describe its fundamental role in financial accounting.
4. Define the term “misstatement” and differentiate between the two types of misstatements.

Question: In Chapter 1 “Why Is Financial Accounting Important?”, mention was made that financial accounting is somewhat analogous to the painting of a giant, complex portrait. How could financial accounting possibly be compared to an artistic endeavor such as the creation of a painting?

Answer: The purpose of a portrait—as might have been painted by Rembrandt, van Gogh, or even Picasso—is to capture a likeness of the artist’s model. In a somewhat parallel fashion, financial accounting attempts to present a likeness of an organization that can be used by interested parties to assess its financial health and anticipate future stock prices, dividend payments, and cash flows. Accounting terms such as **representational faithfulness** and **presents fairly** are commonly used to indicate that reported financial information successfully provides a reasonable picture of the financial position, operations, cash flows, and overall economic vitality of a reporting organization.

In accounting, this portrait is created and communicated in the form of **financial statements**. These statements provide the form and structure for the conveyance of financial information to describe a particular organization. This textbook is about the preparation of those financial statements and the meaning of their contents.

A human portrait, even by a master such as Rembrandt, is not terribly precise. The shape of the person’s chin or the turn of the neck may be off slightly; the color of the eyes and hair cannot possibly be a perfect replica of life. It is a painted portrait, not a photograph (which is much more mechanically accurate). However, absolute exactness is not a necessary element for capturing a proper likeness. Success is achieved when a viewer exclaims, “I know that person!” Exact precision is not required to meet that objective.

Despite public perception, financial accounting information is rarely exact. For example, the reported cost of constructing a building may be off slightly because of the sheer volume of money being spent on the many different aspects of the project. No one expects the reported cost of a \$50 million manufacturing plant to be accurate to the penny. As with the painted portrait, that does not necessarily reduce the usefulness of the data. If financial information is a fair representation, an interested party should be able to make use of it to arrive at the desired projections. A potential investor or creditor does not need numbers that are absolutely accurate in order to assert, “Based on the available financial information, I understand enough about this company to make informed decisions. Even if I could obtain figures that were precise, I believe that I would still take the same actions.”

An artist applies oil paints, pastels, or watercolors to a canvas to capture the essence of a subject. An accountant does something quite similar by using numbers and words. The goal is much the same: to capture a likeness that truly reflects the essence of the model.

Test Yourself

Financial statements can be likened to a work of art because both are not exact replicas of the picture or company. This can still work as long as the painting or the financial statements are:

- A. Are close enough that an observer can recognize the underlying model or business
- B. Give sufficient detail and accuracy that decision makers would not change their decision with further detail or accuracy.
- C. Accountants are too lazy or dishonest to get the financial statements exactly right
- D. Both A and B.

The answer is D – financial statements work even though they are not exact as long as they are close enough for investors to get a picture of the business and with any additional accuracy the investor would not change their decisions

Question: This is a surprising , possibly shocking , revelation . Financial accounting information has universally been branded as exhibiting rigid exactness . In fact , accountants are often referred to as “bean counters ” because of their perceived need to count every bean in the bowl to arrive at obsessively accurate numbers. Here , though , the assertion is made that accounting information is not a precise picture but merely a fair representation of an organization’s financial health and prospects . How correct or exact is the financial information that is reported by a business or other organization?

Answer: In accounting, **materiality** has long been the underlying benchmark in the reporting of information. This concept requires that data presented by an organization to decision makers should never contain any **material misstatements**. For financial accounting information, this is the basic standard for the required level of accuracy. Decision makers want financial statements—such as those prepared by Starbucks or Intel—to contain no material misstatements. Because of their central role in this reporting process, understanding the terms “misstatement” and “material” is essential for any student seeking to understand financial accounting.

A misstatement is an **error** (made accidentally) or **fraud** (done intentionally) where reported figures or words actually differ from the underlying reality. For example, a company official could erroneously record a \$100,000 expenditure that was made to acquire a new building as actually pertaining to the purchase of land. Consequently, the building’s cost might be reported as \$2.3 million when it was actually \$2.4 million. This financial information is misstated. The balance presented for the building contains a \$100,000 misstatement, as does the figure shown for land.

