

Report

Materiality

Task Force on Materiality

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Memorandum

To: All Fellows, Affiliates, Associates and Correspondents of the Canadian Institute of Actuaries

From: Jacques Tremblay, Chairperson
Practice Council
Jacqueline Friedland, Chairperson
Task Force on Materiality

Date: October 31, 2007

Subject: **Report – Materiality**

This report was developed by the Task Force on Materiality of the Canadian Institute of Actuaries (CIA) for discretionary use by actuaries. Its purpose is to assist Canadian actuaries in considering various aspects of materiality as they provide professional services to their principals.

In accordance with the Institute's Policy on Due Process for Approval of Practice-Related Material other than Standards of Practice, this report has been unanimously approved by the Task Force on Materiality and has received final approval for distribution by the Practice Council on October 10, 2007.

If you have any questions or comments regarding this report, please contact Jacqueline Friedland at jfriedland@kpmg.ca.

JT, JF

TABLE OF CONTENTS

1. Preface..... 4

2. Purpose And Scope..... 5

3. Background 5

4. Defining Materiality..... 6

5. Reflecting Upon Materiality: User is Key 7

6. Considerations in the Determination Of Materiality 9

7. Accounting vs. Actuarial Materiality 10

8. Communication and Disclosure..... 11

9. Areas for Further Research and Discussion..... 12

Appendix: Helpful References Regarding Materiality 14

1. PREFACE

This report was developed by the Task Force on Materiality of the Canadian Institute of Actuaries (CIA) for discretionary use by actuaries. Its purpose is to assist Canadian actuaries in considering various aspects of materiality as they provide professional services to their principals. Concepts in this document are broadly applicable to actuaries conducting valuation, pricing, reserving and financial modeling analyses in all practice areas (including life, health, pension, and property/casualty).

This document serves as a first step in the development of Canadian-based literature on the topic. The last section of the document highlights issues that we believe are important for further research and discussion. The task force hopes to promote discussion of materiality within the entire Canadian actuarial profession. We are hopeful that, over time, such discussions might lead to the evolution of revised CIA Standards of Practice (SOP) and generally accepted practices regarding materiality in Canada.

Task force reports represent the views of the task force and do not necessarily represent the views of the CIA. Members should be familiar with task force reports. These reports do not constitute SOP and therefore are not binding. These reports may or may not be in compliance with SOP. Responsibility for the manner of application of SOP in specific circumstances remains that of the members in the various practice areas (i.e., life, health, pension, and property/casualty).

This document relies to a great extent on the American Academy of Actuaries (AAA) Discussion Paper titled “Materiality – Concepts on Professionalism” issued in 2006. We acknowledge the combined efforts of members of both the CIA and the AAA and their contributions to the research, analysis, and composition of this document. Members should note that the professional rules of the CIA differ from the corresponding codes of conduct of the AAA and that the differences might impose different professional obligations on the CIA member than on the AAA member.

The Task Force on Materiality presents these ideas with the expectation that they will be both useful and thought-provoking and will enhance the Canadian actuarial profession’s consideration of aspects of materiality in professional practice. Ultimately, it is the SOP that governs the responsibilities of actuaries in this area. However, the ideas and suggestions offered in this document are intended to assist actuaries in applying the SOP to their individual situations. The task force believes that expanded discussion of the concepts and suggestions offered in this document will benefit the profession.

2. PURPOSE AND SCOPE

This document is intended to stimulate thinking and discussion about materiality in the CIA. The purpose is not only to build upon what exists in the current SOP and what has already occurred in the property/casualty practice area but also to extend the discussion into other practice areas. The task force hopes to promote discussion of materiality within the entire Canadian actuarial profession. We are hopeful that, over time, such discussions might lead to the evolution of revised SOP and generally accepted practices regarding materiality in Canada.

Concepts in this document are broadly applicable to all practice areas (including life, health, pension, property/casualty). The considerations set forth here also apply to all

actuarial work, including that done by actuaries employed by an insurance company or other entity, as well as by consulting actuaries in assignments for their clients.

By sharing the thoughts of several experienced actuaries, the task force encourages each actuary to give appropriate consideration to the concepts and suggestions contained in this document. Ultimately, however, each actuary must decide how to fulfill professional responsibilities in this area according to current SOP.

In this respect, CIA members should take note of the fact that the Rules of the CIA refer directly to the concept of what is *material* in Rule 13. Rule 13 states: “A member shall comply with the procedures set out in Annotation 13-1 if the member becomes aware of any apparent material noncompliance by another member with the Rules or with the standards of practice.”

