NEWSLETTER NO. 21

SIGNIFICANCE AND MATERIALITY

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This Newsletter has been made available as a result of financial support from the Province of Ontario

Significance and *materiality* are two words that are used a lot in the context of accounting for tangible capital assets. While very similar in connotation, these two abstract concepts have quite different uses and applications. The cynic might ask whether materiality is effectively immaterial in the context of municipal financial statements, as your typical reader is more likely to make investment and credit decisions based on reports from credit rating agencies, who will ask you for a lot more detailed background information than what is in your annual report.

So what do the terms mean, and why does it matter? This newsletter will try to shed light on these somewhat philosophical accounting terms, especially as they relate to accounting for tangible capital assets.

Significance

Webster's defines significance as "*importance, consequence or moment*".

Public Sector Accounting Handbook Introduction, 14 and .15

"*These standards are not intended to apply to insignificant items or matters"* (Introduction.14). The next paragraph (.15) recognizes that "*there is no substitute for the exercise of professional judgment in the determination of what constitutes fair presentation or good practice in a particular case.*"

Note also 1200.016: "*Financial statements should be presented in such form and use such terminology and classification of items that significant information is readily understandable."*

Is it significant?

The determination as to whether something is significant and reportable is yours to make. Besides what must be reported in your financial statements to provide fair presentation, there may be political, economic and/or social considerations that may suggest going beyond this, if not in the financial statements, at least in the other material included in the annual financial report of the municipality.

For tangible capital assets, you do have a choice. Paragraph 14 puts your staplers in their proper place in the schema of assets, namely that they should not have a place. Your selection of capitalization thresholds is a statement that everything below it is not deemed to be significant from an accounting and reporting perspective. You are exercising professional judgment that capitalizing TCAs below this value will not affect fair presentation.

Materiality

Webster's defines materiality as "*Importance, essentiality, or pertinence*". It would be tempting to add *significance* to the list.

Public Sector Accounting Handbook Section 1200.015

"Materiality is a matter of professional judgment in the particular circumstances. Materiality may be judged in relation to the reasonable prospect of its significance in the making of assessments and judgments by the users of financial statements. A material item would be expected to affect assessments of and judgments on government financial operations and management."

Is it material?

The OMBI Reference Manual defines materiality as "the state of having substance or import, particularly that may have some significance, such as to the user of financial statements." An Accounting 101 text (Meigs, Meigs and Lam, 5th edition, p. 546) defines materiality as: "An item is material if there is a reasonable expectation that knowledge of it would influence the decisions of prudent users of financial statements."

Thus materiality is expressed as an assessment by the readers of your financial statements, as to the significance of the financial information provided from their perspective. From an audit perspective, materiality then becomes a concern that any omissions and misstatements in the information behind the financial statements do not cumulatively result in an overall misstatement of financial position and results of operations that would influence or change the decision that such a reader of those statements may make.

Thanks to Enron, standards have changed. This has resulted in a higher level of concern on the part of your external auditor to ensure that everything of importance or pertinence has been fully reported in the statements. And this auditor concern will most definitely be extended to your accounting for tangible capital assets.

The goal of the audit will be to determine that your tangible capital asset valuations have not omitted or excluded any material amount of assets. However, it will be your auditor who determines what an appropriate materiality level will be for your municipality. Let us look at how this is typically determined

Materiality - the dollar value

The OMBI Municipal Guide (p 24) quotes the CICA's guidance to external auditors on the issue of what is a material amount with respect to an organization. The Institute suggests a range of 0.5% to 2.0% of government revenues. For municipalities, the range is typically within 0.5% to 1.0% of revenues, or the non-debt financing from external sources that you generate in a fiscal year.

This would suggest that your materiality level can generally be determined as follows:

If your annual revenues are:-	**Material will be anything worth at least:-**
$ 1 million	$5 to $10 thousand
$10 million	$50 to $100 thousand
$100 million	$500,000 to $1 million *
$1 billion	$5 to 10 million *

* At this level, it may be more appropriate to select the lower level rather than the higher one.

At the same time, your auditor may have a different professional opinion, and cite a different value, based on his/her professional assessment of your municipality's particular circumstances. If so, this will be worth discussing why, in case there are specific issues that you should try to address or resolve.

With respect to your tangible capital assets, the key question will be what have you chosen to expense, or exclude from your asset inventories? How much are they worth? If they are of relatively small value and largely amortized, they may be deemed to be immaterial. Similarly, a case can be made to exclude office computers, if you have a program to replace then every three or four years. Even though the total value new may be significant, if the annual replacement expense is similar to what the amortization expense would otherwise be, there would likely not be a material misstatement in your financial reports. Again, this is something to discuss with your auditor.

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In an earlier newsletter, we mentioned the issue of aggregating and disaggregating assets, asset pools being an example of an aggregated asset. Next, we will look at this way of dealing with certain kinds of tangible capital assets in more detail.

For more information and resources regarding tangible asset management, go to PSAB/Asset Management, or contact:

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NOTE: This Newsletter is published to assist you with your implementation of tangible capital asset accounting and with related matters. The Public Sector Accounting Handbook is the only authoritative primary source on matters relating to GAAP, and you should consult with your auditor to resolve specific issues that you may have.