Materiality and ASOP No. 36: Considerations for the Practicing Actuary

CAS Committee on
Valuation, Finance, and Investments

November 17, 2000

To Actuaries Preparing Statements of Actuarial Opinion Regarding Property/Casualty Loss and Loss Adjustment Expense Reserves:

The Casualty Actuarial Society's (CAS) Valuation, Finance, and Investments Committee (VFIC) has prepared the attached note entitled "Materiality and ASOP No. 36: Considerations for the Practicing Actuary".

Actuarial Standard of Practice No. 36, *Statements of Actuarial Opinion Regarding Property/Casualty Loss and Loss Adjustment Expense Reserves*, became effective on October 15, 2000. Among other things, the new ASOP requires the actuary to use the concept of materiality in a number of important ways. The American Academy of Actuary's Committee on Property and Liability Financial Reporting (COPLFR) asked VFIC to prepare a note that would aid the actuary considering materiality in the context of ASOP No. 36.

This note is the result. It is intended to be distributed as an appendix to the Practice Note prepared by COPLFR as well as via the CAS website and *The Actuarial Forum*.

Some of the general concepts of materiality discussed in the note may be relevant beyond statements of actuarial opinion. However, this note does not discuss the intended purposes of analyses in any other contexts, and intended purpose is key to consideration of materiality.

IMPORTANT CAVEAT: This note is intended only as an aid and does not supercede the actuary's professional judgment or the language of ASOP No. 36. Although the note has been prepared by knowledgeable members of VFIC, it has not received the professional review process required for establishment of actuarial standards. Accordingly, the note is not an authoritative document for actuaries and is not binding on any actuary. VFIC recommends that this note be read in conjunction with ASOP No. 36.

2000 Valuation, Finance, and Investments Committee
Casualty Actuarial Society
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Materiality and ASOP No. 36: Considerations for the Practicing Actuary

Introduction

This note has been prepared by the Valuation, Finance, and Investments Committee (VFIC) of the Casualty Actuarial Society as an aid to the actuary considering the concept of materiality contained in Actuarial Standard of Practice (ASOP) No. 36, *Statements of Actuarial Opinion Regarding Property/Casualty Loss and Loss Adjustment Expense Reserves.*

ASOP No. 36 requires the actuary to use the concept of materiality in a number of important ways, including:

- determination of whether or not to issue a qualified opinion,
- determination of the need for disclosure of significant risks and uncertainties,
- consideration of factors likely to affect the actuary's reserve analysis, and
- determination of the need for a number of other possible disclosures.

There is no formulaic approach to determining the standard of materiality the actuary should use for a given statement of actuarial opinion (SAO). The ASOP instructs the actuary to evaluate materiality based on professional judgment, any applicable guidelines or standards, and the intended purpose of the SAO.

VFIC intends this note to aid the actuary who must evaluate materiality in the course of preparing a SAO. Following this introduction are three sections:

1. **Materiality and ASOP No. 36:** Discusses the use of the concept of materiality in ASOP No. 36, highlighting its impact on decisions made by the actuary in the course of preparing a SAO.
2. **Materiality in Accounting Contexts:** Reviews the concept of materiality in accounting contexts, including both regulatory and SEC financial reporting. This discussion is not intended to be guidance for the actuary, since an actuary's issues and concerns are not in general the same as those of accountants. Instead, this review is provided to enrich the discussion of potential issues with regard to materiality.
3. **Materiality, Statements of Actuarial Opinion, and ASOP No. 36:** Discusses qualitative and quantitative concepts the actuary may wish to consider while coming to a professional judgment on materiality in the context of ASOP No. 36. Although certain quantitative measures can be suggested for consideration in certain circumstances, no formulaic approach to a quantitative materiality standard can be developed.

Several caveats are in order at this point:

- **This note is intended only as an aid and does not supercede the actuary's professional judgment or the language of ASOP No. 36. Although the note has been prepared by knowledgeable members of VFIC, it has not received the professional review process required for establishment of actuarial standards. Accordingly, the note is not an authoritative document for actuaries and is not binding on any actuary. VFIC recommends that this note be read in conjunction with ASOP No. 36.**

- This note discusses concepts of materiality relevant to the SAO's that are the subject of ASOP No. 36. This note does not focus on considerations of materiality that may be required for other purposes, such as GAAP or Statutory financial statements. Although some of the general concepts of materiality that are discussed here are relevant in other contexts, key to the concept of materiality is consideration of the intended purpose of the analysis. Discussion of the intended uses of financial statements is beyond the scope of this document.