Much of the contents of this document relate to how the professional services of the CIA member are viewed by the users of professional services. Members should take note of their professional obligations under Rule 6 (Control of Work Product). Annotation 6-1 states: “Material prepared by a member may be used by another party in a way that may influence the actions of a third party. The member should recognize the risks of misquotation, misinterpretation or other misuse of such material and should take reasonable steps to ensure that the material is clear and presented fairly, and that the member is identified as the source of the material.”

CIA members should also consider the onus placed on them by Annotation 1-2 which states that “It is the professional responsibility of the member not to be associated with anything which the member knows or should know is false or misleading.” This document on materiality points out that it is the judgment of how information prepared by the actuary might affect the user’s decision making or the user’s reasonable expectations that is the key concept underlying materiality.

3. BACKGROUND

The concept of materiality is central to the reporting and interpretation of financial information. Loosely defined as “importance,” the question of whether or not something is “material” means, quite literally, whether or not it matters to the **user** of the information. When related to financial information, the question of materiality arises in the context of inclusion (whether or not an item needs to be considered), in the context of refinement (whether or not a number is accurate enough to convey its intended message), and in the context of disclosure (whether or not a fact needs to be reported).

Accountants have long recognized the issue of materiality and its role in the reporting of financial information. They have defined the concept in both qualitative and quantitative terms, although judgment, by necessity, plays a significant role as well. However, while the concept of materiality is of no less importance to the actuary’s work than it is to the accountant’s, and while the term and related concepts are pervasive in the actuarial literature, there is very little professional guidance for the actuary seeking to evaluate what is and what is not material – what does and does not matter – in a particular situation.

Materiality is a critical element of financial reporting for insurance contracts, employee benefit plans, and other financial instruments for which actuaries provide professional

services. Actuaries' clients and employers, as well as other interested persons, may not always understand the differences between materiality from an accounting perspective, from their personal perspective, and materiality as it is understood and used by actuaries. Moreover, actuaries working in different practice areas may address materiality somewhat differently, and the guidance on materiality available to actuaries from organizations other than the CIA differs among the various practice areas.

Paragraph 1340.03 of the SOP, Materiality, states that ““Material” has its ordinary meaning, but judged from the point of view of a user, having regard for the purpose of the work.” While there is a current SOP related to materiality, many members of the CIA have expressed an interest in further guidance on the topic.

The CIA determined that it would be helpful to develop a document offering non-binding guidance on materiality. Therefore, the CIA's Practice Council established the task force to prepare a document for broad dissemination to the membership. The purpose of the document is not to impose any new or revised requirements to the existing SOP, but to identify issues, enhance awareness, and assist actuaries and others toward a clearer understanding of the topics addressed in this document.

4. DEFINING MATERIALITY

Paragraph 1340.03 of the SOP contains the following generalized description of the concept of materiality:

...an omission, understatement, or overstatement is material if the actuary expects it materially to affect either the user's decision making or the user's reasonable expectations.

Most descriptions of materiality emphasize that an omission or misstatement is material if the judgment of a *reasonable person* would have been changed or influenced by the inclusion or correction of the item, given *surrounding circumstances*.

The reader may find it helpful to keep this in mind when reading this document. Further discussion of the description of materiality appears in the next section, “Reflecting Upon Materiality: User is Key.”

In understanding what materiality is, it is also important to recognize what materiality is not. The task force wishes to emphasize that the concept of materiality is different from the concepts of:

- the range of reasonable values in an actuarial estimate; and
- the inherent uncertainty associated with actuarial estimates.

Sources of discussion to which actuaries have access include:

- actuarial and accounting guidance from other countries and from International Standards on Auditing;
- Actuarial Standards of Practice (ASOP) of the American Academy of Actuaries (AAA);
- Canadian Institute of Chartered Accountants (CICA);
- Financial Accounting Standards Board (FASB);

- International Accounting Standards Board (IASB);
- National Association of Insurance Commissioners (NAIC) Financial Examiners' Handbook and Accounting Practices and Procedures Manual;
- Practice and Educational Notes of actuarial societies;
- Securities and Exchange Commission (SEC);
- US Federal and state courts;
- Valuation, Finance and Investment Committee (VFIC) of the Casualty Actuarial Society (CAS).

In the Appendix, we include a wide range of extracts from relevant literature to assist actuaries in their consideration of materiality.

