Financial reporting developments

A comprehensive guide

Reinsurance

(before the adoption of ASU 2018-12, *Financial Services — Insurance (Topic 944): Targeted Improvements to the Accounting for Long-Duration Contracts* (LDTI))

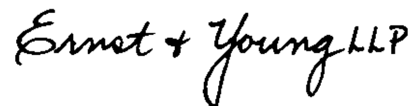
Revised December 2023

EY

Building a better working world

To our clients and other friends in the insurance industry

The accounting guidance for reinsurance transactions is codified in Accounting Standards Codification 944, *Financial Services — Insurance* (ASC 944). This publication will help you understand the overall accounting and financial reporting requirements and how they apply to certain types of reinsurance transactions. Our observations are based on our experience in addressing the insurance accounting, actuarial, tax and financial reporting issues of our clients. The application of the guidance for a particular transaction requires careful evaluation of its facts and circumstances. Your EY insurance executive will be pleased to answer any questions you may have on this topic.



December 2023

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Notice to readers:

This publication includes excerpts from and references to the Financial Accounting Standards Board (FASB or Board) Accounting Standards Codification (Codification or ASC). The Codification uses a hierarchy that includes Topics, Subtopics, Sections and Paragraphs. Each Topic includes an Overall Subtopic that generally includes pervasive guidance for the Topic and additional Subtopics, as needed, with incremental or unique guidance. Each Subtopic includes Sections that in turn include numbered Paragraphs. Thus, a Codification reference includes the Topic (XXX), Subtopic (YY), Section (ZZ) and Paragraph (PP).

Throughout this publication references to guidance in the Codification are shown using these reference numbers. References are also made to certain pre-Codification standards (and specific sections or paragraphs of pre-Codification standards) in situations in which the content being discussed is excluded from the Codification.

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1 Overview

1.1 Introduction

The Reinsurance Contracts Subsections of ASC 944 provide guidance on accounting for and financial reporting of reinsurance contracts, including those that reinsure short-duration insurance contracts and long-duration insurance contracts. They establish the conditions required for reinsurance contracts to satisfy the "transfer of risk" criteria and also:

- Require reinsurance contracts to be classified as either short-duration or long-duration reinsurance contracts, and require short-duration reinsurance contracts to be classified as either prospective or retroactive contracts
- Disallow the immediate recognition of gains from ceded reinsurance transactions, unless the ceding company's obligations to its policyholders are extinguished
- Prescribe accounting and reporting guidance for multiple-year retrospectively rated reinsurance contracts
- Require insurance companies to report their liabilities gross of reinsurance ceded and require that reinsurance recoverables (i.e., ceded liabilities) and prepaid reinsurance premiums (i.e., ceded unearned premiums) be reported as assets
- Require disclosures for reinsurance transactions in the financial statements of ceding and assuming companies, including disclosures for concentrations of credit risk related to reinsurance recoverables

ASC 340-30 provides deposit accounting requirements for contracts that neither transfer insurance risk nor qualify for reinsurance accounting.

In this publication, the terms "risk transfer" and "transfer of risk" are equivalent to the phrase "indemnification of the ceding entity against loss or liability relating to insurance risk," because that phrase is used and defined in ASC 944-20-15-41 (formerly paragraph 9 of FASB Statement No. 113) for short-duration contracts and in ASC 944-20-15-59 for long-duration contracts.

The FASB issued Accounting Standards Update (ASU) 2018-12 in August 2018 to change how insurers recognize and measure insurance liabilities and deferred policy acquisition costs (DAC) and require new disclosures about long-duration insurance contracts. The guidance is intended to provide financial statements users with more meaningful information about the amount, timing and uncertainty of cash flows related to these contracts. A Securities and Exchange Commission (SEC) filer that is not a smaller reporting company (SRC) is required to adopt the guidance for fiscal years beginning after 15 December 2022 (i.e., 2023 for calendar-year insurers), and for interim periods therein. All other entities (i.e., SRCs and private insurers) are required to adopt the guidance for annual periods beginning after 15 December 2024 (i.e., 2025 for calendar-year insurers), and interim periods within fiscal years beginning a year later (i.e., 2026).

Although ASU 2018-12 does not directly change the guidance on how to recognize ceded or assumed reinsurance transactions, insurers will need to evaluate whether changes to the broader guidance affect how they account for their reinsurance transactions. Considerations include the following:

- ASU 2018-12 requires insurers to determine the unit of account (i.e., the cohort) for which the liability for policyholder benefits is measured. When determining the cohort under ASU 2018-12, insurers may group contracts issued in the same quarter or year but may not group contracts from different issue years. This same principle should be applied when determining the unit of account for reinsured contracts.

- ASU 2018-12 requires insurers to measure the reserves for future policyholder benefits recognized for its insurance contracts under the net premium model. To be consistent with this guidance, insurers should also determine a separate net premium ratio for the reinsurance contract or cohort of reinsurance contracts based on the cohort determined for the underlying reinsured contracts. When ceded reinsurance transactions are non-contemporaneous (i.e., arrangements to cede an existing block of in-force contracts), using a current discount rate as of the date of the reinsurance contract will generally result in measurement differences between the reinsurance recoverable and the liability for future policyholder benefits of the underlying insurance contract.
- For arrangements that reinsure a group of in-force contracts, the ceding entity is required under existing guidance in ASC 944-605-30-4 to include any differences between the consideration paid for the reinsurance coverage and the "amount of the liabilities for policy benefits" related to the underlying insurance contracts in the estimated cost of reinsurance. After adopting ASU 2018-12, we believe insurers should consider the liabilities recorded on the balance sheet, which are measured using a current discount rate, when applying this guidance.
- The revised DAC amortization model under ASU 2018-12, which requires insurers to amortize DAC for long-duration insurance contracts on a constant level basis over the expected life of the underlying contracts, independent of profitability or revenue components, also affects the amortization of other balances currently being amortized on a basis consistent with DAC, whether due to existing requirements in ASC 944 or to an existing accounting policy election. Balances amortized on a basis consistent with DAC as a result of an existing accounting policy election could include the cost of reinsurance.
- ASU 2018-12 creates a new category of benefit features (i.e., market risk benefits) that will be measured using a fair value model. The guidance requires that insurers evaluate the terms of any arrangements that cede annuitization, death or other insurance benefits in accordance with the defined scope of market risk benefits outlined in ASC 944-40-25-25C through 25-25D. If each of the market risk benefit criteria is met, we believe the ceding entity should treat the arrangement as the purchase of a separate market risk benefit, and the assuming entity should treat it as the issuance of a market risk benefit. As such, insurers will need to determine the fair value measurement of ceded and assumed market risk benefits.
- Rollforward disclosures are required on a gross basis under ASU 2018-12 for both the liability for future policyholder benefits related to traditional and limited-payment contracts and the additional liability for annuitization, death or other insurance benefits, with the amount of any related reinsurance recoverable required to be included in each rollforward disclosure. In addition, the guidance requires the rollforward of market risk benefits, which should include both ceded and assumed market risk benefits.