- ASOP No. 36 applies to any written SAO on loss and loss expense reserves. Many SAO's are prepared to be filed for regulatory purposes with an insurer's statutory annual financial statements. If the actuary is preparing an SAO for some other purpose, e.g., valuation of a company or of a book of business, then the actuary's materiality standards may differ from those relevant to the statutory SAO.

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Materiality and ASOP No. 36

ASOP No. 36 applies to actuaries issuing written statements of actuarial opinion regarding property/casualty loss and loss adjustment expense reserves in the following situations:

- the opinion is provided to comply with requirements of law or regulation for a statement of actuarial opinion; or
- the opinion is represented by the actuary as a statement of actuarial opinion.

Further, if the actuary's statement includes opinions regarding amounts for items other than loss and loss adjustment expense reserves, ASOP No. 36 applies only to the portion of the statement of actuarial opinion that relates to loss and loss adjustment expense reserves.

Whenever the actuary determines that a material condition exists, the actuary is required to make some response to the condition. The following lists sections of ASOP No. 36 that use the word "material". For convenience, the discussion below quotes some of the context showing how the term ***material*** (with added highlighting) is used in the section.

Again, please note that VFIC has not reproduced ASOP No. 36 in this note. Actuaries should read that document in conjunction with this one.

Sections 3.3.2 d: "The actuary is not required to issue a qualified opinion if the actuary reasonably believes that the item or items in question are not likely to be ***material***."

Section 3.3.3: "When the actuary reasonably believes that there are significant risks and uncertainties that could result in ***material*** adverse deviation, the actuary should also include an explanatory paragraph in the statement of actuarial opinion." This statement is further clarified. "The actuary is not required to include in the explanatory paragraph general, broad statements about risks and uncertainties due to economic changes, judicial decisions, regulatory actions, political or social forces, etc., nor is the actuary required to include an exhaustive list of all potential sources of risks and uncertainties."

Section 3.4: "... the actuary should consider the purposes and intended uses for which the actuary prepared the statement of actuarial opinion. The actuary should evaluate ***materiality*** based on professional judgment, ***materiality*** guidelines or standards applicable to the statement of actuarial opinion and the actuary's intended purpose for the statement of actuarial opinion."

Section 3.5: "In addition to the reserve methods used, the actuary should consider the relevant past, present, or reasonably foreseeable future conditions that are likely to have a ***material*** effect on the results of the actuary's reserve analysis or on the risk and uncertainties arising from such conditions."

Specific considerations listed in Section 3.5 are the following:

- Coverage Provisions – consider coverage changes, coverage disputes, or coverage litigation.

- Changing Conditions – consider changes in conditions particularly with regard to claims, losses, or exposures that are new or unusual.

- External Conditions – consider forces in the environment that are likely to have a ***material*** effect on the results of the actuary's reserve analysis. However, the actuary is not required to have detailed knowledge of all the economic changes, regulatory changes, judicial decisions, political or social forces, etc., that may affect the settlement values.

- Data – consider whether there are significant data problems or issues.

- Assumptions – consider the sensitivity of the reserve estimates to reasonable, alternative assumptions. When the use of reasonable, alternative assumptions would have a ***material*** effect the actuary should consider the implications regarding the risks and uncertainties associated with such an effect.

- Changes in Assumptions, Procedures or Methods – consider whether the change is likely to have a ***material*** effect on the results. The use of assumptions, procedures or methods for new reserve segments that differ from those used previously is not a change is assumptions, procedures, or methods. Similarly, when the determination of reserves is based on the periodic updating of experience data, factor, or weights, such periodic updating is not a change in assumptions, procedures or methods.

Section 3.7.1 Collectibility: "If the amount of ceded reinsurance reserves is ***material***, the actuary should consider the collectibility of ceded reinsurance."

Section 3.7.4 Risk Transfer Requirements: "... the actuary should ascertain whether an adjustment to the reserves to meet such requirements is likely to have a ***material*** effect on the actuary's reserve analysis or on the risk and uncertainties associated with the reserves."

Section 4.5 Changes in Opining Actuary's Assumptions, Procedures, or Methods: "If a change occurs in the opining actuary's assumptions, procedures, or methods from those previously employed in providing an opinion on the entity's reserves, and if the actuary believes that the change is likely to have a ***material*** effect on the results of the actuary's reserve analysis, then the actuary should disclose the nature of the change. If the actuary can not make a judgement as to whether the change is likely to have a ***material*** effect on the results of the actuary's reserve analysis, the actuary should disclose that there has been a change in actuarial assumptions, procedures, or methods, the effect of which is unknown. No disclosure is required unless the actuary believes that the changes are likely to have a ***material*** effect on the results of the actuary's reserve analysis."

