EDUCATIONAL NOTE

Educational notes do not constitute standards of practice. They are intended to assist actuaries in applying standards of practice in specific matters. Responsibility for the manner of application of standards in specific circumstances remains that of the practitioner.

THE EASTERN CANADA ICE STORM – TREATMENT IN FINANCIAL REPORTING

COMMITTEE ON PROPERTY AND CASUALTY INSURANCE FINANCIAL REPORTING

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Background

Eastern Ontario, Québec, New Brunswick, Prince Edward Island, Nova Scotia and the north eastern United States were subject to precipitation from one weather system from January 5, 1998 through January 9, 1998. Much of that precipitation fell as freezing rain, resulting in the build-up of as much as 25 cm of ice on some structures. This caused the collapse of these structures, most notably hydro towers and poles. Many areas were blacked out, and some areas are likely to be without power for weeks. Damage and suffering have been compounded by a subsequent cold front. Initial estimates of insured damage exceed $500 million, making this ice storm potentially the largest ever insured event in Canada.

Guidance and Assumptions

Federal and provincial insurance acts require that the annual statement of property and casualty insurance companies be accompanied by an actuarial report on the policy liabilities. The statements must also be prepared in accordance with generally accepted accounting principles (GAAP). Accordingly, accounting and actuarial standards are relevant when considering the appropriate treatment of the ice storm in financial reporting for property and casualty insurance companies. Key standards that deal with the treatment of subsequent events are Section 3820 of the CICA Handbook and Section 4.6 of the exposure draft of the CIA's consolidated standards of practice (CSOP). The italicized sections of this guidance are reproduced in Appendix A.

Issues that arise in other reporting contexts (i.e., solvency monitoring) will not be addressed.

This paper will assume that the ice storm damage is material, was not expected as at December 31, 1997, does not reveal any data defect or calculation error, and that an estimate of the cost to the company is available. Further discussion of these assumptions is included in Appendix B.

Alternatives to Consider

(1) Change Premium Liabilities – The vast majority of the primary policies affected by this event will have been in force on December 31, 1997. If the premium liabilities are altered to reflect the insured ice storm costs, it may be necessary to reduce the amount of deferred policy acquisition costs recorded as an asset. In extreme cases, it may be necessary to post a premium deficiency reserve. In these cases, expense ratios for 1997 will be affected.

(2) Disclose in Notes – If no adjustment is made to 1997 figures, disclosure is clearly a likely consequence of both CICA and CIA guidance.

(3) Do Nothing – This is an unlikely outcome, given that we have already assumed materiality, but is included for completeness of discussion.

Implications of Actuarial Guidance

The first step required by actuarial guidance is to classify the subsequent event. Having eliminated error from consideration (see assumptions), the three possibilities are that the event:

- provides information about the entity as it was
- retroactively makes the entity different

- makes the entity different after the calculation date

The ice storm clearly does not retroactively make the insurance company different. The non-italicized text indicates that an example of an event that provides information about the entity as it was is the “reporting to an insurer of a claim incurred on or before the balance sheet date.” In contrast, “the reporting to an insurer of a claim incurred after the balance sheet date” is an example of an event that makes an entity different after. Accordingly, the ice storm is an event that makes an entity different after the balance sheet date.

In this case, it is necessary to make a further distinction depending on the purpose of the report. If the purpose is to report on the entity as it was, then the actuary would not take the event into account in the selection of methods and assumptions. Again, the non-italicized text indicates that the purpose of financial reporting under GAAP is to report on the entity as it was.

Further, both the italicized and plain text indicate that the actuary should report the event, making no further distinction on the nature and amount of the event, once the materiality hurdle has been passed, and it has been determined that it is not appropriate to amend methods and assumptions.

Accordingly, the committee believes that a careful reading of existing CIA guidance points to alternative (2).

Implications of Accounting Guidance

The first step in the accounting guidance also appears to be one of classification. Basically, a subsequent event may either:

(a) provide further evidence of conditions which existed at the statement date, or
(b) be indicative of conditions which arose subsequent to the statement date.

