RMAD

Significant Risk of Material Adverse Deviation from an “Accounting” Perspective

Dale F. Ogden

Casualty Loss Reserve Seminar

September 11, 2007

Statutory RMAD Requirements

- The NAIC’s Annual Statement Instructions for P&C insurance companies require the Appointed Actuary to provide specific relevant comments to address the risk of material adverse deviation. The Actuary must:
  - identify the standard and disclose the amount in $US;
  - explicitly state if the Actuary reasonably believes there are significant risks that could result in material adverse deviation in the reserves; and
  - if such risk exists, include an explanatory paragraph to describe the major risk factors.

ASOP 36 RMAD Requirements

- Requires an explanatory paragraph when the actuary reasonably believes that there are significant risks and uncertainties that could result in material adverse deviation. This paragraph should contain the following:
  - the amount of adverse deviation that the actuary judges to be material with respect to the Statement of Actuarial Opinion; and
  - a description of the major factors or particular conditions underlying risks and uncertainties that the actuary believes could result in material adverse deviation.

ASOP 36 RMAD Considerations

“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. The actuary should understand which financial values are usually important to the intended uses of the statement of actuarial opinion and how those financial values are likely to be affected by changes in the reserves and future payments for losses and loss adjustment expenses.”

CATF Practice Note "Suggestions"

- Regulatory Guidance: The Actuary is encouraged to comment on the risks and other factors even when no RMAD is judged to exist. CATF:
  - stresses importance of considering the unique characteristics of each company vs. using "boiler plate" language; and
  - expects the Actuary to disclose such risks and uncertainties even when the carried reserve is within the actuary's reasonable range.

Just What is Material?

- Materiality is typically determined based on the impact of a change (most likely adverse) in the reserves.
- You may want to compare your definition of materiality to the auditor's definition of materiality and understand any differences.
- What are the auditors' definition(s) of materiality?
  - based on AICPA guidelines?
  - based on FASB guidelines?
  - based on SEC guidelines?
  - other (e.g., IAS) guidelines?

Materiality: Accountant vs. Regulator

In the Accounting context, materiality is much broader than for state insurance regulators. State insurance regulators are concerned primarily with solvency and financial solidity, i.e., the ability of an insurer to pay claims and continue to underwrite business without disrupting markets.

Other users of financial statements (e.g., owners, creditors, etc.) have concerns in addition to those of the state insurance regulators, including, but not limited to, net income and the ability to service debt, make payroll, pay bills, pay dividends, and continue to grow.

Materiality to an Accountant (SAS 47)

- The primary discussion of materiality is contained within AICPA's Statement on Auditing Standards SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*...which premises the discussion of materiality in audits with two concepts:
  - "The concept of materiality recognizes that some matters, either individually or in the aggregate, are important for fair presentation of financial statements in conformity with generally accepted accounting principles, while other matters are not important."
  - "In planning the audit, the auditor is concerned with matters that could be material to the financial statements. The auditor has no responsibility to plan and perform the audit to obtain reasonable assurance that misstatements, whether caused by errors or fraud, that are not material to the financial statements are detected."

Materiality to an Accountant (SAS 107)

- (SAS 107 will replace SAS 47) The auditor's consideration of materiality is a matter of professional judgment and is influenced by the auditor's perception of the **needs of the users** of financial statements. The **perceived needs of users** are recognized in the discussion of materiality in FASB's Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information*, which defines materiality as **"...the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement."** That discussion recognizes that materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations.

Consider the Needs of Users as a Group

- The auditor considers matters that are material to users of financial statements as a group, but does not consider the possible effects of misstatements on specific individual users, whose needs may vary widely. Users are assumed to:
  - 1. Have an appropriate knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with an appropriate diligence;
  - 2. Understand that financial statements are prepared and audited to levels of materiality;
  - 3. Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment, and the consideration of future events; and
  - 4. Make appropriate economic decisions on the basis of the information in the financial statements."

Materiality Definition - U.S. GAAP

Materiality is defined in the glossary of Financial Accounting Standards Board ("FASB") Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information* as:

"...the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement."

Materiality Definition - U.S. SEC

The SEC references the above U.S. GAAP definition of materiality in its Codification of Staff Accounting Bulletins. The materiality section of the codification points out that this definition:

> "...is in substance identical to the formulation used by the courts in interpreting the federal securities laws. The Supreme Court has held that a fact is material if there is "...a substantial likelihood that the...fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."

The SEC discussion of materiality addresses the issue of quantifying materiality and references the use of benchmarks.

Materiality Definition - International

International Accounting Standards: Materiality is defined in the glossary of the International Accounting Standards Board's "Framework for the Preparation and Presentation of Financial Statements" as:

Materiality—Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cutoff point rather than being a primary qualitative characteristic which information must have if it is to be useful.

VFIC Pronouncement on Materiality

- The Committee on Valuation, Finance, and Investments note on ASOP 36, included as an appendix to the COPLFR Practice Note, discusses considerations often used by the accounting profession and includes such considerations as whether a change would:
  - change someone's conclusion about the basic financial condition of the company;
  - put a company in danger of breaching a covenant or regulatory requirement;
  - turn a profit into a loss;
  - change an earnings trend; or
  - hide a failure to meet analysts' expectations.

Accountant versus Regulator
Are they really much different?

- Accountant (Auditor)
  - Accuracy of Income
  - Solvency
  - Going Concern Issues
  - Ability to Grow & Prosper
  - Ability to Service Debt
  - Ability to Pay Shareholder Dividends
  - Concerned with the Financial Statements as a whole and reserves are a major area of risk and uncertainty.
- Regulator (Appointed Actuary)
  - Solvency
  - Accuracy of Income
  - Going Concern Issues
  - Ability to Write Business
  - Ability to Pay Claims
  - Ability to Pay Policyholder Dividends
  - Concerned specifically with Gross and Net Reserves and related matters (e.g., ceded reinsurance) as the major area of risk and uncertainty.

Resources on Materiality

- ASOP 36;
- VFIC Practice Note;
- COPLR Practice Note;
- Academy Task Force on Materiality June 2006 Discussion Paper on Materiality;
- Annual Opinion Writers Symposium (October 17 or 18, 2007) at the O'Hare Hilton Hotel; and
- Accounting Literature.