Throughout this document, SOP refers to the Standards of Practice promulgated by the CIA, and ASOP refers to the Standards of Practice of the AAA. This document contains references to the Standards of Practice of both organizations due to the participation of members from both organizations in the research and development of the document.

5. REFLECTING UPON MATERIALITY: USER IS KEY

Subsection 1340 of the SOP provides a generalized description of “materiality.” This document does not seek to propose a universal definition of materiality for actuarial purposes. We preferred to focus on applying judgment about materiality. We were somewhat startled at the strong emphasis of the Merriam-Webster OnLine dictionary’s definition of “material - having real importance or great consequences” – and in particular the word “great.” Upon reading this definition, one immediately responds “to whom?”

User perspective is typically the key element in materiality determinations. In applying judgment to determine how to address materiality, the actuary normally focuses on the purpose of the work and its intended user(s). The definitions in the Appendix at the end of this document collectively appear to send the message: “know your user.” However, this is sometimes more difficult than it may seem, since it is quite common for actuarial work products to be used, in one way or another, by indirect users about whom the actuary cannot possibly be knowledgeable. Indeed, different users (including unintended users) may have different expectations regarding materiality.

In section 1800 of the SOP Reporting, the focus is on external user reports and internal user reports. The issue of intended and unintended users is not specifically addressed in the SOP. The ASOP 41 does address this specific issue. ASOP 41 states that the actuary is not responsible to unintended users with whom they did not intend to communicate. Notwithstanding the presence or absence of a specific SOP, actuaries may be found to retain some responsibility to assure that a report is not misused or misapplied by all users of the work product as stated in CIA Annotation 6-1 on Control of Work Product.

Having decided upon the selected materiality level for a particular assignment, the actuary might be well advised to test it by asking rhetorically “would my users come to a different conclusion or a different decision if I used some other materiality level?” Then

we immediately encounter the difficulty referred to above, i.e., the actuary cannot possibly be knowledgeable about all indirect users.

ASOP No. 41, *Actuarial Communications* provides an approach to resolve this difficulty. Section 2.5 thereof defines “intended audience” as “The persons to whom the actuarial communication is directed and with whom the actuary, *after discussion with the principal* (emphasis added), intends to communicate.” The rest of the definition makes it clear that, unless otherwise agreed, the principal is always part of the intended audience, and gives examples of others (such as regulators, policyholders and plan participants) who may be designated by the principal, with consent of the actuary, as members of the intended audience.

Section 2.6 of ASOP No. 41 defines “other user” as “Any user of an actuarial communication who is not a principal or member of the intended audience.” This framework provides valuable protection for the actuary, who is entitled to be in control at all times regarding the intended audience and therefore cannot be taken by surprise by the existence of “other users” about whom the actuary is ignorant. Note too that Section 3.5.2 of ASOP No. 41 provides that there is no obligation for the actuary to communicate with any person other than the intended audience. We recognize that ASOP are not binding on members of the CIA who are not also members of the AAA.

SOP Section 1800 Reporting requires the actuary to ensure that the form and content of the actuarial reporting are clear and appropriate to the particular circumstances. SOP paragraph 1820.14 states: “Description of the purpose of the work and its users permits another person to assess its appropriateness to his or her needs and may thereby avoid unintended use of the work.” Consequently, by taking due care as to who is included as part of the intended audience, the actuary is able to apply informed judgment in arriving at the selected materiality level. For example, if policyholders are included, then the actuary should have due regard of the fact that policyholders, in general, are likely to be less sophisticated than the actuary’s principal, regulators or investors.

In summary, the actuary who prepares the work (the “preparer”) is expected to take reasonable steps to ensure that the work does not mislead the intended users of the work. An evaluation of whether this threshold is met should consider: the intended users, their knowledge, and their situations. A clear statement by the preparer of both the intended users of the work product and the intended uses of the work product is a valuable tool to focus the attention of the preparer on what may be material.

6. CONSIDERATIONS IN THE DETERMINATION OF MATERIALITY

Paragraph 1340.02 states in part:

Judgment about materiality pervades virtually all work and affects the application of nearly all standards.

The appropriate degree of rigor in establishing or communicating the selected materiality level for a particular assignment may vary depending upon the needs, skill, sophistication, and experience of the intended audience for the actuary’s work. The Appendix at the end of this document contains numerous references as to how the selected materiality level might conceivably affect the user’s decision-making or reasonable expectations.

Materiality tends to be more task-specific than practice-specific. For example, we expect there to be more similarities in applying judgment about materiality to valuation type work among the various practice areas (life, health, pension, property/casualty) than we would when applying such judgment to valuation type work and product/rate development work within the same practice area.