It is hard to argue that the ice storm is a condition which existed at the statement date. This would imply a predictability to medium-range weather forecasts that is belied by our day-to-day experience of short-range forecasts. Further, the committee has seen no evidence that a forecast of an unusually severe ice storm was made. In addition, Section 3820.09(a) notes that an example of events in the second classification are “a fire or flood which results in a loss.” Accordingly, the ice storms are indicative of conditions that arose subsequent to December 31, 1997.

The accounting guidance is clear that, for events in this second category, it is not appropriate to make an adjustment to the financial statements.

In discussing disclosure, Section 3820.10 uses the term “significant.” We believe that the natural interpretation is similar to material. Accordingly, disclosure is also required by accounting standards. That is, alternative (2) is again appropriate. If “significant” means something different than “material,” it may be that disclosure is not required, but it may still be desirable.

Other Considerations

It is clear that the actual premium liability will likely be larger than the premium liability anticipated as at December 31, 1997. However, this is not the key issue in the context of financial reporting under GAAP. The key issue is the purpose of the work, which is to report on the insurance company as it was on December 31, 1997.

Although the B.C. snowstorm was not material for the industry, it would have been material for some companies. Although it does have a number of interesting differences from the ice storm

(i.e., it was forecast to continue on December 31, 1996, for at least another day), it might be interesting to know (anonymously) how that event was handled.

Some people have also referenced the January 1, 1994 implementation of Bill 164, which was considered in valuations of premium liabilities for the year ended December 31, 1993. Again, the committee thinks that the fact that this was known well in advance of December 31, 1993, is a clear distinction from the ice storms. In fact, it could easily be argued that the key event was the ministerial announcement of the effective date, which definitely occurred in 1993. It should be added that the premiums charged in 1993 by insurers did not include a specific factor (loading) for Bill 164 requirements. What is of utmost importance here is the fact that this event did represent a permanent trend for insurers and consequently had to be specifically considered when the actuary was doing his premium adequacy testing. The actuary had to modify his future costs assumptions appropriately.

In the case of the eastern Canada ice storm, insurance premiums, normally, already include a specific or implicit factor for catastrophe and the expected loss ratios also include a provision (loading) for catastrophe. Moreover, as the event does not represent a permanent trend for insurers, we can quite safely say that it is an *ad hoc* event in terms of materiality that is already taken into account in catastrophe loading. Thus, this year, the actuary does not have to change his catastrophe loading assumptions since it is already taken into account in premiums and expected loss ratios.

Many catastrophe reinsurance programmes begin on January 1. Accordingly, reinsurers often have little or no unearned premium on catastrophe treaties, and a correspondingly smaller premium liability to catastrophe events. Under option (1), this might have resulted in primary companies recognizing future recoveries from reinsurers, without any recognition of the liability on the part of reinsurers themselves. Fortunately, the logic behind selecting option (2) applies equally to reinsurers, and a disclosure would be anticipated, even when the premium liability was nil!

Disclosure Suggestions

The actuary should recognize that regulators may be interested in the company's exposure to the ice storm, and should consider disclosure in their actuarial reports, even if it is only a simple statement that the event is not material to the company. If it is material, it may be useful to have a more detailed discussion/disclosure in the actuarial report to the regulators than would be appropriate in the notes to the financial statements. The following points should be considered in formulating the disclosure:

- a description of the nature of the event
- an estimate of the financial effect, when possible, or a statement that such an estimate cannot be made:
    - an estimate of the gross amount of claims (indemnities and loss adjustment expenses)
    - an estimate of the reinsurance recoveries
    - an estimate of the reinsurance reinstatement premiums
- a discussion about the impact of the event:
    - on future insurance results of the entity
    - on reinsurance risk of non recovery from reinsurers
    - other related events

Summary

Both actuarial and accounting guidance are consistent in indicating that the appropriate course of action is to disclose the impact of the ice storm in the notes to the financial statements, but to make no changes to the calculations that underlie 1997 results.