Further, the statement of opinion should include the following disclosure(s):

Section 4.6.a.: "If there have been changes in accounting or processing procedures that significantly affect the consistency of the data used in the reserve analysis and that the actuary believes are likely to have a ***material*** effect on the results of the actuary's reserve analysis, then the actuary should disclose the nature of such changes in accounting or processing procedures."

Section 4.6.c.: "If the scope of the opinion includes consideration of regulatory or accounting requirements regarding risk transfer in reinsurance contracts and if an adjustment to the reserves to satisfy such requirements is likely to have a ***material*** effect on the results of the actuary's reserve analysis, then the actuary should disclose the impact of the risk transfer requirements."

Section 4.6.g.: "If the actuary reasonably believes that there are significant risks and uncertainties that could result in ***material*** adverse deviation, an explanatory paragraph (as described in section 3.3.3) should be included."

Section 4.6.h.: "If the statement of actuarial opinion relies on present values and if the actuary believes that such reliance is likely to have a ***material*** effect on the results of the actuary's reserve analysis, the actuary should disclose that present values were used in forming the opinion ... ."

Section 4.6.i.: "If the statement of actuarial opinion relies on risk margins and if the actuary believes that such reliance is likely to have a ***material*** effect on the results of the actuary's reserve analysis, then ... ."

Nota bene: The use of ***materially*** in the following excerpt from ASOP No. 36 differs from those discussed above as it refers to the actuary's procedures rather than to the results of the actuary's analysis.

Section 4.8.: The "actuary must be prepared to justify the use of any procedures that depart ***materially*** from those set forth in this standard and must include, in any actuarial communication disclosing the results of the procedures... ."

Materiality in Accounting Contexts

As of this writing, there is no ASOP specifically addressing materiality. Therefore, the primary guidance to the opining actuary is the language in ASOP No. 36. Secondarily, the opining actuary may consider other documents (including this one) originating both inside and outside the actuarial profession.

The NAIC in the preamble to its new Accounting Practices and Procedures Manual (Codification) and the SEC in its Staff Accounting Bulletin (SAB) No. 99 have addressed materiality. These documents discuss materiality from an accounting viewpoint. While neither document can be taken as an Actuarial Standard of Practice, the language itself may provide some understanding as to what constitutes materiality for certain parties interested in the opining actuary's work (e.g., regulators and public auditors).

A. NAIC Accounting Practices and Procedures Manual

The Codification defines a material omission or misstatement of an item in a statutory financial statement as having a magnitude such that it is probable that the judgment of a reasonable person relying upon the statutory financial statement would be changed or influenced by the inclusion or correction of the item.

In narrowing the definition, the following considerations are discussed:

- Some items are more important than others and require closer scrutiny. These include items which may put the insurer in danger of breach of covenant or regulatory requirement (such as an RBC trigger), turn a loss into a profit, reverse a downward earning trend, or represent an unusual event.
- The relative size of the judgment item is usually more important than the absolute size. An example for this is a reserve amount that would significantly impact the earnings of a small company but barely impact the earnings of a large company.
- The amount of the deviation of an item that is considered immaterial may increase if the attainable degree of precision decreases.

B. S.E.C. Staff Accounting Bulletin No. 99

SAB No. 99 uses a similar definition of materiality and has many of the same considerations as does Codification, but it applies to financial statements filed with the SEC.

Of primary importance is that an item that is small in absolute magnitude may be important if its inclusion or modification would change someone's conclusion about the basic financial condition of the company. Numerous examples given in the document include, but are not limited to, masking a change in earnings or other trends, changing a loss into a gain or vice versa, hiding a failure to meet analysts' expectations, and affecting a portion of the business identified as having a key operational role.

But SAB No. 99 notes additional concerns beyond those it has in common with Codification. One issue is that the common practice of using quantitative thresholds as rules of thumb for materiality has no basis in law or accounting literature. Another is that the materiality of items should be considered both separately and in total. An example given considers materiality issues affecting revenues and expenses even though the difference in net income may net out to be small. Similarly, an item may be immaterial in the context of the current year financial statements only to cumulate with other items in the future to yield material differences.

Following are summarized concepts from SAB No. 99 concerning whether a particular set of circumstances is material.