Perhaps understandably, in light of regulatory scrutiny and the sophistication of users of actuarial work involving policy liabilities valuations as well as mergers and acquisitions transactions, actuaries in Canada appear to have more experience in applying judgment about materiality in the context of valuation work (used here to include not only statement reserves and merger/acquisition work but also portfolio transfers) than has been the case when setting rates. Nevertheless, the concepts of materiality are also applicable in product/rate development work.

There currently exists a difference in practice among actuaries with respect to the establishment of single or multiple materiality levels. Some actuaries develop a separate materiality level for data that is generally much smaller than the materiality level for the organization in total. For example, an actuary may choose a \$25,000 materiality level for data and a \$5 million materiality level for the organization's total policy liabilities. The more common practice, however, is the selection of a single materiality level.

Returning to the user focus and the generalized description of materiality contained in subsection 1340 of the SOP, unless there are good reasons, an actuary would generally select one materiality level for a particular actuarial task or assignment, and there would not be separate materiality levels identified for data and the overall actuarial analysis. Although it may be appropriate to identify a separate "tolerance level" as a threshold for accuracy and completeness of data, this concept is separate from the matter of materiality and would not normally be referred to or labeled as a selected materiality level.

In the normal course of events, an actuary generally would not change the materiality level significantly from year to year or valuation to valuation. However, as an organization approaches a threshold or some external benchmark, an actuary may well choose to consider changing the approach or the degree of rigor applied when determining materiality. For example, if an insurance company is close to breaching regulatory action levels, many actuaries would agree that there are likely to be good grounds for changing the selected level of materiality.

In summary, when determining materiality, the user will want to keep in mind the following considerations frequently cited in discussions on materiality:

- The materiality level should be related to the purposes and intended uses of the work. The actuary should understand which financial values are usually important for the intended uses. For example:
 - For regulatory or solvency issues, the materiality level is typically related to statutory surplus or the solvency benchmark ratio;
 - For appraisal work, the materiality level is generally related to net worth, net income, or earnings per share;

- For DCAT work, the materiality level is expected to be less rigorous than for valuation work;
- For general purpose financial statement work, the materiality level is generally related both to net income and net capital (or net surplus);
- Exclusive reliance on quantitative benchmarks is inappropriate. A quantitative rule-of-thumb may be a starting point, but it must be reviewed to take into account the purpose of the work and the individual entity's circumstances.
- The materiality level is also expected to vary according to other characteristics of the entity including but not limited to the:
 - Size of the entity;
 - Entity's access to capital;
 - Stage of organizational life cycle;
 - Type of business (e.g., multi-line vs. single line, personal lines vs. commercial lines);
 - Net retention.

The materiality level will also vary according to the financial strength of the entity. In particular, paragraph 1340.04 of the SOP states: "The standard of materiality for work involving a threshold...would become more rigorous as the entity approaches that threshold."

7. ACCOUNTING VS. ACTUARIAL MATERIALITY

As noted in the "Defining Materiality" section of this document, an actuary selects an appropriate materiality level based on his or her professional judgment as to the magnitude of an omission, understatement or overstatement that would cause the user to reach a different conclusion or follow a different course of action. An accountant or auditor working for the same entity would presumably base his or her selection of the materiality level on similar criteria. Some actuaries would argue that, at least in theory, the materiality level selected by the actuary would normally be close to that selected by the accountant or auditor given that the report was prepared for financial reporting purposes.

An important consideration for the "preparer" actuary to bear in mind might be that the "user" auditor is also a "preparer" of the general purpose financial statements. While the direct users of an appointed actuary's report might be relatively sophisticated regulatory and auditing professionals, the "preparer" actuary should also consider how the auditor might use the report in communicating with the ultimate, less sophisticated, general purpose financial statement user.

According to SOP subsection 1630 CIA/CICA Joint Policy Statement (effective October 1, 2007), communication regarding materiality is expected between the actuary and the auditor. Paragraph 1630.10(e) states:

“The enquiring professional would:

...make the responding professional aware of the enquiring professional’s needs. This would include a discussion of:

- (i) the application of the concept of materiality to determine that the responding professional will be using a materiality level that is appropriate in relation to the enquiring professional’s materiality level in accordance with applicable professional standards...”

