MATERIALITY IN ACCOUNTING VERSUS DECISION-MAKING: A NON-PROFIT CASE STUDY

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ABSTRACT

The purpose of this paper is to demonstrate the concept of materiality. The most common application of materiality concerns the financial item considered. An item with a large dollar amount omitted from the financial statements is generally considered material. Size may be considered in relative terms, for example, as a percentage of the relevant base (sales, expenses, net income, total assets, etc.) rather than an absolute amount. The view that size is a special determinant of materiality means that, for financial reporting purposes, materiality can only be judged in relation to items or errors which are quantifiable in monetary terms. For decision-making, materiality is subjective because it relates to the overall impact on the response to a particular decision such as an investment or purchase. As a percentage, the resulting materiality may not be considered significant or material.

Keywords: Allocations, Budget, Decision-Making, Materiality, Non-Profit, and Reserves.

INTRODUCTION

The Sarbanes Oxley Act of 2002 reiterated the importance of ensuring that financial statements are free of material misstatements due to error or fraud. Materiality judgments should be based on the perceived needs of a reasonable investor or other interested party. Investor needs for quality accounting information relate to disclosures for assessing profitability, liability, and solvency of a company. Thus, for materiality considerations the focus should be on items included or omitted from the financial statements that would likely influence the judgment of a reasonable investor. Therefore, consideration should be given to both quantitative and qualitative materiality (Gist and Shastri, 2003).

The thrust of this case study is to emphasize materiality quantitatively as being quite different for a board of administration of a non-profit organization as compared to a for-profit organization. The study is based on the actual experience of a board of administration member of a non-profit organization. The details that follow demonstrate the process and decision-making based on what the board considers a material amount given the infeared owners' preference of any increase in maintenance fees, including reserves, should be avoided based on the fact that the fees continue to rise year after year. The original and revised budget allocation figures are illustrated to demonstrate the source and impact of changes that help to explain materiality.

A budget is a planning tool and should be prepared well in advance of the period of the actual performance. Plenty of time should be allowed for presenting the budget to the board of administration so they can approve the budget and make any final changes (Virginia Society, 1998). The concept of materiality certainly enters into the decision-making process.

BACKGROUND INFORMATION

Every time-share association has an approved set of condominium documents. The condominium documents provide a comprehensive set of rules and regulations to operate and maintain the association. Some of the relevant and selected information from the actual condominium documents include:

1) "Interval Ownership", is a concept whereby a Unit and share of the Common Elements assigned to the Unit are conveyed for the period of time, the purchaser receiving a stated Unit Week for a period of years, together with a remainder over in fee simple as tenant in common with all other purchasers of "Unit Weeks" in each such Condominium Unit in that percentage interest determined and established by original Declaration of Condominium at 12:00 noon on the first Commencement-Termination Day in the year 2022.

2) Each of the Unit Owners of the Condominium shall own an undivided interest in the Common Elements and Limited Common Elements, and the undivided interest, stated as percentages of such ownership in the said Common Elements and Limited Common Elements, as set forth in the original declaration.

3) The common expenses of the Condominium shall be shared by the Unit Owners, as specified and set forth in the original declaration and amended by the Association. Any common surplus of the Association shall be owned by each of the Unit Owners in the same percentage specified for sharing common expenses.

4) All Owners of Units committed to Interval Ownership shall pay a “maintenance fee”. The maintenance fee shall include the following applicable items:

- The unit’s share of common expenses, as set forth;
- Repair and upkeep of the Unit for normal wear and tear (for example - repairing interior walls);
- Repair and replacement of furniture, fixtures, appliances, carpeting and utensils;
- Casualty and/or liability insurance on the Unit;
- Utilities for the subject Unit;
- Personal property, real estate, and any other applicable taxes not billed directly to the Owners of the Unit Weeks in the Unit;
- Any other expenses incurred in the normal operations and maintenance of the Unit which can not be attributed to a particular unit week Owner (D of CD, 1998).

The maintenance fee shall be prorated among all Owners of Unit Weeks in a specific Unit by applying a fraction, the numerator of which is the number of Unit Weeks owned by a specific Owner, the denominator of which is fifty-one (51), to the total of all such expenses. The foregoing shall not apply to any Unit Week conveyed to the Association (D of CD, 1998).

Notwithstanding any other provision, the Board of Administration may at their option, make a determination to exclude from the maintenance fee all or part of the personal property, real estate, and any other applicable taxes not billed directly to the Owners of the Unit Weeks in any Unit committed to Interval Ownership. In the event the Board of Administration makes such a determination, then the Owners of Unit Weeks shall be separately assessed for said taxes based upon the formula provided for herein for the proration of the maintenance fee (D of CD, 1998).

