

25. (1.75 points)

a. (0.5 point)

Identify two considerations in determining whether to disclose the materiality standard to the intended user of an actuarial work product.

b. (0.5 point)

Briefly describe two reasons why determining materiality can be difficult.

c. (0.75 point)

Propose language for the RELEVANT COMMENTS paragraph of the Statement of Actuarial Opinion related to the materiality standard.

## SAMPLE ANSWERS AND EXAMINER'S REPORT

<b>QUESTION: SPRING 2018 EXAM 6U, QUESTION 25</b>	
<b>TOTAL POINT VALUE: 1.75</b>	<b>LEARNING OBJECTIVE: D</b>
<b>SAMPLE ANSWERS</b>	
<b>Part a: 0.5 point</b>	
<ul style="list-style-type: none"><li>• <u>Sample Responses for the complexity of the concept of materiality</u><ul style="list-style-type: none"><li>○ If the standard will blur the message of the work product</li><li>○ Will it be misleading for intended users</li><li>○ Whether the materiality standard is easy to understand</li><li>○ If it is a highly complicated product, the user may be confused by the methodology used to derive the standard</li></ul></li> <li>• <u>Sample Responses for the potential importance of the concept to the user</u><ul style="list-style-type: none"><li>○ If it will change the decision made by the user</li><li>○ Is the standard important to the user?</li><li>○ Whether the materiality standard is relevant to the user</li><li>○ Is the standard likely to change the user's understanding of the work product</li><li>○ Consider how the user will use the materiality standard</li></ul></li> <li>• <u>Sample Responses for the sophistication of the user who will be receiving the work product</u><ul style="list-style-type: none"><li>○ Intended user's sophistication</li><li>○ The user's background</li><li>○ Whether the user will know what materiality is</li><li>○ Will the user understand the concept of materiality or take it out of context?</li></ul></li> <li>• <u>Sample Responses for legal or regulatory requirement to disclose the standard</u><ul style="list-style-type: none"><li>○ Is it a required disclosure?</li><li>○ Is the disclosure required? E.g. the SAO requires disclosure.</li><li>○ If the corresponding regulations require disclosure</li></ul></li></ul>	
<b>Part b: 0.5 point</b>	
<ul style="list-style-type: none"><li>• <u>Sample Responses for indirect users of the actuarial work product about whom the actuary cannot possibly be knowledgeable</u><ul style="list-style-type: none"><li>○ It is often difficult to determine exactly what users will do with the actuarial work product (how they will use it) so it is tough to know what may impact their opinion/decision</li><li>○ The actuary does not always know what sort of omission/understatement/overstatement would cause a change in decision making. The actuary doesn't know if the report will get shared with other users.</li></ul></li> <li>• <u>Sample Responses for different users may have different expectations regarding materiality</u></li></ul>	

## SAMPLE ANSWERS AND EXAMINER'S REPORT

- Materiality standards could be different for different users.
- Because there might be multiple users; regulator has different focus (solvency) vs. management (ongoing/profit drivers).
- The definition of “material” and the level at which someone determines something is material is very different depending on the person.
- Sample Responses for no formula can be developed that will substitute for professional judgment by providing a materiality level for each situation.
  - Determining materiality standard is somewhat arbitrary, as the materiality standard of say 10% of reserves vs. 5% of surplus can be equally good, and it is difficult to justify why one prefers one over the other.
  - There is no formulaic method to determine materiality. It involves a lot of judgment
  - What to base the standard on can be difficult as there are many options, each with pros and cons, but all valid: % of surplus, % of held reserves, next RBC action level.
- Sample Responses for desire to reference a proprietary rating agency model without being able to accurately predict the impact on the model.
  - Because it is hard to estimate an amount that will result in downgrade of financial rating in rating model used by rating agency, which is not available.

### Part c: 0.75 point

Full credit responses should include the following information:

- The materiality standard as an amount
- The basis for determining the standard
- The purpose of the standard. That is, wording that addresses the risk of material adverse deviation of the company's reserves.

Example of full credit responses include:

- In forming my opinion, I examined 10% of surplus, \$1.5, to be the materiality standard of my analysis, which would trigger unusual IRIS Ratios. The major factor of material adverse deviation of this company is the unexpected emergence of A&E claims. Considering the existence of this factor, I consider the company has the risk of material adverse deviation.
- The materiality standard was chosen to be 2M. This is the amount which could cause the company to breach the RBC company action level. I believe there is no risk of material adverse deviation associated with this amount.
- My materiality standard is \$X and represents the amount that would lead to the next RBC action level (Company action level). There is RMAD.

### EXAMINER'S REPORT

Candidates were expected to know considerations in determining whether to disclose the materiality standard, difficulties in determining the materiality standard, and know the key elements of the RELEVANT COMMENTS paragraph of the Statement of Actuarial Opinion related to the materiality standard addressing the Risk of Material Adverse Deviation in the company's reserves.

## SAMPLE ANSWERS AND EXAMINER'S REPORT

### Part a

Candidates were expected to identify two considerations in determining whether to disclose the materiality standard to the intended user of the actuarial work product. The most common mistakes were providing responses that did not relate back to either the materiality standard to its importance to the user, complexity of the concept, sophistication of the user, or a regulatory requirement, such as:

- Intended use of analysis
- Is there a risk of material adverse deviation?
- Who is the intended user?

### Part b

Candidates were expected to describe two difficulties with determining a materiality standard, including items such as the focus of materiality on the users of the actuarial work product, the application of judgment over a set formula, and challenges with calculating some materiality standards.

Common mistakes were:

- Confusing materiality with the range of reasonable values in an actuarial estimate
- Confusing difficulty of determining a materiality standard with the inherent uncertainty associated with actuarial estimates
- Failing to adequately describe their example. Responses such as "It's judgmental" do not describe the difficulty.

### Part c

Candidates were expected to propose language related to the materiality standard for Risk of Material Adverse Deviation in the RELEVANT COMMENTS paragraph of the Statement of Actuarial Opinion.

Common mistakes were:

- Not including the materiality standard as an amount
- Failing to include the basis for establishing the standard (e.g. percent of surplus, percent of reserves, amount to trigger an event like next RBC level)
- Failing to include risk of material adverse deviation as the purpose for the materiality standard
- Simply concluding that the company does not have a risk of material adverse deviation
- Confusing the disclosure of the materiality standard with the disclosure of the risk of MAD.
- Confusion between risk of material adverse deviation and adverse development of reserves. For example:
  - Stating that there is a potential risk of material adverse deviation as the insurer writes Workers' Compensation policies with high deductibles
  - Stating that the fact that there is no material change in loss and LAE reserves from the prior review means there is no RMAD