As a practical matter, however, accountants and auditors may select a materiality level without first communicating with the actuary. For example, auditors of an insurance company attest to the existence and value of assets on the one hand (large numbers that are usually comparable with reserves, at least in the aggregate) and premium data and expenses on the other (which, by contrast, tend to be relatively smaller numbers, especially at the policy or contract level). Auditors may not always use the same materiality level when making these two attestations.

Good communication between the actuary and the auditor (for which specific guidance is offered in SOP Sections 1620 Auditor’s Use of an Actuary’s Work and 1630 CIA/CICA Joint Policy Statement) is likely to lead to selection of appropriate materiality levels by both actuary and auditor. If such materiality levels are not the same, good communication would facilitate the discussion of any differences with the intended audience.

An important part of knowing the user in communications between the actuary and the auditor may also be to understand what constitutes a material subsequent event to the accountant user who is also the preparer of general purpose public financial statements.

8. COMMUNICATION AND DISCLOSURE

Throughout this document, the main factor underlying the selection of a materiality level has been the impact on the user. It would normally be in the user’s interest to be aware of the materiality level selected and used by the actuary. Accordingly, it seems reasonable that the actuary would usually at least consider some disclosure regarding the materiality level within the actuarial work product.

However, this consideration must also take into account the complexity of the concept of materiality, the potential importance of the concept to the user, as well as the sophistication of the user who will be receiving the work product. In some cases, it may be apparent that any discussion of the materiality level is likely to give rise to misunderstanding and confusion. In other cases, full disclosure of the materiality level selected, as well as the rationale behind the selection, may be appropriate.

According to paragraphs 1820.07 and 1820.08 of the SOP:

Appropriate description and disclosure in a report strike a balance between too little and too much. Too little deprives the user of needed information. Too much may exaggerate the importance of minor matters, imply a diminution of the actuary’s responsibility for the work, or make the report hard to read.

The appropriate criterion for description and disclosure is the question: what qualitative and quantitative information best serves the user's understanding and decision-making?

While subsection 1630 of the SOP, CIA/CICA Joint Policy Statement, requires communication regarding materiality between the actuary and the auditor, subsection 1340, Materiality, does not currently require disclosure of the selected materiality level. In actuarial work other than policy liabilities valuations and dynamic capital adequacy testing, it is currently left to the actuary's professional judgment as to whether disclosure of the materiality level is appropriate for the user's understanding of the actuarial work product, and to determine the nature and scope of appropriate disclosure under the circumstances.

According to paragraph 1340.03, "If practical, the actuary would discuss the standard of materiality with the user. Alternatively, the actuary would report the purpose of the work as precisely as possible, so that the user is warned of the risk of using the work for a different purpose with a more rigorous standard of materiality." This approach will mitigate some of the actuary's concerns towards unintended users who would use different materiality levels for their respective purposes. Observance of Section 1340 is made more likely if the intended users of the work product and uses of the work product are enumerated in the actuarial work product.

9. AREAS FOR FURTHER RESEARCH AND DISCUSSION

This document is intended to be a first step in an ongoing process of research and discussion on the topic of materiality. In preparing this introductory document, particular attention was paid to features of the Rules, Standards, and Statements applicable to members of the CIA. The task force has identified the following issues for further investigation and discussion:

- How does materiality relate to the range of reasonable results in an actuarial estimate?
- How does materiality relate to the inherent uncertainty associated with an actuarial estimate?
- Whether examples of the application of materiality in a variety of situations should be provided?
- Is there an impact on materiality if each and every assumption must stand on its own?
- Should the actuary treat materiality differently in an internal user report?
- Should the discussion on actuaries and auditors be expanded upon?

- With respect to communication:
 - Should the actuary consider not only disclosure about materiality but also the application of materiality?
 - What communication is required if there is no written report?

The task force presents the above list of items to be considered for example purpose only and not to limit future efforts.

APPENDIX A

HELPFUL REFERENCES REGARDING MATERIALITY

Peter D. Arthur, CA, CIA Open Forum #21: Unresolved Issues in Standards of Practice

A misstatement or the aggregate of all misstatements in financial statements is considered to be material if, in the light of surrounding circumstances, it is probable that the decision of a person who is relying on the financial statements and who has a reasonable knowledge of the business and economic activities would be changed or influenced by the misstatement or the aggregate of all misstatements.

ASOP No. 5, Incurred Health and Disability Claims

- 2.8 Material – Resulting in an impact, significant to the interested parties, on the affected actuarial incurred claim estimate.”

ASOP No. 17, Expert Testimony by Actuaries

- 2.7 Material – An item is material if it has an impact on the affected actuarial opinion, which is significant to the interested parties.”