However, this is a general interpretation that depends on the assumptions outlined in Appendix B. The actuary should review the treatment of the ice storm with the auditor, and consider the specific circumstances of the insurance company to ensure that the treatment is appropriate for the entity, and that the audit and actuarial approaches are consistent.

APPENDIX A

SELECTED GUIDANCE

Section 4.6 of the Consolidated Standards of Practice (Second Exposure Draft, May 1997)

4.6 – Subsequent Events

The actuary should correct any data defect or calculation error which a subsequent event reveals.

For work with respect to an entity, the actuary should take a subsequent event into account in the selection of methods and assumptions for a calculation, other than a pro forma calculation, if the subsequent event:

> *Provides information about the entity as it was at the calculation date, or*
>
> *Retroactively makes the entity a different entity at the calculation date, or*
>
> *Makes the entity a different entity after the calculation date and a purpose of the work is to report on the entity as it will be as a result of the event.*

The actuary should not so take the subsequent event into account if it makes the entity a different entity after the calculation date and a purpose of the work is to report on the entity as it was at the calculation date, but the actuary should report that event.

CICA Handbook – Subsequent Events [July 1979]

3820.06 Financial statements should be adjusted when events occurring between the date of the financial statements and the date of their completion provide additional evidence relating to conditions that existed at the date of the financial statements.

3820.10 Financial statements should not be adjusted for, but disclosure should be made of, those events occurring between the date of the financial statements and the date of their completion that do not relate to conditions that existed at the date of the financial statements but:

(a) cause significant changes to assets or liabilities in the subsequent period; or

(b) will, or may, have significant effect on the future operations of the enterprise.

3820.12 Disclosure of a subsequent event that does not require adjustment of the financial statements should include:

(a) a description of the nature of the event; and

(b) an estimate of the financial effect, when practicable, or a statement that such an estimate cannot be made.

APPENDIX B

Key Assumptions

Materiality

At $500 million, the potential size of the insured damage exceeds 2.5% of industry premium income. Further, the fact that there is extensive discussion of the accounting treatment reinforces this perception of materiality. By way of contrast, the Dec. 30, 1996 to January 2, 1997 snow storms in B.C. were estimated to have insured damage of $100 million, but there was little discussion of the accounting treatment of that event. Clearly, ice storm damage will not be material for some companies (for instance, those writing only in Western Canada), and those companies have no need to consider the accounting treatment. Also, there could be companies where the event could threaten the going-concern assumption. The discussion in this paper makes no attempt to cover this situation. This paper should be considered by the companies in between, that receive material, but not life threatening claims. Note that materiality of both gross and net amounts should be considered.

Expectations on December 31, 1997

Weather reports are commonly provided for four days. Accordingly, the reports of December 31, 1997, and January 1, 1998, would generally not have extended through January 5, 1998. Further, even if there were some forecasts available of freezing rain on January 5, it is unlikely that anyone was predicting the severity of the precipitation, including its continuation through January 9. Certainly, the committee has not seen any news reports that talked about any significant early warning being given. Accordingly, we conclude that the ice storm was not expected as at December 31, 1997. Of course, the premium liabilities should include an allowance for the “expected” level of catastrophes.

Data Defects and Calculation Errors

It is possible that the ice storm reveals a data defect (i.e., Didn’t you know that we had started writing personal property in Québec?), but this should be unusual. This avoids the first CSOP criteria. Where a defect/error is revealed, that should be corrected before considering the discussion in the body of this paper.

Estimation of Amount

The ability to estimate an amount does not really affect the theoretical discussion. For one thing, since the impact is acknowledged to be material, that means a lower limit can be placed on the cost. Also, it is clear that market share estimates can often be made. It is true that many of these estimates are very uncertain at this point in time. This is not an excuse for doing nothing, it merely implies that consideration of the guidance in Section 1520 of the CICA Handbook (Measurement Uncertainty) is appropriate when preparing the notes to the financial statements.