- There should not be exclusive reliance on a percentage or numerical threshold to determine something is material or not.

- The use of a percentage or numerical threshold may provide the basis for a preliminary assumption regarding materiality.

- A matter is material if there is a substantial likelihood that a reasonable person would consider it important.

- Both "quantitative" and "qualitative" factors should be considered in assessing an item's materiality. Experienced human judgment is necessary and appropriate.

Following are qualitative considerations excerpted from SAB No. 99. Note that these items are not necessarily the appropriate items for considering materiality with regard to an SAO submitted to fulfill regulatory requirements. To quote:

> "Among the considerations that may well render material a quantitatively small misstatement of a financial statement item are –
>
> - whether the misstatement arises from an item capable of precise measurement or whether it arises from an estimate and, if so, the degree of imprecision inherent in the estimate
> - whether the misstatement masks a change in earnings or other trends
> - whether the misstatement hides a failure to meet analysts' consensus expectations for the enterprise
> - whether the misstatement changes a loss into income or vice versa
> - whether the misstatement concerns a segment or other portion of the registrant's business that has been identified as playing a significant role in the registrant's operations or profitability
> - whether the misstatement affects the registrant's compliance with regulatory requirements
> - whether the misstatement affects the registrant's compliance with loan covenants or other contractual requirements
> - whether the misstatement has the effect of increasing management's compensation – for example, by satisfying requirements for the award of bonuses or other forms of incentive compensation
> - whether the misstatement involves concealment of an unlawful transaction."

Further, SAB No. 99 concludes that each misstatement should be considered both separately and in the aggregate.

Materiality, Statements of Actuarial Opinion, and ASOP No. 36

VFIC intends that the prior section's review of materiality in an accounting context be regarded as suggestive of issues an actuary may consider in evaluating materiality in the context of ASOP No. 36. One common element between financial reporting and the SAO is that judgments regarding materiality involve both qualitative and quantitative considerations. As noted in Section 3.4 of ASOP No. 36:

> "The actuary should evaluate materiality based on professional judgment, materiality guidelines or standards applicable to the statement of actuarial opinion and the actuary's intended purpose for the statement of actuarial opinion."

Requiring the use of professional judgment and placing importance on intended purpose both emphasize the role of qualitative considerations in evaluating materiality.

Actuaries will naturally also focus on quantitative considerations related to judgments on materiality. No formula can be developed that will substitute for professional judgment by providing a materiality level for each situation. What can be done is to highlight some of the numerical considerations that may be relevant to the determination of materiality in some situations.

A. SAO's Filed with Statutory Annual Statements

Many SAO's are prepared to satisfy the regulatory requirement that such a statement be filed along with a company's annual statement. In that case, a key concern of the management and regulatory audiences for the SAO is company solvency. At least two qualitative issues suggest themselves for consideration in this context:

- Would the item under consideration affect the opining actuary's judgment as to whether the loss and loss expense reserves make a reasonable provision for the liabilities of the entity being opined on?
- Would the item under consideration affect the opinion reader's judgment concerning the impact of the loss and loss expense reserves on the solvency of the entity being opined on, even if the loss and loss expense reserves do make a reasonable provision for the liabilities of the entity being opined upon?

Following are possible quantitative measures that the actuary could consider in the initial phase of determining whether a particular item is material in the context of a SAO prepared for filing with regulators:

- Absolute magnitude of item that represents a correction or a different result if reviewing the work of others.
- Absolute magnitude of item for which data are not available or are incomplete.
- Ratio of item to reserves or statutory surplus.

- Impact of item on IRIS ratios.
- Impact of item on risk-based capital results.
- Likelihood or size of potential variation of ultimate actual result from current expectations.

B. SAO's Prepared for Other Purposes

If the SAO is prepared for a purpose other than that of reporting to regulators, other measures may be appropriate. As a qualitative consideration, the actuary may wish to consider the following issue:

- Would the item under consideration affect the opinion reader's judgment of the impact of loss and loss expense reserves relative to the purpose for which the SAO was obtained?

Here are some other quantitative measures that may be relevant in these contexts:

- Ratio of item to net income or net worth.
- Impact of item on earnings per share.

Evaluation of these quantitative measures to determine a materiality standard must be considered in conjunction with the purpose or intended use of the opinion, the specific circumstances of the entity being opined upon, and the actuary's professional judgment. Variations in a company's circumstances or in the purpose for which the opinion is sought can cause variations in materiality standards even for analyses of otherwise equivalent liabilities.