ASOP No. 36, Statements of Actuarial Opinion regarding Property/Casualty Loss and Loss Adjustment Expense Reserves

Although the ASOP itself applies only to property/casualty work of a particular kind, Section 3.4 of the ASOP contains some useful ideas for action in all practice areas that actuaries may wish to consider when selecting standards of materiality. The section is reproduced here in full.

- 3.4 Materiality – In evaluating materiality within the context of a reserve opinion, 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. 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. For example, materiality might be evaluated in terms of the specified reserve amount for which an opinion is being given. For a statement of actuarial opinion for an insurance company to be used for financial reporting to insurance regulators, materiality might be evaluated in terms of the company’s reported statutory surplus. As another example, for a statement of actuarial opinion to be used for an actuarial appraisal of an insurance company, it might be appropriate to evaluate materiality in terms of both the company’s net worth and annual net income, since both values are usually important factors in assessing the value of the company.

ASOP No. 41, Actuarial Communications

- 2.5 Intended Audience—The persons to whom the actuarial communication is directed and with whom the actuary, after discussion with the principal, intends to communicate. Unless otherwise specifically agreed, the principal is always a member of the intended audience. In addition, other persons or organizations, such as regulators, policyholders, plan participants, investors, or others, may be designated by the principal, with consent of the actuary, as members of the intended audience.
- 2.6 Other User—Any user of an actuarial communication who is not a principal or member of the intended audience.
- 3.1.2 Form and Content—The actuary should take appropriate steps to ensure that the form and content of the actuarial communication are clear and appropriate to the particular circumstances, taking into account the intended audience. To accomplish these actuarial communication objectives, the actuary should consider whether such actuarial communication should be made in an actuarial report. Factors to consider in making such a determination include the complexity of the actuarial engagement or assignment; the actuary’s perception of the significance of the actuarial findings; and relevant communication guidance in other ASOPs. Information included in previous actuarial communications that are available to the intended audience may be incorporated by reference, by the actuary, into an actuarial communication issued under this standard.
- 3.5.2 No Obligation to Communicate with Other Users—Nothing in this standard creates an obligation for the actuary to communicate with any person other than the intended audience.

Paragraph 1340.02 through to 1340.06 of the SOP

- 1340.02 Judgment about materiality pervades virtually all work and affects the application of nearly all standards. The words “materiality” and “material” seldom appear in the standards, but are understood throughout them. For example, the recommendation that approximation is appropriate if it does not affect the result means that it does not **materially** affect the result.
- 1340.03 “Material” has its ordinary meaning, but judged from the point of view of a user, having regard for the purpose of the work. Thus, an omission, understatement, or overstatement is material if the actuary expects it materially to affect either the user’s decision making or the user’s reasonable expectations. Usually, however, the user does not specify a standard of materiality, so the judgment falls to the actuary. That judgment may be difficult for one or more of these reasons:

The standard of materiality depends on how the user uses the actuary’s work, which the actuary may be unable to foresee. If practical, the actuary would discuss the standard of materiality with the user. Alternatively, the actuary would report the purpose of the work as precisely as possible, so that the user is warned of

the risk of using the work for a different purpose with a more rigorous standard of materiality.

The standard of materiality may vary among users. The actuary would choose the most rigorous standard of materiality among the users.

The standard of materiality may vary among uses. For example, the same accounting calculations may be used for a pension plan's financial statements and the financial statements of its participating employer. The actuary would choose the more rigorous standard of materiality between those two uses.

The standard of materiality depends on the user's reasonable expectations, consistent with the purpose of the work. For example, advice on winding-up a pension plan may affect each participant's share of its assets, so there is a conflict between equity and practicality. Similarly for advice on a policyholder dividend scale.

1340.04 The standard of materiality also depends on the work and the entity which is the subject of that work. For example:

A given dollar standard of materiality is more rigorous for a large than for a small entity.

The standard of materiality for valuation of an insurer's policy liabilities is usually more rigorous for those in its financial statements than for those in a forecast in dynamic capital adequacy testing.

The standard of materiality for data is more rigorous for determining an individual benefit (such as in a pension plan wind-up) than for a valuation of a group benefits plan (such as a going-concern valuation of a pension plan's liabilities).

The standard of materiality for work involving a threshold, such as a regulatory capital adequacy requirement calculation of an insurer or a statutory minimum or maximum funding level for a pension plan would become more rigorous as the entity approaches that threshold.

1340.05 The actuary would not report an immaterial deviation from a particular recommendation or other guidance in the standards except if doing so assists a user to decide if the standard of materiality is appropriate for that user.

