Association of Workers' Compensation Boards of Canada

Executive Briefing

Accounting and Actuarial Standards

Occupational Disease Liability

November 2013

Submitted by: **AWCBC CFO COMMITTEE**

Background

In 2011, the Actuarial Standards Board (ASB) of the Canadian Institute of Actuaries amended its Standards of Practice (SoP 5000) for Public Personal Injury Compensation Plans (PPICP), the key change being the inclusion of an allowance for all long latency occupational disease (OD) exposures, regardless of whether a claim has been reported or not. For WCBs, which fall within the definition of a PPICP, the new standard prescribes recognition of a liability based on exposures to OD causative factors. This may represent a major change in the timing of recognition and the basis of measurement for the expected liability, both of which could have significant reporting and business implications for WCBs.

Categories of Occupational Disease Claims

OD is a medical condition arising from exposure to injurious substances or hazards that may lead to compensable disablement. OD claims can be classified as follows:

- *Type 1* – exposure has occurred, workplace causality has been established and disease has been reported. No change to current practice; claims are included in the valuation,
- *Type 2* – exposure has occurred, workplace causality has been established, and disease is in the latency phase but has NOT been reported. To this point, inclusion of these unreported claims in the valuation has been optional, and
- *Type 3* – exposure has occurred, and workplace causality has NOT been established, but may be in the future. Claims are not likely to be included in the valuation since workplace causality does not exist.

The updated Standards of Practice requires all PPICPs to include Type 2 exposures. As at December 2012, Alberta, Manitoba, New Brunswick, and Ontario have included Type 2 exposures in their liability valuations.

Key Findings and Conclusions

The broad conclusions and implications for WCBs are as follows:

- OD type 2 exposures are contingent liabilities with a high probability of settlement that can likely be reliably estimated, and therefore the standards require WCBs to include an estimate in the liability.
- The Actuarial Standards indicate that the definition of a liability is ultimately an 'accounting' construct under the accounting policies adopted by each WCB. Therefore, if a WCB elects to adopt an accounting policy that explicitly excludes OD type 2 liabilities, the certifying actuary is permitted to prepare the valuation in accordance with the accounting standards and such exclusion must be disclosed in the actuarial valuation report. WCB's are highly encouraged to consult with their external auditor before adopting an accounting policy position.
- Existing allowances for *incurred but not reported* (IBNR) claims may not be sufficient to meet SoP 5000 requirements.
- SoP 5000 represents a change in actuarial methodology, and as such, is a change in accounting estimate (basis of measurement) rather than a change in accounting policy. This means that the impact is applied prospectively on the WCB's financial statements.
- Measurement uncertainty for the OD Type 2 liabilities is likely to remain high even after adopting the changes in valuation practice under SoP 5000.
- SoP 5000 does allow the actuary to exclude the allowance if it conflicts with the accounting or compensation policy of the PPICP. Such exclusion would need to be disclosed in the Actuary's valuation report.
- Because of the potentially material and pervasive effects of implementing SoP 5000, rigorous change management efforts should be undertaken to mitigate possible adverse consequences.
- Collaboration with other WCBs may be desirable to establish best practices relating to the OD liability, actuarial methods and assumptions, funding approaches, and financial reporting.

Findings and conclusions for specific jurisdictions will require detailed accounting, actuarial and possibly legal review of the circumstances in each jurisdiction, which may differ from those outlined in this briefing.

Key Issues

This briefing note provides the context for the decision to include an allowance for latent OD exposures and addresses some important considerations in recognizing and characterizing the OD liability, the appropriate accounting treatment if recognized, as well as implementation concerns if SoP 5000 were adopted.

Actuarial Considerations

KEY PROVISIONS OF STANDARDS OF PRACTICE PART 5000

The ASB considers that OD exposures represent a current constructive or equitable liability for WCBs that should be recognized in order to reflect economic reality in the financial statements. Any existing allowance for IBNR claims may not be adequate to cover the extent of OD exposures in a particular jurisdiction, in that current reserving practice for IBNR may be based on a narrower interpretation of liability than the broader equitable construction of liability adopted in SoP 5000.

In order to allow the actuarial profession to study the issue and to develop methodologies that will comply with SoP 5000, the ASB has deferred this requirement to December 31, 2014 with early adoption permitted.

Notwithstanding the strong recommendation of SoP 5000, the ASB allows the actuary to exclude the OD allowance if it conflicts with the legislation or policy of a PPICP. Such exclusion would have to be disclosed in the actuary's valuation report.

Accounting Considerations

RECOGNITION AND MEASUREMENT PRINCIPLES

Since accounting standards do not provide explicit guidance on whether OD type 2 exposures represent an existing liability (a provision) or a contingent liability, judgment must be applied to the fact pattern in arriving at an accounting conclusion. The following standards are relevant to the issues arising from SoP 5000:

Provisions (IAS 37)

A provision is "*a liability of uncertain timing or amount*" and "a *present obligation (legal or constructive) arising from a past event*" (i.e., exposure). This definition fits the OD allowance as described in SoP 5000, which clearly reflects the ASB view that the OD liability meets the criteria for a provision (i.e., a constructive obligation). Unlike for-profit insurers that are governed by a narrow (i.e., contractual) view of liability, WCBs may be subject to public policy (i.e., equitable) expectations that align with an equitable construct of liability.

Contingent liabilities (IAS 37)

A contingent liability is "*a possible obligation that arises from past events and whose existence will be confirmed by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity*." OD Type 2 exposures are '*possible obligation*s' because some claims are never filed, exposure does not automatically result in disablement, and because certain claims may be obligations of other jurisdictions. In other words, these can be viewed as contingent claims because the key requirement, i.e., the '*uncertain future event*' – claim reporting – has not yet occurred to trigger liability. Regardless, IAS 37 requires recognition of a contingent liability when the probability of settlement has been established, and the amount can be reliably estimated. The first criterion appears well established (i.e., many workplace exposures result in claims), while SoP 5000 guidance addresses the second one in prescribing development of reliable measurement approaches.

To conclude, the SoP 5000 position is that OD type 2 exposures represent a constructive obligation of WCBs, based on exposure as the obligating event rather than the reporting of the claim and is consistent with accounting standards (IAS 37). Reliable measurement can be presumed, given an actuary's training and experience and the requisite time and effort to develop appropriate methodologies.

Recognition of this additional OD liability is likely a change in accounting estimate which could be applied prospectively (i.e., effective only in the current and future fiscal periods).

Business Implications

Some business issues that WCBs might face with implementation of SoP 5000 are:

IMPLEMENTATION

- There may be insufficient data or claims experience to support a rigorous valuation.
- Changes in compensation policy and/or adjudication practices may be required.
- The level of actuarial resources and effort required to apply SoP 5000 could be fairly high and fees could increase.
- The increase in claim liabilities could have a material impact on funded position.
- Changes to funding policy or rate setting may be necessary to address any funding challenges or consequences.
- Future re-measurement of the OD allowance is likely.

CHANGE MANAGEMENT

- Board and management education may be necessary to understand the underlying issues and risks associated with this allowance for OD still in the latency period.
- Compensation policy and adjudication practices may need to be amended to ensure effective administration of the liability and related benefit payments.
- There may be challenges with respect to communicating the rationale for the additional OD allowance in the liability, and particularly if premium rates must be increased.