See our Technical Line, ***A closer look at how insurers will have to change their accounting and disclosures for long-duration contracts***, for a detailed discussion.

The remainder of this publication has not been updated for any considerations related to ASU 2018-12.

2 Basic provisions

2.1 Scope

Excerpt from Accounting Standards Codification

Insurance Activities

Overview and Background

Reinsurance Contracts

944-20-05-38

The Reinsurance Contracts Subsections provide guidance on accounting for and financial reporting of reinsurance contracts, including those that reinsure short-duration insurance contracts and long-duration insurance contracts.

944-20-05-39

Insurers may enter into various types of contracts described as reinsurance, including those commonly referred to as fronting arrangements.

944-20-05-39A

An insurance entity may purchase reinsurance to reduce exposure to losses from the events it has agreed to insure, similar to a direct insurance contract purchased by an individual or noninsurance entity. The insurance entity also may contract with a reinsurer to facilitate the writing of contracts larger than those normally accepted, to obtain or provide assistance in entering new types of business, or to accomplish tax or regulatory objectives.

944-20-05-40

Insurance provides indemnification against loss or liability from specified events and circumstances that may occur or be discovered during a specified period. In exchange for a payment from the policyholder, an insurance entity agrees to pay the policyholder if specified events occur or are discovered. Similarly, the insurance entity may obtain indemnification against claims associated with contracts it has written by entering into a reinsurance contract with another insurance entity (the reinsurer or assuming entity). The insurer (or ceding entity) pays (cedes) an amount to the reinsurer, and the reinsurer agrees to reimburse the insurer for a specified portion of claims paid under the reinsured contracts. However, the policyholder usually is unaware of the reinsurance arrangement, and the insurer ordinarily is not relieved of its obligation to the policyholder. The reinsurer may, in turn, enter into reinsurance contracts with other reinsurers, a process known as retrocession.

Master Glossary

Insurance risk

The risk arising from uncertainties about both underwriting risk and timing risk. Actual or imputed investment returns are not an element of insurance risk. Insurance risk is fortuitous; the possibility of adverse events occurring is outside the control of the insured.

The Reinsurance Contracts Subsections of ASC 944 apply to short-duration and long-duration insurance contracts of property/casualty insurance entities (including stock entities, mutual entities, and reciprocals or interinsurance exchanges), life and health insurance entities (including stock life and mutual life insurance entities), captive insurance entities, mortgage guaranty insurance entities, and title insurance entities.

This guidance requires that a contract with a reinsurer meet certain conditions to transfer insurance risk and therefore qualify for reinsurance accounting. Deposit accounting requirements are prescribed for contracts that do not provide for indemnification of the ceding entity by the reinsurer against loss or liability against insurance risk.

Any transaction, regardless of form, that indemnifies an insurer against loss or liability relating to insurance risk is within the scope of the reinsurance contracts guidance. Therefore, certain insurance-related guarantees (e.g., a guarantee from a seller to reimburse a buyer for all insurance-related losses in excess of a stated amount in connection with the sale of an insurance company or a portion of an insurance business) could be subject to the provisions of the Reinsurance Contracts Subsections. If a contract does not meet the risk transfer conditions, then both the ceding company and assuming company generally should follow deposit accounting for the contract.

The financial statement disclosure requirements for reinsurance transactions apply to both ceding and assuming entities.

2.2 Definitions

The appropriate financial reporting for any given reinsurance contract depends on whether the reinsurance contract meets certain risk transfer conditions, whether the reinsurance contract reinsures short-duration or long-duration insurance policies, and whether the reinsurance contract is prospective or retroactive.

Excerpt from Accounting Standards Codification

Insurance Activities

Scope and Scope Exceptions

Reinsurance Contracts

944-20-15-34

The financial reporting for a contract with a **reinsurer** depends on whether the contract is considered to be reinsurance for purposes of applying this Subtopic. Financial reporting for a reinsurance contract also depends on whether the contract reinsures short-duration or long-duration insurance contracts and, for short-duration contracts, on whether the contract is considered **prospective reinsurance** or **retroactive reinsurance**. For contracts that reinsure long-duration contracts, characteristics of the reinsurance contract determine whether the contract is short- or long-duration.

ASC 944 divides the guidance on contracts into the following three categories: short-duration contracts, long-duration contracts and reinsurance contracts.

Short-duration contracts are insurance policies that provide insurance protection for a fixed period of short duration and enable the insurer to cancel the contract or to adjust the provisions of the contract at the end of any contract period, such as adjusting the amount of premiums charged or the coverage provided. Examples of short-duration contracts include most property and liability insurance policies and certain term life insurance policies (e.g., credit life insurance) (ASC 944-20-15-5 through 15-7).