A non-profit organization needs to have the ability to balance its cash inflows and cash outflows. In more recent years time-share associations have had the challenge of maintaining fees, while trying to hold down rising costs. Even in a period of relatively low inflation, costs do go up (Rich).

Over the years, time share associations have developed more pertinent and sophisticated budgeting procedures. The ownership has demanded more accountability and therefore, management representing the ownership, has responded.

In addition to annual operating expenses, the proposed budget must include reserve accounts for capital expenditures and deferred maintenance as required by law. These accounts shall include, but not be limited to, interior replacement, roof replacement, building painting, and pavement resurfacing, as well as any capital expenditure or deferred maintenance item for which the estimated cost exceeds $10,000.00. The amount to be reserved shall be computed by a formula based upon the estimated life and replacement cost of each item. These reserves shall be funded unless the members subsequently determine by majority vote of those present in person or by proxy at a duly called meeting to fund no reserves or less than adequate reserves for a fiscal year. The vote to waive or reduce reserves, if any is taken, shall be conducted only after the proposed budget has been sent to the members (D of CD, 1998).

In addition to the statutory reserves provided above, or in place of them if the members so vote, the Board may establish one or more additional reserve accounts for insurance deductibles, contingencies, general operating expenses, repairs, improvements or special projects. There is never enough to handle every conceivable contingency (Rich). The purpose of the reserves is to provide financial stability and to avoid the need to make special assessments on a frequent basis. The amounts proposed to be so reserved shall be reported in the proposed annual budget each year. These funds may be spent for any purpose approved by the Board (D of CD, 1998).

Every time-share association must prepare an approved reserve budget for the year so the maintenance and reserve fees can be assessed and sent out to the ownership before year end for the next year. Taxes are part of the total fee but the ownership has no control over the taxes and therefore, they are ignored for this paper.

All reductions, even small amounts such as reducing the reserves by fifty cents per unit week can have an impact on the owners' perception of the maintenance fee increase. Therefore, when the board of Administration reviews the reserve budget, all possible and realistic options are considered. With the reserves, rarely is an item omitted but rather an item, such as patio furniture, may be extended as to replacement for an additional year or years. This will have a small impact on the total reserve increase but with the consideration of other items, may add up to what is considered a significant or material impact.

MATERIALITY

A priority for the accounting profession, particularly in the United States and other countries such as Ireland and the UK, has been to preserve professional judgment, and to continue to strive for a principles-based, rather than a rules-driven, accounting environment. The professional judgment is particularly relevant in considering materiality, where guidance has sought to avoid percentage or absolute numerical benchmarks. The preference is to define the concept by reference to the relative significance of the matter under review (Nolan, 2005). The definition provided in auditing standards for materiality can be stated as:

"Materiality is an expression of the relative significance or importance of a particular matter in the context of financial statements if its omission would reasonably influence the decisions of an addressee of the auditors' report; likewise a misstatement is material if it would have a similar influence. Materiality may also be considered in the context of any individual primary statement or within the financial statements of individual items included in them. Materiality in not capable of general mathematical definition as it has both qualitative and quantitative aspects" (Nolan, 2005).

Despite the general mathematical definition, it is hard to resist the temptation to resort to benchmarks, such as percentages or sliding scales. For example, a percentage of between 5% and 10% of a critical component such as profit after tax might normally be considered appropriate in determining materiality. However, the debate really arises when a misstatement has been identified and not corrected. Therefore, materiality is a key tool in the evaluation of misstatements (Nolan, 2005).

Accountants have had to rethink their understanding of materiality and its uses. The Sarbanes-Oxley Act of 2002 has put demands on management to detect and prevent material control weaknesses in a timely manner. Materiality is not a simple calculation but rather a determination of what will vs. what will not affect the decision of a knowledgeable investor given a specific set of circumstances that relate to the fair presentation of an organization's financial statements and disclosures concerning existing or future debt and equity instruments. However, accountants tend to quantify estimates to identify potential materiality issues (Vorhies, 2005).

RESERVES MODIFICATIONS

The three year reserve disbursements are shown in Table A for a non-profit organization. This table represents the original proposed budget allocations for a three year reserve disbursement include the categories of interior, roof painting, paving, and capital improvements. The reserve modifications addressed in this paper are in the categories of interior and capital improvements. Additional details such as proposed changes are provided after the Tables A and B.