A misstatement is judged to be material if it is so significant that its presence would impact a decision made by an interested party. Using the above illustration, assume the accidental \$100,000 reduction in the reported cost of this building leads an outside decision maker to alter a choice being made (such as whether to buy or sell capital stock, the price to exchange for such shares, or whether to grant a loan). Because of that outcome, the misstatement is material by definition. Financial information can (and almost always does) contain misstatements. However, the reporting entity must take adequate precautions to ensure that the information holds **no material misstatements** for the simple reason that the data can no longer be considered fairly presented. The portrait of the company does not properly look like the model if it contains any material misstatements. The decision maker is being misled.

The concept of materiality can seem rather nebulous. For a small convenience store, a \$10 misstatement is clearly not material whereas a \$10 million one certainly is. For a company with real estate holdings of \$30 billion, even a \$10 million misstatement is probably not material. The problem for the accountant is determining where to draw the line for each organization. That is one of the most difficult decisions for any financial accountant. An exact dollar amount for materiality is virtually impossible to identify because it is a measure of the effect on an external party’s judgment. Other than sheer magnitude, the cause of the problem must also be taken into consideration. An accidental mistake of \$100,000 is probably less likely to be material than one of \$100,000 that resulted from a fraudulent act (like actual theft). As an example consider your how your reaction may differ if you knew a friend lost accidentally something of yours worth \$100 compared to knowing that they actually took \$100 out of your wallet. **Both the size and cause** should be weighed in judging whether the presence of a misstatement has the ability to impact a decision maker’s actions.

Therefore, a financial accountant never claims that reported information is correct, accurate, or exact. Such precision is rarely possible and not needed when decision makers are analyzing the financial health and prospects of an organization. However, the accountant must take all precautions necessary to ensure that the data contain no material misstatements. Thus, financial figures are never released without reasonable assurance being obtained that no errors or other mistakes are present that could impact the decisions that will be made. All parties need to believe that reported information can be used with confidence in order to evaluate the financial condition and prospects of the organization as a whole.

When a company reports that a building was constructed at a cost of \$2.3 million, the real message is that the cost was not materially different from \$2.3 million. This figure is a fair representation of the amount spent, one that can be used in making decisions about the organization’s current financial situation as well as its future prospects.

Check yourself

Materiality in accounting is:

- A. Always the same amount no matter what the size and cause of a misstatement.
- B. A way for accountants to take some of the company’s money without getting caught.
- C. An amount that is large enough to change the financial decision of a careful observer of information.
- D. The opposite of accurate or fairly stated.

The answer is C – an amount that is material is large enough that it would influence the decision of investors. It would vary in amount based on the size of the company and what caused the misstatement.

Question: Does this mean that all the amounts recorded in the accounting records are not exact and that accountants are not concerned with being accurate?

While accountants understand that it is not possible to get every amount - especially those representing the summary of many events and involving many transactions - to be without misstatement, this does not mean that reasonable effort is not made to achieve accuracy. Accountants do want to communicate information that is as accurate as possible. In many areas, even small, immaterial errors with some reported amounts could cause concern for those using the information. The amount deposited in the bank account should be very accurate as would our calculation of the paychecks for employees based on the application of several payroll tax laws. Even immaterial differences from reality would cause a lack of confidence on the part of those who use this information. Fortunately, computer software has been developed that completes many of the calculations and helps accounting personnel to eliminate many of the small errors that may sneak into the financial information. It is also true that many immaterial errors can add up to be a material error that is big enough to make a difference to decision makers so accuracy is still an important even if elusive goal.

The other misconception of accounting's approach to materiality is that if an amount is too small to matter, accountants will ignore recording it all together. This is almost never the case - accountants may summarize it with other amounts, wait to record or not be as particular about where it is recorded but it is **not good accounting** to completely ignore any completed transaction no matter how small.

Key Takeaway

Financial accounting does not attempt to provide exact numbers because such accuracy is often impossible to achieve and not really required by decision makers. Instead, reported accounting information is intended to provide a likeness of an organization and its operations—a type of portrait. To achieve this goal, the balances and other data cannot contain any material misstatements. A misstatement is inaccurate information reported by accident (an error) or intentionally (fraud). Materiality refers to the point at which the size or the nature of such misstatements would cause a change in the decisions made by an individual using that information. If all material misstatements can be eliminated, interested parties should be able to use the information to make considered decisions.

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