Long-duration contracts are insurance policies that are expected to remain in force for an extended period and generally are not subject to unilateral changes in their provisions. They require the performance of various functions and services (including insurance protection) for an extended period and often include noncancelable or guaranteed renewable features. Examples of long-duration contracts include universal life-type contracts, limited-payment contracts, certain participating life insurance contracts and whole-life and term life insurance contracts (ASC 944-20-15-8 through 15-14).

Reinsurance contracts are contracts for transactions entered into by a reinsurer (assuming entity), for a consideration (premium), to assume all or part of a risk undertaken originally by another insurer (ceding entity). For indemnity reinsurance, the legal rights of the insured are not affected by the reinsurance transaction and the insurance entity issuing the insurance contract remains liable to the insured for payment of policy benefits. Assumption or novation reinsurance contracts that are legal replacements of one insurer by another extinguish the ceding entity's liability to the policyholder (ASC 944-20-15-34 through 15-39).

For reference purposes, additional definitions are provided below.

Excerpt from Accounting Standards Codification

Master Glossary

Assuming Entity

The party that receives a reinsurance premium in a reinsurance transaction. The assuming entity (or reinsurer) accepts an obligation to reimburse a ceding entity under the terms of the reinsurance contract.

Ceding Entity

The party that pays a reinsurance premium in a reinsurance transaction. The ceding entity receives the right to reimbursement from the assuming entity under the terms of the reinsurance contract.

Contract Period

The period over which insured events that occur are covered by insurance or reinsurance contracts. Commonly referred to as the coverage period or period that the contracts are in force.

Deposit Method

A revenue recognition method under which premiums are not recognized as revenue and claim costs are not charged to expense until the ultimate premium is reasonably estimable, and recognition of income is postponed until that time.

Prospective Reinsurance

Reinsurance in which an assuming entity agrees to reimburse a ceding entity for losses that may be incurred as a result of future insurable events covered under contracts subject to the reinsurance. A reinsurance contract may include both prospective and retroactive reinsurance provisions.

Retroactive Reinsurance

Reinsurance in which an assuming entity agrees to reimburse a ceding entity for liabilities incurred as a result of past insurable events covered under contracts subject to the reinsurance. A reinsurance contract may include both prospective and retroactive reinsurance provisions.

Settlement Period

The estimated period over which a ceding entity expects to recover substantially all amounts due from the reinsurer under the terms of the reinsurance contract.

2.3 Assessing risk transfer

To apply reinsurance accounting to a contract, the entity must determine whether the contract meets the risk transfer provisions. The issue of what constitutes risk transfer under a reinsurance contract has been debated within the insurance industry for years. Judgment plays a significant role in the determination, since comprehensive implementation guidance on risk transfer is not provided.

This section addresses the basic concepts of risk transfer. Sections 3 and 4 of this publication provide additional guidance on the evaluation of risk transfer for reinsurance of short-duration and long-duration contracts.

Excerpt from Accounting Standards Codification

Insurance Activities

Scope and Scope Exceptions

Instruments

944-20-15-37

The guidance in the Reinsurance Subsections of this Subtopic applies to the following instruments:

a. Any transaction, regardless of its form, whose individual terms indemnify an insurer against loss or liability relating to **insurance risk**. That is, all contracts, including contracts that may not be structured or described as reinsurance, shall be accounted for as reinsurance if those conditions are met, including reinsurance contracts used to, in effect, sell a line of business by coinsuring all or substantially all of the risks related to the line.

b. All contract amendments.

Assessing Indemnification Against Loss and Liability Relating to Insurance Risk

944-20-15-40

Determining under paragraph 944-20-15-37(a) whether a contract with a reinsurer provides indemnification against loss or liability relating to insurance risk requires a complete understanding of that contract and other contracts or agreements between the ceding entity and related reinsurers. A complete understanding includes an evaluation of all contractual features that do either of the following:

a. Limit the amount of insurance risk to which the reinsurer is subject (such as through experience refunds, cancellation provisions, adjustable features, or additions of profitable lines of business to the reinsurance contract)

b. Delay the timely reimbursement of claims by the reinsurer (such as through payment schedules or accumulating retentions from multiple years).

This risk transfer assessment shall be made at contract inception, based on facts and circumstances known at the time.

944-20-15-40A

Reinsurance programs often entail the reinsurance of various layers of exposure through multiple reinsurance contracts. Indemnification against loss or liability relating to insurance risk shall be determined in relation to the provisions of the individual reinsurance contract being evaluated.

The determination of whether a contract with a reinsurer meets the risk transfer conditions requires a complete understanding of the contract and knowledge of other contracts or agreements between the ceding company and its reinsurers. In evaluating whether a reinsurance contract satisfies the risk transfer conditions, entities need to consider contractual features that limit the amount of insurance risk to which the reinsurer is subject, or delay the timely reimbursement of claims by the reinsurer. In this context, "timely" refers to the relationship between the date that a ceding company pays a claim covered by a reinsurance contract and the date of actual cash reimbursement by the reinsurer. Generally, reimbursement is considered "timely" if settlement is consistent with financial reporting practices (i.e., monthly or quarterly). Often, a ceding company's reinsurance program consists of several reinsurance contracts that cover different "layers" of exposure. Those reinsurance contracts can be with one or several reinsurers. The evaluation of risk transfer should be based on the provisions of the contract being evaluated.

ASC 944-20-55-27 through 55-35 discusses but does not define what constitutes a "contract," which essentially is a question of substance.[1] Therefore, for purposes of assessing the risk transfer provisions, companies may have to combine multiple contracts that have interlocking provisions into one overall transaction to determine whether risk transfer exists. In other words, the assessment of risk transfer requires the consideration of all features of a reinsurance contract or other related contracts that directly or indirectly compensate the reinsurer or related reinsurers (i.e., affiliated entities) for losses. For example, the profit-sharing provisions of one contract may refer to experience on other contracts, which may indicate one contract in substance exists.