TABLE A

ORIGINAL PROPOSED BUDGET ALLOCATIONS

THREE YEAR RESERVE DISBURSEMENT

	2006	2007	2008
INTERIOR RESERVES			
Living/Dining Room			
Range	$ 16,000		
Microwave	11,200		
Refrigerator	19,200		
Dishwasher	12,800		
Kitchen Fan W/Light	4,000		
Master Bedroom			
King Upholstered Headboard			$ 9,600
Television		$ 9,600	
Window Treatment			4,800
King Bedspread/Cornice			9,600
Lamps			6,400
Guest Bedroom			
Twin Headboards (2)			16,000
Box Springs/Matt (2)	19,360		
Dresser W/Glass Top			25,600
2 DR-Dresser W/Glass Top			8,000
Television	7,200		
Window Treatment			4,800
Twin Bedspreads/Cornice			14,400
Lamps			6,400

Porch			
Ceiling Fan-Patio	4,000		
Lanai Surface		25,600	
Re-Screen		12,800	
Miscellaneous			
Air Handler		24,000	
Air Conditioner	10,400		
Air Handler		8,000	
Carpet (Living Area)		28,800	
Carpet (Bedrooms)		28,800	
Wet Bar Counter/Sink		21,600	
Wet Bar Mirror		28,800	
Mirrors-General		51,200	
Front Door	64,000		
Electronic Door Locks			12,800
Total Interior	**$ 168,160**	**$ 239,200**	**$ 118,400**
ROOF RESERVE	**2006**	**2007**	**2008**
Total Roof	**$ -**	**$ -**	**$ -**
PAINTING RESERVE			
Interior Master Bedroom			9,600
Interior Guest Bedroom			9,600
Total Painting	**$ -**	**$ -**	**$ 19,200**
PAVING RESERVE			
Total Paving	**$ -**	**$ -**	**$ -**
CAPITAL IMPROVEMENTS			
Spa	$ 20,000		
Swimming Pool/Spa Equipment			$ 20,000
Pool Furniture			15,000
Tennis Courts-Resurface	4,000		
Grills (3)		$ 1,600	
Front Office Windows			10,000
Lobby Furniture		2,000	
Computer Equip. I			8,000
Computer Equip. II		2,000	
Telephone System		15,000	
Boardwalk (Beach-Platform/Stringers)	32,000		
Boardwalk (Beach-Railings)	8,000		
Sundecks (2)			40,000

Total Capital	**$ 64,000**	**$ 20,600**	**$ 93,000**
Totals:			
INTERIOR	**$ 168,160**	**$ 239,200**	**$ 118,400**
ROOF	**-**	**-**	**-**
PAINTING	**-**	**-**	**19,200**
PAVING	**-**	**-**	**-**
CAPITAL IMPROVEMENTS	**64,000**	**20,600**	**93,000**
TOTAL DISBURSEMENTS	**$ 232,160**	**$ 259,800**	**$ 230,600**

TABLE B

REVISED PROPOSED BUDGET ALLOCATIONS

THREE YEAR RESERVE ISBURSEMENT

	2006	2007	2008
INTERIOR RESERVES			
Living/Dining Room			
Range			$ 16,000
Microwave	$ 11,200		
Refrigerator	19,200		
Dishwasher	12,800		
Kitchen Fan W/Light			4,000
Master Bedroom			
King Upholstered Headboard			9,600
Television		$ 9,600	
Window Treatment			4,800
King Bedspread/Cornice			9,600
Lamps			6,400
Guest Bedroom			
Twin Headboards (2)			16,000
Box Springs/Matt (2)	14,080		
Dresser W/Glass Top			25,600
2 DR-Dresser W/Glass Top			8,000
Television			7,200
Window Treatment			4,800
Twin Bedspreads/Cornice			14,400
Lamps			6,400
Porch			
Ceiling Fan-Patio		4,000	
Lanai Surface		25,600	
Re-Screen		12,800	
Miscellaneous			
Air Handler		24,000	
Air Conditioner	10,400		