1340.06 The recommendation applies to both calculation and reporting standards.

Judicial Application of Materiality Levels

The following excerpts have been selected from a sampling of cases in which the courts have defined materiality in the context of financial statements.

SEC v. Price Waterhouse, 797 F.Supp. 1217, 1237 (S.D.N.Y., 1992).

“Materiality is defined in the accounting literature as ‘[t]he magnitude of an omission or misstatement of accounting information that, in light of surrounding circumstances, makes it probable that the judgment of a reasonable person would have been changed or influenced by the omission or misstatement.’ (citation omitted) While the literature reflects that the 5 to 10 percent range relied on by the Commission is ‘useful’ (citation omitted), that literature also makes clear that there are no generalized standards for determining the materiality of a particular ‘judgment item’ (citation omitted), because a materiality decision is a qualitative one requiring consideration by an accountant of a wide range of information factors including, *inter alia*, the nature of the item under consideration; whether it arises from a routine or abnormal transaction; the size of the enterprise; and the company’s financial condition and trends in profitability. (citation omitted) Moreover, FAS Con 2 explicitly states that ‘[m]agnitude by itself, without regard to the nature of the item and the circumstances in which the judgment has to be made, will not generally be a sufficient basis for a materiality judgment.’” (citation omitted)

Delta Holdings, Inc. v. National Distillers and Chemical Corp., 945 F.2d 1226, 1242 (C.A.2 (N.Y.), 1991).

“The applicable legal standard regarding the materiality of omitted information is whether ‘there is a substantial likelihood that a reasonable shareholder would consider it important’ or ‘a substantial likelihood that the disclosure...would have been viewed by the reasonable investor as having significantly altered the total mix of information made available.’” (citation omitted)

Hudson v. General Dynamics Corp., 118 F.Supp.2d 226, 249 (Conn., 2000).

“This determination [of materiality] is . . . based on whether there is a substantial likelihood that the misrepresentation would mislead a reasonable employee in making an adequately informed decision about if and when to retire. (citation omitted) [There are] a number of factors to consider when determining materiality, including ‘how significantly the statement misrepresents the present status of internal deliberations regarding future plan changes; the special relationship of trust and confidence between the plan fiduciary and beneficiary; whether the employee was aware of other information or statements from the company tending to minimize the importance of the misrepresentation or should have been so aware, taking into consideration the broad trust responsibilities owed by the plan administrator to the employee and the employee's reliance on the plan administrator for truthful information.’” (citation omitted)

FASB Statement of Financial Accounting Concepts No. 2, “Qualitative Characteristics of Accounting Information”

FASB Statement No. 2 generally provides that quantitative and qualitative factors should both be considered when determining materiality. It further states that FASB has long emphasized that materiality cannot be reduced to a numeric formula. “The predominant

view is that materiality judgments can properly be made only by those who have all the facts. The Board's present position is that no general standards of materiality could be formulated to take into account all the considerations that enter into an experienced human judgment." Additionally, FASB Statement No. 2 provides that "Magnitude by itself, without regard to the nature of the item and the circumstances in which the judgment has to be made, will not generally be a sufficient basis for a materiality judgment."

The omission or misstatement of an item in a financial report is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item.

International Accounting Standard 1, "Presentation of Financial Statements"

"Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor."

International Accounting Standards

"Users are assumed to:

- Have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence;
- Understand that financial statements are prepared and audited to levels of materiality and that there is a relationship between the level of materiality used and the cost and timing of the audit;
- Recognize the uncertainties in the measurement of amounts based on the use of estimates, judgment and the consideration of future events;
- Make reasonable economic decisions on the basis of the information in the financial statements.

The determination of materiality, therefore, takes into account how users with such characteristics could reasonably be expected to be influenced in making economic decisions.

- When determining materiality in audits of financial statements or other historical financial information, prepared for a special purpose, the auditor considers the needs of specific users in the context of the objective of the engagement.
- Materiality is determined without regard to the degree of inherent uncertainty associated with the measurement of particular items. For example, the fact that the financial statements include very large provisions with a high degree of estimation uncertainty (e.g., provisions for insurance claims in the case of an insurance company, oil rig

decommissioning costs in the case of an oil company, or more generally, legal claims against an entity) does not cause the auditor to determine the materiality level for the financial statements to be higher than for financial statements that do not include such inherent estimation uncertainties.”