In some circumstances, it may be difficult to determine the boundaries of a "contract." An individual contract within a reinsurance program should pass the risk transfer tests on its own to be accounted for as reinsurance. However, while an individual contract may transfer risk on a stand-alone basis, after an entity considers the entirety of a reinsurance program (i.e., all contracts with the same or related reinsurers), there may be an indication that the contracts do not transfer risk in the aggregate. In that case, each of the individual contracts with the same or related reinsurers should not be accounted for as reinsurance, since the risk transfer conclusion at the reinsurance program level effectively negates the risk transfer conclusion for the individual contracts. Conversely, although a reinsurance program as a whole may transfer risk, individual contracts within the program may not be accounted for as reinsurance if they do not, by themselves, transfer risk.

For example, a company could have a coinsurance contract that cedes certain policies and claims to a reinsurer, but the same underlying policies and claims are also subject to a yearly renewable term (YRT) contract with the same reinsurer. If the YRT contract contains provisions allowing the reinsurer to reprice the coverage based on experience, the ceding company would need to consider whether the terms of the YRT contract affect the risk transfer of the coinsurance contract (i.e., consider whether risk is transferred at the aggregate level for the entirety of the reinsurance program).

2.3.1 When to evaluate whether risk transfer exists

All reinsurance contracts require a risk transfer evaluation. Under ASC 944-20-15-40, the ceding company must evaluate once a contractual agreement is reached whether the contract transfers insurance risk at the contract's inception. Frequently, a reinsurance contract is not finalized and executed (i.e., signed) until sometime after the inception of the contract (i.e., the date of agreement). That is, the terms of the contractual agreement may have been agreed to, but a final written agreement has not been formally executed. In those situations, the contract would be effective as of the inception date, unless the final signed reinsurance contract differs substantively from the basic terms agreed to at inception. There is no requirement to perform a re-evaluation of risk transfer as experience develops under the contract.

The guidance does not allow a ceding company to re-evaluate whether a contract qualifies as reinsurance after the initial evaluation. However, if a reinsurance contract is amended after its effective date, the amendment may result in a new contract for purposes of applying the risk transfer criteria of ASC 944-20-15-41. Additional guidance in evaluating whether an amendment creates a new contract is included in section 2.3.2.

For complex reinsurance contracts, the time-consuming process of preparing detailed cash flow analyses will be necessary to evaluate whether risk transfer exists. However, for straightforward reinsurance contracts (e.g., an excess of loss[2] arrangement with a fixed premium and no adjustable features), the risk transfer evaluation generally could be limited to understanding the historical and expected loss experience

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[1] This concept is consistent with statutory accounting guidance provided by the National Association of Insurance Commissioners (NAIC). Question number 10 in Exhibit A to Statement of Statutory Accounting Principles (SSAP) No. 62R, *Property and Casualty Reinsurance*, addresses the evaluation of what constitutes a contract.

[2] Excess of loss is a type of non-proportional reinsurance contract that requires the insurer to pay all the losses up to a stated amount or retention limit on each risk covered under the reinsurance arrangement, with losses incurred above the limit paid by the reinsurer. The excess of loss contract typically provides a fixed coverage for a fixed premium without any risk-limiting features and can be on a per-risk or per-occurrence basis.

for the business reinsured, which would eliminate the need for detailed cash flow analyses. Because many reinsurance contracts have adjustable features, the number of contracts that will qualify as straightforward reinsurance contracts may be limited.

2.3.2 Amended contracts

Excerpt from Accounting Standards Codification

Insurance Activities

Scope and Scope Exceptions

Reinsurance Contracts

Amendments

944-20-15-62

Any change or adjustment of contractual terms is considered an amendment for purposes of applying this Subtopic, including all but the most trivial changes and without distinction between financial and nonfinancial terms.

944-20-15-63

Examples of amendments include but are not limited to the following:

a. Replacing one assuming entity with another (including an affiliated entity)

b. Modifying the contract's limit, **coverage**, premium, commissions, or experience-related adjustable features.

944-20-15-64

If contractual terms are amended, risk transfer shall be reassessed. For example, a contract that, upon its inception, met the conditions for reinsurance accounting under this Subsection could later be amended so that it no longer meets those conditions. The contract shall be reclassified and accounted for as a deposit in accordance with the guidance in Subtopic 340-30.

944-20-15-65

Whether an amended contract in substance transfers risk shall be determined considering all of the facts and circumstances in light of risk transfer requirements. Judgment also will be required to determine whether an amendment in effect creates a new contract.

As shown above, ASC 944 broadly defines an amendment to a contract, and that definition encompasses any change to or adjustment of any contractual term. The change or adjustment could relate to either a financial or a nonfinancial term or provision. For purposes of ASC 944-20-15-62, amendments include, among other items, the replacement of one assuming company by another company, a modification of contract limits, an expansion or reduction of coverage, an adjustment of the premium or commission amounts, or a modification of any adjustable contract feature. Any amendment that creates a new contract requires the ceding company to assess risk transfer criteria at the amendment date.

The effective date of a new contract that is created by an amendment to an existing contract cannot have the same effective date as the original contract. Because the "new" contract and the original contract have different effective dates, the cash flows also may differ. Judgment will be required to determine whether an amendment creates a new contract and which cash flows should be used if a new contract is created.

An amendment that creates a new contract could result in a prospective contract becoming either a retroactive or a combination contract. This generally occurs because the reinsured liabilities will include liabilities incurred as a result of past insurable events. Because ceding companies are not permitted to immediately recognize gains from retroactive contracts, ceding companies should thoroughly evaluate before amending a contract the potential effect of an amendment on the recognition of revenues and costs.

Often there is a period of time between the inception of the contract and its finalization, and if the ceding and assuming companies substantively change the intent of the basic terms agreed to, those changes could be considered an amendment to the original contract. If such a change creates a "new" contract, the entity may be required to account for the intervening contract (i.e., the original contract that covered the period from inception to the finalization of contract terms) and the "new" contract separately.

