



ENOUGH TO STING:

PUNITIVE DAMAGES AND THE

CONCEPT OF MATERIALITY

A PRESENTATION BY

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FINANCIAL STATEMENTS ARE RESPONSIBILITY OF
MANAGEMENT

AUDITORS EXPRESS AN OPINION ON THESE FINANCIAL
STATEMENTS:

“....the financial statements present fairly, in all material respects, the financial position of the Company and the results of its operations for the year ended...., in accordance with generally accepted accounting principles.”

CICA HANDBOOK:

“In issuing Recommendations, the Assurance Standards Board recognizes that no rule of general application can be phrased to suit all circumstances or combination of circumstances that may arise, nor is there any substitute for the exercise of professional judgment in the determination of what constitutes good practice in a particular case. Recommendations need not be applied to insignificant matters; significance is a matter of professional judgment in the particular circumstances.”

Introduction to Assurance Recommendations

“Materiality is the term used to describe the significance of financial statement information to decision makers. An item of information, or an aggregate of items, is material if it is probable that its omission or misstatement would influence or change a decision. Materiality is a matter of professional judgment in the circumstances.”

S.1000.17 Financial Statement Concepts

“When considering significance, the practitioner needs to understand and assess what factors might influence the decisions of intended users. Significance can be considered in the context of quantitative and qualitative factors, such as relative magnitude, the nature and extent of impact on the subject matter and the expressed interests of intended users. The assessment of significance and the relative importance of

quantitative and qualitative factors in a particular engagement are matters for the practitioner's professional judgment."

S.5130.53

TO UNDERSTAND THE CONCEPT OF MATERIALITY/SIGNIFICANCE ONE MUST ANSWER THE QUESTION - SIGNIFICANT TO WHO?

USERS OF FINANCIAL STATEMENTS ARE PRESUMED TO BE THOSE WHO ARE RELYING ON THE FINANCIAL STATEMENTS AND HAVE A REASONABLE KNOWLEDGE OF BUSINESS AND ECONOMIC ACTIVITIES:

USER	PURPOSE
Management	Internal Decision Making
Shareholders	Investment/Divestment Decisions
Financial Creditors	Lending Decisions
Suppliers	Ongoing Supply and Terms Decisions
Canada Customs and Revenue Agency	Income Taxes, PST and GST
Regulators	Compliance
Customers	Purchasing Decisions
Other	According to Need
<i>Policyholders</i>	<i>Insurance Coverage Decisions</i>

RELEVANT ISSUES THAT ARISE FROM HAVING SO MANY CLASSES OF USERS:

1. Competing Needs, e.g. management may choose accounting policies that lead to reduced income for income tax minimization or many choose those that lead to increased income to attract investors.
2. What happens when users, such as policyholders, are not reasonably knowledgeable with respect to business and economic policies? They must rely on auditors to ensure

that they plan their audits of insurance companies with the objective of detecting misstatements that are material to the financial statements.

1. COMPETING NEEDS

Management must choose accounting policies to satisfy whichever user group they deem most important. They also make estimates which reflect their views towards conservatism and the bottom line.

For example, reserves or actuarial liabilities are dependent on various books of business and related assumptions with respect to mortality, claims experience, interest rates, lapse rates, expenses, etc.:

“The Company uses best estimate assumptions for expected future experience in calculating actuarial liabilities. An additional margin is then added to provide for possible adverse deviations from the best estimates. The best estimate assumptions and provisions for adverse deviations are reviewed annually. Revisions are made to either the best estimate assumptions and/or the margins, where deemed necessary and prudent. Due to the long-term nature of the policy liabilities, the time spans of the assumptions are usually longer than a single year. Accordingly, the assumptions are expected to change slowly over time.”

**Sun Life Financial of Canada, 1999 Annual Report,
Excerpt From Note 18 to the Financial Statements**

2. PROTECTING POLICYHOLDERS

In detecting misstatements that are material to the financial statements, auditors apply both qualitative and quantitative guidelines in determining materiality. Particularly, when evaluating the misstatements detected, the auditor would consider qualitative factors that may result in a misstatements of relatively small amounts having a material effect on the financial statements.

For example, punitive damages may be quantitatively too low if they can be buried in the income statement as a cost of doing business without users of financial statements being aware of them. On the other hand, even if they are quantitatively low, they may be qualitatively high or sensitive enough to merit disclosure.

When punitive damages are determined to be material, management must either disclose them as separate “unusual items” in the income statement or disclose them in notes to the financial statements. Otherwise, the auditor will have to qualify the audit report by bringing the situation to the attention of financial statement users. Either way, policyholders are protected by being made aware of the situation. They can then decide what relationship, if any, they wish to have with the insurance company.