Proposed International Standard on Auditing 320 (Revised)

Materiality in Planning and Performing an Audit

Materiality in the Context of an Audit

5. The auditor’s consideration of materiality is a matter of professional judgment, and is affected by the auditor’s perception of the financial information needs of users of the financial statements. For the purposes of the audit, the auditor is concerned with misstatements, including omissions, which could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements. In this context, it is reasonable for the auditor to assume that users:
 - (a) Have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence;
 - (b) Understand that financial statements are prepared and audited to levels of materiality;
 - (c) Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and
 - (d) Make reasonable economic decisions on the basis of the information in the financial statements.
6. Furthermore, the auditor’s consideration of materiality is based on the common financial information needs of users as a group; the auditor does not consider the possible effect of misstatements on specific individual users, whose needs may vary widely.
7. Materiality depends on the size and nature of the misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.

Use of Benchmarks in Determining Materiality

11. Determining what is material to users of the financial statements requires the exercise of professional judgment. The auditor often applies a percentage to a chosen benchmark as a starting point in determining a materiality level for the financial statements as a whole.
12. When identifying an appropriate benchmark, the auditor has regard to factors such as:
 - The elements of the financial statements (e.g., assets, liabilities, equity, income, expenses);
 - Whether there are items on which the attention of the users of the particular entity’s financial statements tends to be focused (e.g., for the

purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets);

- The nature of the entity, where the entity is at in its life cycle, and the industry and economic environment in which the entity operates;
- The size of the entity, nature of its ownership and the way it is financed (e.g., if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings); and
- The relative volatility of the benchmark.

14. Having identified an appropriate benchmark, the auditor identifies relevant financial data to be used in determining materiality. The auditor ordinarily considers prior periods' financial results and financial positions, the period-to-date financial results and financial position, and budgets or forecasts for the current period, taking account of significant changes in the circumstances of the entity (e.g., a significant business acquisition) and relevant changes of conditions in the industry or economic environment in which the entity operates. For example, when the auditor, as a starting point, determines materiality for a particular entity based on a percentage of profit before tax from continuing operations, circumstances that give rise to an exceptional decrease or increase in such profit may lead the auditor to conclude that materiality is more appropriately determined using a normalized profit before tax from continuing operations figure based on past results.

Documentation

26. The auditor should document:

- (a) The materiality level for the financial statements as a whole;
- (b) The materiality level for a particular class of transactions, account balance or disclosure, if applicable;
- (c) The amount (or amounts) determined for purposes of assessing risks of material misstatement and designing further audit procedures;
- (d) Any changes made to (a) – (c) as the audit progressed; and
- (e) How the amounts in (a) – (d) were determined.

Mary D. Miller, FCAS, MAAA, Actuary Ohio Department of Insurance

“Materiality and the Actuary”, Casualty Loss Reserve Seminar, September 2005

Materiality reviewed in relationship to financial values that are important to the intended audience, for example:

- Regulator: statutory surplus; risk based capital; loss, LAE and unearned premium reserves; IRIS tests
- Appraisal: net worth (GAAP); net income; earnings per share

Materiality considerations:

- Single vs. multi-line company
- Net retention
- Single company vs. member of a group
- Access to capital
- Management
- Prior loss reserve runoff
- Financial strength

“Materiality and ASOP No. 36: Considerations for the Practicing Actuary”, CAS Committee on Valuation, Finance, and Investments

“No formula can be developed that will substitute for professional judgment by providing a materiality level for each situation.”

Possible quantitative matters that the actuary could consider in the initial phase of determining whether a particular item is material:

- Absolute magnitude of item that represents a correction or a differing 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 results from current expectations
- Ratio of item to net income or net worth
- Impact of item on earnings per share

NAIC Financial Examiners Handbook

Planning materiality: starting point is 1% to 5% of surplus.

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.

- 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.

SEC Staff Accounting Bulletin: No. 99 – Materiality

The relevant portions of this SEC bulletin may be summarized as follows:

- The common practice of using quantitative thresholds as rules of thumb for materiality has no basis in law or accounting literature. Exclusive reliance on certain quantitative benchmarks to assess materiality in preparing financial statements ... is inappropriate; misstatements are not immaterial simply because they fall beneath a numerical threshold.
- The use of a percentage as a numerical threshold, such as 5%, may provide the basis for a preliminary assumption regarding materiality. There is no objection to a “rule of thumb” as an initial step in assessing materiality.
- Both quantitative and qualitative factors should be considered.
- Experienced human judgment is necessary and appropriate.
- 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.
- Materiality 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.

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