The Reinsurance Contracts Subsections of ASC 944 do not provide any guidance on what a reasonable timetable might be between the time that the parties to the reinsurance contract agree, in principle, to the basic terms and when documentation is final. The entity should consider the information available (e.g., placement slips, term sheets, other types of documentation indicating the entities are accounting for the transaction according to the terms) and determine whether that information is sufficient to conclude that a reinsurance arrangement is in effect.

2.4 Reporting gross amounts

Assets and liabilities relating to reinsured policies are required to be recorded at their gross amounts and not net of the effects of reinsurance. Reinsurance recoverables (i.e., ceded reserves for unpaid claims, including amounts related to incurred but not reported (IBNR) and ceded life benefit reserves) and prepaid reinsurance (i.e., ceded unearned premiums) are required to be reported separately as assets. However, the guidance neither prohibits nor requires a separate classification of reinsurance recoverables between amounts applicable to paid claims and unpaid claims, including recoverable amounts applicable to IBNR claims and ceded life benefit reserves. Amounts recoverable and payable between a ceding company and a reinsurer should be offset and reported on a net basis only when a valid right of setoff exists, as defined in ASC 210-20 for offsetting of balance sheet items.

Gross reporting is not required in the income statement. However, ASC 944-605-45-1 requires that ceded earned premiums and recoveries recognized under reinsurance contracts be either reported in the income statement (e.g., separate line items, parenthetically) or disclosed in the notes to the financial statements. In addition, DAC may be reported on the balance sheet net of commission and expense allowances related to reinsurance ceded (ASC 944-30-35-64).

Section 7 of this publication provides illustrations of the gross reporting requirements.

2.5 Disclosures

Insurance companies (both ceding and assuming companies) are required to disclose the following reinsurance-related matters in their financial statements:

- The nature, purpose and effect of ceded and assumed reinsurance transactions on the insurance company's operations (ceding companies also should disclose the fact that the insurer is not relieved of its primary obligation to the policyholder in a reinsurance ceded transaction)
- For short-duration contracts, premiums from direct business, reinsurance assumed and reinsurance ceded, on both a written and an earned basis, if the difference between the written and earned premiums is significant
- For long-duration contracts, premiums and amounts assessed against policyholders from direct business, reinsurance assumed and reinsurance ceded and premiums and amounts earned
- The accounting methods used for income recognition on reinsurance contracts
- Concentrations of credit risk associated with reinsurance recoverables and prepaid reinsurance premiums

Section 7 of this publication provides additional discussion of the disclosure requirements.

3 Short-duration contracts

3.1 Accounting for reinsurance of short-duration contracts

When evaluating whether a short-duration contract should be accounted for as reinsurance, the ceding company must determine whether the reinsurance of the short-duration contracts indemnifies the ceding company against loss or liability (i.e., risk transfer). The accounting treatment for the reinsurance of short-duration contracts will depend on whether a reinsurance contract is prospective or retroactive. Contracts that that do not qualify as reinsurance and are deemed to be financing arrangements will be accounted for as deposits.

ASC 944-20-15-41 specifically requires the indemnification of loss or liability to encompass insurance risk (with insurance risk being defined as *both* underwriting risk and timing risk) for a contract to qualify as reinsurance. Considerable judgment is necessary when determining whether a reinsurance contract qualifies for reinsurance accounting.

Excerpt from Accounting Standards Codification

Master Glossary

Insurance Risk

The risk arising from uncertainties about both underwriting risk and timing risk. Actual or imputed investment returns are not an element of insurance risk. Insurance risk is fortuitous; the possibility of adverse events occurring is outside the control of the insured.