Air Handler		8,000	
Carpet (Living Area)		28,800	
Carpet (Bedrooms)		28,800	
Wet Bar Counter/Sink		21,600	
Wet Bar Mirror		28,800	
Mirrors-General		51,200	
Front Door	64,000		
Electronic Door Locks			12,800
Total Interior	**$ 131,680**	**$ 243,200**	**$ 145,600**
ROOF RESERVE			
	2006	**2007**	**2008**
Total Roof	**$ -**	**$ -**	**$ -**
PAINTING RESERVE			
Interior Master Bedroom			9,600
Interior Guest Bedroom			9,600
Total Painting	**$ -**	**$ -**	**$ 19,200**
PAVING RESERVE			
Total Paving	**$ -**	**$ -**	**$ -**
CAPITAL IMPROVEMENTS			
Spa			$ 20,000
Swimming Pool/Spa Equipment			20,000
Pool Furniture			15,000
Tennis Courts-Resurface	$ 4,000		
Grills (3)		$ 1,600	
Front Office Windows			10,000
Lobby Furniture		2,000	
Computer Equip. I			8,000
Computer Equip. II		2,000	
Telephone System		15,000	
Boardwalk (Beach-Platform/Stringers)		32,000	
Boardwalk (Beach-Railings)		8,000	
Sundecks (2)			40,000
Total Capital	**$ 4,000**	**$ 60,600**	**$ 113,000**
Totals:			
INTERIOR	**$ 131,680**	**$ 243,200**	**$ 145,600**

ROOF	-	-	-
PAINTING	-	-	19,200
PAVING	-	-	-
CAPITAL IMPROVEMENTS	4,000	60,600	113,000
TOTAL DISBURSEMENTS	$ 135,680	$ 303,800	$ 277,800

	Proposed Budget		Final Budget	
	2006	2005	2006	2005
Proposed maintenance fee per unit week	$ 617.76	$ 583.74	$ 616.04	583.74
Dollar increase	$ 34.02		$ 32.30	
Percentage increase	5.83 %		5.53 %	
Dollar operating increase	$ 12.02		$ 12.02	
Dollar reserve increase (Key Point)	$ 22.00		$ 20.28	

PROPOSED CHANGES

The proposed changes in Table B include:

1. Move range replacement ($16,000) out 2 years from 2006 to 2008 to conserve cash and extend the life of the current ranges.

2. Move kitchen fan w/ light ($4,000) out 2 years from 2006 to 2008 to conserve cash and extend the life of the current fans.

3. Reduction in guest bedroom box spring and mattresses from $19,360 to $14,080, due to a more reasonably priced supplier.

4. Move guest bedroom television ($7,200) out 2 years from 2006 to 2008 to conserve cash and extend the life of the current televisions.

5. Move ceiling fan- patio ($4,000) out 1 year from 2006 to 2007 to conserve cash and extend the life of the current fans.

6. Move spa ($20,000) out 2 years from 2006 to 2008 to conserve cash and extend the life of the current spa.

The overall impact of the above changes reduces the dollar reserve increase from $22.00 down to $20.28 or a savings of $1.72. The dollar reserve increase seems small but that reduces the increase by 7.8%. This is a case where decision-making is significant or material from a percentage standpoint. However, the impact of the $1.72

savings on the total reserve of $150.50 is only 1.1%. The $150.50 represents the original proposed reserve portion of the total maintenance fee of $617.76. The final budget of of $616.04 includes $148.78 for reserves. Therefore, the overall percentage increase for the total fees is 5.53% as compared to the original proposal of 5.83%; a total percentage reduction of just .3%. The possible owner reaction to such a small percentage change is negligible. The revised three year reserve disbursements are shown in Table B. The per week maintenance fee is based on the total unit weeks.

An important point is that when it comes to capital reserves, moving items out 1 or 2 years has a minimal impact on percentage changes. It is evident that only items that are eliminated will significantly or materially impact the capital reserves, as demonstrated in the budget figures. However, very few items, if any, can avoid their replacement in the future such as the ranges.

CONCLUSION

As individual items are combined, the essence of materiality changes as compared to the accounting concept. The overall impact of combining a set of proposed changes reduces the dollar reserve increase and thus the overall percentage increase for the total fees. Therefore, for decision-making, consideration must be given to the impact of more than one item being changed. The relationship and analysis of numbers and percentages could have a significant impact on the outcome especially as perceived by the owners of the resort. There are many “what ifs” that could be considered as referred to in the paper such as delaying replacement of appliances. However, the board of administration looks at what is realistic based on prior experience and feasibility. The figures for future capital reserves beyond 2006 are only estimates that may not include the full impact of inflation.
The annual budget review allows the board to assess prior decisions as to time frames and reserve amounts for various line items such as the ranges. The deferral of expenditures of earlier replacement of assts is judgmental based on cash reserves, condition of the assets, priorities, and other factors.

Case questions may include:

1. What is the difference between for-profit and non-profit organizations?

2. What is the meaning of materiality in a for-profit organization?

3. What is the meaning of materiality in a non-profit organization?

4. What is the role of constraints such as a set of rules and regulations in decision-making?

5. What is the purpose of reserves for operating and maintaining in organization?

6. How would someone prove the correctness of the percentages given? Consider one specific example.

7. What is the overall intent of the case?

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