QUANTITATIVE MATERIALITY

Auditors use rules of thumb to determine quantitative materiality. The rules are applied based on the nature of a company's operations. Using Sun Life of Canada, 1999 Consolidated Financial Statement Results, the following represents examples of various materiality levels that may result:

Percentage	Base	Amount
5% - 10%	Income From Continuing Operations	\$16,700,000
	to	\$33,400,000
1/2% - 1%	Revenue	\$73,745,000
	to	\$147,490,000
1/2% - 1%	Total Assets	\$503,825,000
	to	\$1,007,650,000

Similarities between quantitative materiality and punitive damages:

"...In light of the defendant's admission that its net worth was approximately \$231 million, I cannot take issue with the jury's conclusion that a very substantial award for punitive damages was required to punish the defendant and to effectively send the implied reminder to the defendant and to other insurers that they owe their insured a duty of good faith in responding to claims made under policies of insurance issued by them."

Matlow J., Whiten v. Pilot Insurance Company

In the analysis of the Supreme Court of Canada decision in Whiten v. Pilot Insurance the comment was made that:

"..because the punishment is tailored to fit not only the crime but the financial circumstances of the defendant, defendants complain that they are being punished for who they are rather than for what they have done."

However, it is precisely because of who they are that insurance companies can try to get away with what they do. In Richard Clarfield

and Crown Life Insurance Company, the point was made that if punitive damages are not sufficient, the insurance company can simply deny the next policyholder's claim and make back the profit.

In addition, rules of thumb like those used by auditors, have been applied by the courts in determining the size of punitive damages:

- Court of Appeal in *Thompson v. Commissioner of Police of the Metropolis* [1997] 2 All E.R. 762 England - Useful rule of thumb is total damages = 3 times basic compensatory damages.
- In U.S., numerous pieces of state and federal legislation have capped punitive damages at 3 times compensatory awards.

However, in *Whiten v. Pilot Insurance*, the conclusion was reached that since the proper focus of punitive damages should be on the defendant's conduct and not on the plaintiff's loss, a mechanical or formulaic approach does not allow sufficiently for the many variables that ought to be taken into account in arriving at a just award.

QUALITATIVE MATERIALITY

Qualitative considerations may result in misstatements of relatively small amounts having a material effect on the financial statements. Consider:

- The potential effect of the misstatement on the entity's compliance with loan covenants, other contractual agreements and regulatory provisions.
- The existence of statutory or regulatory reporting requirements that affect materiality thresholds.
- The sensitivity of the circumstances surrounding the misstatement.
- The significance of the misstatement or disclosures relative to the auditor's perception of user's needs.

In this light, the award of \$1,000,000 punitive damages in *Whiten v Pilot Insurance* may be qualitatively material.

In *Whiten v Pilot*, the objective of punitive damages was concluded to be to send a message of “denunciation, retribution and deterrence”. Further, it was stated that punitive damages should be assessed in an amount reasonably proportionate to such factors as the harm caused, the degree of the misconduct, the relative vulnerability of the plaintiff and any advantage or profit gained by the defendant. A disproportionate award overshoots its purpose and becomes irrational. A less than proportionate award fails to achieve its purpose. Therefore, the proper amount of punitive damages is that amount, which a reasonable jury, properly instructed, could have determined, and no less, was rationally required to punish the defendant’s conduct.

QUALITATIVE FACTORS IN PUNITIVE DAMAGES

According to the decision in *Whiten v Pilot Insurance*, a proper award must look at several qualitative factors:

- Proportionality to the Blameworthiness of the Defendant’s Conduct (the more reprehensible the conduct, the higher the rational limits to the potential award).
- Proportionality to the Degree of Vulnerability of the Plaintiff (where there is a power imbalance).
- Proportionality to the Harm or Potential Harm Directed Specifically at the Plaintiff.
- Proportionality to the Need for Deterrence (it takes a large whack to wake up a wealthy and powerful defendant to its responsibilities).
- Proportionality, Even After Taking Into Account the Other Penalties, Both Civil and Criminal, Which Have Been or are Likely to be Inflicted on the Defendant for the Same Misconduct.

- Proportionality to the Advantage Wrongfully Gained by a Defendant from the Misconduct.

CONCLUSIONS

- Quantitative materiality represents the upper range of acceptable error, misstatements or omissions in the financial statements that would not need to be corrected or disclosed as they would not likely have any impact on the decisions being made by users of financial statements.
- Qualitative materiality represents a lower threshold above which changes would need to be made to financial statements, including corrections of numbers or disclosure of information. It requires more professional judgment and is likely to be a result of more sensitive issues.
- Therefore, punitive damages should be set somewhere in the range between quantitative and qualitative materiality so that the goals of denunciation, retribution and deterrence are met.
- The \$1,000,000 punitive damage award in *Whiten v Pilot Insurance* may be seen as qualitatively material and hopefully will ensure that the goals of denunciation, retribution and deterrence are met. While we are not going to see reference to this decision in Pilot's financial statements, the publicity surrounding this case will likely have the same effect as financial statement disclosure.