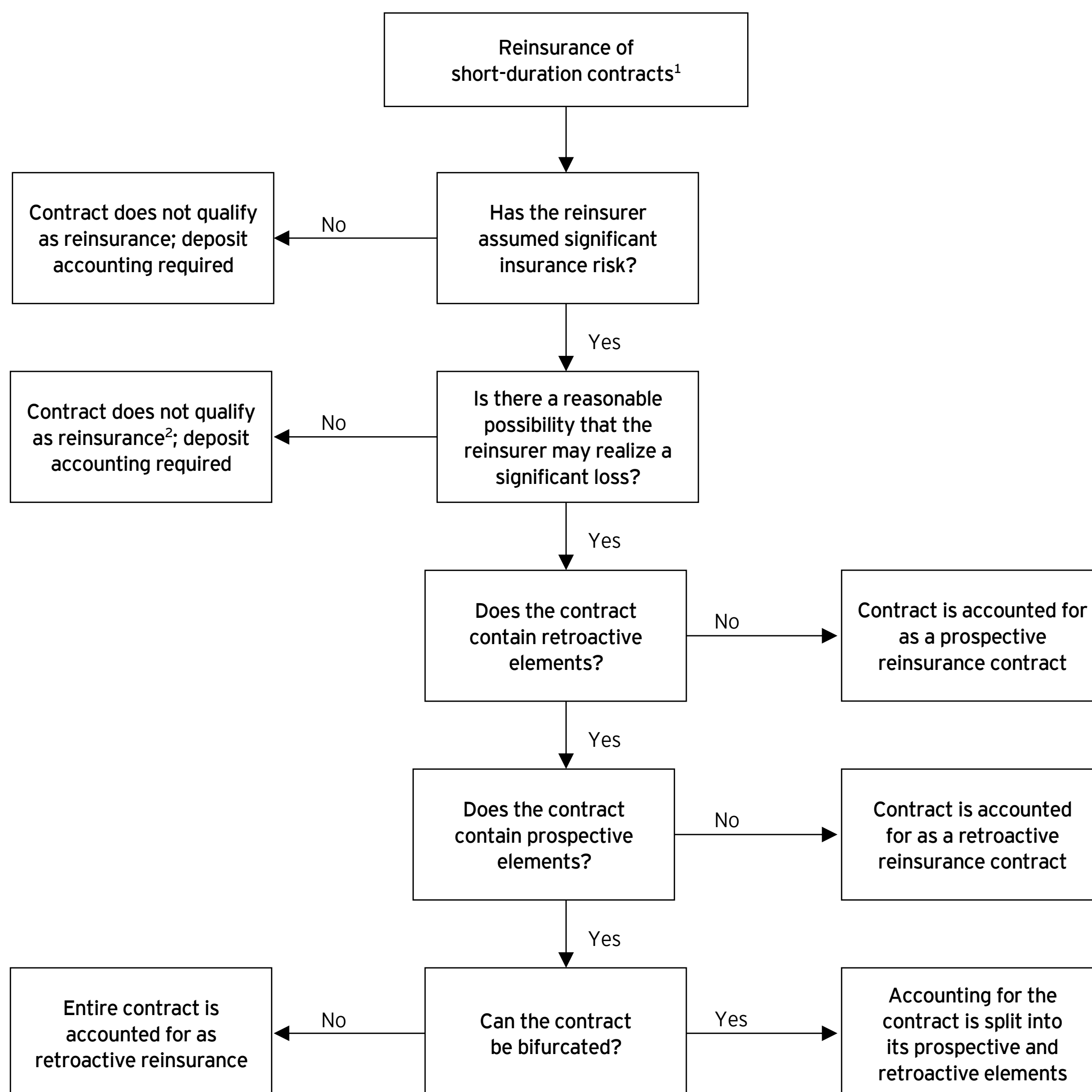
Timing Risk

The risk arising from uncertainties about the timing of the receipt and payments of the net cash flows from premiums, commissions, claims, and claim settlement expenses paid under a contract.

Underwriting Risk

The risk arising from uncertainties about the ultimate amount of net cash flows from premiums, commissions, claims, and claim settlement expenses paid under a contract.

3.2 Classification of reinsurance of short-duration contracts



[1] Assumes that multiple-year retrospectively rated reinsurance contracts meet the three conditions of ASC 944-20-15-55 (see section 3.8.1); multiple-year contracts that do not meet those conditions are accounted for using deposit accounting.

[2] The contract may qualify as reinsurance if the reinsurer assumes substantially all insurance risk relating to the reinsured portions of the underlying contracts (see section 3.3.2.3).

The decision tree above is intended to provide a logical sequence of questions that need to be answered when determining the appropriate accounting for the reinsurance of short-duration contracts.

The NAIC adopted guidance on accounting for the reinsurance of short-duration contracts that is substantially similar to the US GAAP requirements. Both ASC 944 and Statement of Statutory Accounting Principles (SSAP) No. 62R, *Property and Casualty Reinsurance*, require the transfer of insurance risk and include similar concepts for determining whether the risk transfer criteria have been met, as discussed in the next section.

3.3 Risk transfer criteria

Excerpt from Accounting Standards Codification

Insurance Activities

Scope and Scope Exceptions

Reinsurance of Short-Duration Contracts

944-20-15-41

Unless the condition in paragraph 944-20-15-53 is met, indemnification of the ceding entity against loss or liability relating to insurance risk in reinsurance of short-duration contracts exists under paragraph 944-20-15-37(a) only if both of the following conditions are met:

a. Significant insurance risk. The reinsurer assumes significant insurance risk under the reinsured portions of the underlying insurance contracts. Implicit in this condition is the requirement that both the amount and timing of the reinsurer's payments depend on and directly vary with the amount and timing of claims settled under the reinsured contracts.

b. Significant loss. It is **reasonably possible** that the reinsurer may realize a significant loss from the transaction.

The conditions are independent and the ability to meet one does not mean that the other has been met. A substantive demonstration that both conditions have been met is required for a short-duration contract to transfer risk.

944-20-15-42

The reference in (a) in the preceding paragraph acknowledges that a ceding entity may reinsure only part of the risks associated with the underlying contracts. For example, a proportionate share of all risks or only specified risks may be reinsured. The conditions for reinsurance accounting are evaluated in relation to the reinsured portions of the underlying insurance contracts, rather than all aspects of those contracts.

944-20-15-43

The assessment of the criterion in paragraph 944-20-15-41 shall be applied from contract inception, considering the effect of any subsequent contract amendments. Careful evaluation and considered judgment is required to determine whether a significant loss to the reinsurer was reasonably possible at inception. The status of a contract should be determinable at inception and, absent amendment, subsequent changes shall be very rare.

944-20-15-44

The assessment in paragraph 944-20-15-41 is applied to a particular scenario, not to the individual assumptions used in the scenario. Therefore, a scenario is not reasonably possible unless the likelihood of the entire set of assumptions used in the scenario occurring together is reasonably possible.

The FASB established criteria for assessing whether a reinsurance contract transfers risk. ASC 944-20-15-41 requires that both the following conditions be met for a ceding company to be indemnified against loss or liability from reinsurance of short-duration contracts[3]:

- Significant insurance risk (41a test or variability test) — The reinsurer assumes significant insurance risk (i.e., both underwriting risk and timing risk) under the reinsured portions of the underlying insurance policies (ASC 944-20-15-41a).

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[3] The two conditions frequently were known as the "9a test" and "9b test" respectively, in reference to the related paragraph numbers in the original FASB Statement No. 113.

- Significant loss (41b test or significant loss test) — It is reasonably possible that the reinsurer may realize a significant loss from the transaction (ASC 944-20-15-41b).

The variability test (41a test) essentially requires that the business ceded under a reinsurance contract be subject to some degree of variability with respect to both the amount and timing of underwriting results. Further, the reinsurer's financial results should vary, to some extent, with the ceding company's results. Although the relationship between the ceding company and the reinsurer does not have to be directly proportional, when the ceding company incurs a claim that is covered by the reinsurance contract, the reinsurer's financial results should be negatively affected by that claim. In other words, if the claims that are subject to the reinsurance contract are not inherently variable, both with respect to amount and timing, or if the reinsurer's results are not affected negatively by adverse experience, the contract does not transfer "significant" insurance risk. See section 3.3.1 for further discussion of the assumption of significant insurance risk.

