

The Pareto Principle

Using the 80/20 rule to focus financial reporting on the few items that drive most of the value. BY SHAYNE KAVANAGH

Mental models help us simplify complexity, direct our attention, and make better decisions when time and information are limited. One of the most useful—and widely applicable—is the Pareto Principle.

Often called the “80/20 rule,” the Pareto Principle describes a pattern that appears across many domains: A relatively small share of causes tends to drive a large share of results. The exact ratio varies, but the underlying idea is consistent: importance is often concentrated, not evenly distributed.

This makes the Pareto Principle a powerful mental model—before treating everything as equally important, ask whether a small number of items are doing most of the work. When that pattern is present, attention and effort should be concentrated where impact is greatest.

Financial reporting provides an example of how this mental model can be applied. In many areas of financial reporting, a small number of items account for most of the total value, while a large number of smaller items have little influence on a user’s understanding of financial condition. A common example is capitalized assets. A handful of assets make up a very large portion of the total value. GFOA examined the assets of more than 60 governments and found that 20 percent of the most expensive assets made up more than 80 percent of the total reported value.

Seen through the Pareto lens, this suggests a different approach. Instead of distributing effort evenly, we can align it with where it matters most. This is the

idea behind GFOA’s work on rethinking materiality. Materiality is not about eliminating all error. It is about preventing decision-relevant error—the kind that could mislead users about financial condition or performance.

Applying the Pareto Principle raises the following questions:


- **Which items are large enough to include?** This question speaks to the threshold below which assets won’t be reported. The Pareto Principle tells us that the smallest assets make up a negligible portion of total value. That means many governments have an opportunity to raise their reporting thresholds substantially.
- **How much precision is warranted once included?** This question asks us to consider the role of estimates in financial reporting. The Pareto Principle shows us that the assets just above a new, higher reporting threshold still make up a very small amount of total reported value. That amount may be non-trivial, so it still should be reported. However, it might be advisable to estimate the value of these assets, rather than account for them precisely. GFOA has found that there is great potential to apply estimates to these small, reported assets while still remaining well within acceptable accuracy tolerances on the total reported value of all assets.

It is not just capital assets that conform to the Pareto Principle. Leases and some kinds of accruals are leading examples.

The Pareto Principle helps us recognize an alternative to applying the same level of effort to everything. In

accounting, uniformly applied effort produces precise numbers, but not necessarily more useful ones. In fact, excessive precision consumes time and attention that could be better spent elsewhere. The Pareto Principle reminds us that when importance is concentrated, treating everything equally is not neutral. It is inefficient.

For finance professionals, the mental model offered by the Pareto Principle is simple: look for concentration. Where are the few factors driving most of the outcome? Where is effort producing diminishing returns? Where could a shift in focus improve results without increasing cost? Wherever you find yourself overwhelmed by detail, it offers a useful starting point: Focus where it counts.

In this issue of *GFR*, “Materiality As a Process: What Really Counts” provides new research on applying the Pareto Principle and other strategies to materiality and estimates in financial reporting: powerful tools to reduce the cost and time of producing financial reports, without sacrificing the decision-usefulness of reporting. 



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