Under the significant loss test (41b test), the significance of loss is determined by comparing, under one or more reasonably possible outcomes, the present value of all the expected cash flows (e.g., premiums, claim recoveries, ceding commissions, experience refunds, cancellation penalties) between the ceding company and the reinsurer to the present value of the amount paid or deemed to be paid to the reinsurer (e.g., reinsurance premiums). If more than one reasonably possible outcome is evaluated, the same interest rate must be used to compute the present value of the cash flows for each reasonably possible outcome (ASC 944-20-15-49).

The FASB intended for these two conditions to be separately evaluated. Therefore, any analysis or reasoning supporting that one of the conditions is satisfied, in and of itself, cannot be viewed as evidence that the other condition is met, as shown in the example below (the likelihood of the fact pattern illustrated is relatively remote):

Illustration 3-1: Evaluating both risk transfer conditions

A ceding company determined that the probability of a significant variation in the amount of the payments by the reinsurer is remote and, therefore, the reinsurer has not assumed significant insurance risk (i.e., the 41a test has not been met). However, because of the possible variations in the payment patterns, the ceding company's analysis of the present value of cash flows between the ceding company and assuming company indicates that, under at least one reasonably possible outcome, the reinsurer could incur a significant loss.

Regardless of the size of the possible loss under the cash flow analysis, the ceding company cannot use the cash flow analysis to support that the reinsurer has assumed significant insurance risk. Therefore, the contract satisfies only one of the two required conditions. Although the reinsurer may realize a significant loss, the contract does not qualify for reinsurance accounting because it does not meet the condition that requires the reinsurer to assume significant insurance risk.

If the reinsurer is not exposed to a reasonable possibility of significant loss, the 41b requirement has not been met unless substantially all of the insurance risk related to the reinsured portions of the underlying insurance contracts has been assumed by the reinsurer (i.e., the ceding company retains only insignificant insurance risk for the portions of the underlying policies reinsured). ASC 944-20-15-53 implies that the ability of a ceding company to use that exception would be limited because the reinsurer's economic consequences should be virtually the same as if it wrote the business directly. Therefore, the inclusion of any adjustable feature within a reinsurance contract may prevent the use of this exception.

Examples of reinsurance contracts that are deemed to indemnify the ceding company even though the reinsurer is not exposed to the possibility of a significant loss would include quota-share reinsurance contracts (i.e., contracts without adjustable features), and historically profitable reinsurance contracts in which substantially all of the reinsured insurance risk has been assumed by the reinsurer.

Evaluating risk transfer under ASC 944-20-15-41 may be difficult when the terms of the contract are not fixed due to adjustable contract features (i.e., experience refunds, retrospective premium or commission adjustments, coverage adjustments, or any other type of adjustable feature) that may limit or alter the amount and timing of cash flows between the ceding and assuming companies. Along with understanding and evaluating the financial effect of adjustable features, determining that the risk transfer criteria are met also requires a complete understanding of each contract and any other affected contracts or agreements between the ceding company and the assuming company.

Illustrations 3-2a and 3-2b highlight how companies could evaluate individual contracts that have interrelated adjustable features.

Illustration 3-2a

A ceding company has $1 million retention and reinsures its excess exposure on the underlying insurance policies on an excess-of-loss basis, in three layers up to $10 million. The three layers are as follows:

Layer 1 — Contract A — $2 million excess $1 million

Layer 2 — Contract B — $3 million excess $3 million

Layer 3 — Contract C — $4 million excess $6 million

The reinsurance for each layer is provided through separate reinsurance contracts, and there are no provisions in any of the contracts that affect the amount of insurance risk in any other contract. In determining whether the ceding company is indemnified against loss or liability, the ceding company must evaluate Contracts A, B, and C individually.

If Contracts A and B transfer risk, but Contract C does not transfer risk, then only Contracts A and B would qualify for reinsurance accounting. However, if the terms of Contract C were favorable to the reinsurer, and it is determined that those terms were intended to offset any potential negative outcomes from either Contract A or B, then the three contracts may have to be evaluated for risk transfer on a collective basis to evaluate whether Contracts A and B should apply reinsurance accounting.

Illustration 3-2b

Assume the same basic contract coverages in Illustration 3-2a, except that Contract B has a provision that reduces the insurance risk assumed by the reinsurer under Contract A (e.g., an experience refund, a provision that increases the premium under Contract A for adverse results under Contract B, a cancellation provision, an accumulating retention).

Under those circumstances, when evaluating whether Contract A qualifies as reinsurance, the ceding company must consider the mitigating provision in Contract B. Again, the ceding company may have to test the combined expectations for Contracts A and B to determine whether both contracts qualify for reinsurance accounting.

Another factor that ceding and assuming companies need to consider when evaluating whether a contract qualifies for reinsurance accounting is whether the contract, in essence, contains separate and distinct loss exposures. Specifically, the minutes in connection with the EITF's consensus on multiple-year retrospectively rated reinsurance contracts (EITF 93-6, now codified in ASC 944-20-15-56) indicate that contracts that combine two or more underlying exposures of the reinsured policies (e.g., personal auto insurance, workers' compensation insurance) that are unrelated into one contract for the sole purpose of obtaining reinsurance accounting treatment for those contracts should be evaluated separately.

Contracts that do not meet the risk transfer conditions do not qualify for reinsurance accounting and are to be accounted for as deposits. Section 5 of this publication addresses accounting for reinsurance contracts that do not indemnify an insurer against loss or liability relating to insurance risk.

3.3.1 Assumption of significant insurance risk

To qualify for reinsurance accounting, a reinsurance contract has to result in significant insurance risk being assumed by the reinsurer under the terms of the contract. Insurance risk is constituted by both underwriting risk and timing risk. Companies frequently focus on the requirements for the significant loss test, which is the mathematical analysis to determine whether the reinsurer could incur a significant loss.

However, under ASC 944-20-15-41, the requirements for both the variability test (i.e., 41a requirement) and the significant loss test (i.e., 41b requirement) are equally important. When there are contractual features that limit the reinsurer's exposure to loss from claims incurred by the ceding entity for the business ceded, a reinsurance contract may meet the 41b requirement but not the 41a requirement. Regardless of what a feature might be called, any feature that can delay the timely reimbursement of claims to the ceding entity violates the requirements for reinsurance accounting.

Excerpt from Accounting Standards Codification

Insurance Activities

Scope and Scope Exceptions

Significant Insurance Risk — Short-Duration Contracts

944-20-15-46

A reinsurer shall not be considered under paragraph 944-20-15-37(a) to have assumed significant insurance risk under reinsured short-duration contracts if the probability of a significant variation in either the amount or timing of payments by the reinsurer is **remote**. Contractual provisions that delay timely reimbursement to the ceding entity would prevent this condition from being met because they prevent the reinsurer's payments from directly varying with the claims settled under the reinsured contracts.

944-20-15-47

Whether **underwriting risk** has transferred to the reinsurer depends on how much uncertainty about the ultimate amount of net cash flows from premiums, commissions, **claims**, and claim settlement expenses paid under a contract has been transferred to the reinsurer. The preceding paragraph indicates that insurance risk transfer requires that both the amount and timing of the reinsurer's payments depend on, and directly vary with, the amount and timing of claims settled under the reinsured contracts. Accordingly, the significance of the amount of underwriting risk transferred shall be evaluated in relation to the ceding entity's claims payments.

Master Glossary

Remote

The chance of the future event or events occurring is slight.

The 41a test requires an evaluation of the inherent variability of the underwriting experience of the business to be reinsured and then an evaluation of the reinsurer's results when the terms of the proposed reinsurance contract are applied to the expected experience of the underlying policies. There is not comprehensive guidance on how to determine whether significant insurance risk has been transferred in a reinsurance contract. However, ASC 944-20-15-46 states that the reinsurer has not assumed significant insurance risk in any contract where the "probability of a *significant variation* in either the amount or timing of payments by the reinsurer is remote (emphasis added)."

For example, if a company historically had an accident-year loss ratio in excess of 70% and has an accident-year stop-loss reinsurance contract that provides coverage when the accident-year loss ratio exceeds 60%, but limits the coverage to a 70% accident-year loss ratio, there is no significant variability expected in the amount of the losses. In this example, the reinsurer's primary risk is a timing risk as to when those losses will require cash settlements and, as such, the contract would not appear to pass the 41a test.

Although the determination of "significant variation" is unique to each contract and company and involves a great deal of judgment, the following common factors should be evaluated when determining whether a variation is significant:

- The possible variation in the amount of losses ceded to the reinsurer
- The possible variation on the timing of reimbursements to the ceding company for losses reinsured (i.e., the reinsurer's loss payment reimbursement practices)
- The effect of contract provisions on the amounts and timing of reinsurance recoveries to the ceding company, such as unreasonably wide retrospective-rating adjustment corridors, accumulating retentions or predetermined payment schedules

Companies should use historical information on the business to be ceded when evaluating the possible variation in the amount of losses ceded to the reinsurer. The historical information should be derived from the ceding company's experience; however, if the ceding company does not have its own experience or its experience is not reflective of the business, relevant industry data could be used.

In analyzing whether a reinsurance contract transfers significant insurance risk, companies should use their general knowledge and understanding of the type of business reinsured to reach a conclusion. In situations where the variability is difficult to assess, companies will generally need to prepare some form of financial analysis to determine whether significant variability is present.

Companies also are required to consider how the reinsurer is affected by loss experience under the contract. ASC 944 does not require that the reinsurer's loss experience be directly proportional to the ceding company's loss experience, but some correlation between losses at the ceding company and the reinsurer should be expected to pass the 41a test. For example, as claims are ceded to the reinsurer in excess of those originally expected, the reinsurer's underwriting results under the contract should decline for a reinsurance contract to satisfy the 41a requirement. Reinsurance contracts that have adjustable features (e.g., a sliding scale commission) or other complex provisions (e.g., a loss corridor or loss ratio cap) that substantially eliminate unfavorable underwriting results to the reinsurer generally would not meet the 41a requirement.

3.3.1.1 Timely reimbursement of claims

Excerpt from Accounting Standards Codification

Insurance Activities

Scope and Scope Exceptions

Significant Insurance Risk — Short-Duration Contracts

944-20-15-48

The word timely is used in paragraph 944-20-15-40 in the ordinary temporal sense to refer to the length of time between payment of the underlying reinsured claims and reimbursement by the reinsurer. While the test for reasonable possibility of significant loss to the reinsurer provides for a present-value-based assessment of the economic characteristics of the reinsurance contract, the concept of timely reimbursement relates to the transfer of insurance risk (the condition in paragraph 944-20-15-41[a]), not the reasonable possibility of significant loss (the condition in paragraph 944-20-15-41[b]). Accordingly, timely reimbursement shall be evaluated based solely on the length of time between payment of the underlying reinsured claims and reimbursement by the reinsurer.

Reinsurance contracts sometimes include provisions that delay the reimbursement of claims paid to the ceding company (e.g., payment schedules or accumulating retentions[4]) so that the reinsurer can retain the funds. This may allow the reinsurer to earn investment income to reduce its loss exposure.

The FASB believes that those provisions mitigate the reinsurer's exposure to the timing risk component of insurance risk, and the inclusion of such provisions may prevent the contract from meeting the requirement that the reinsurer assume significant insurance risk. Therefore, if a contract includes a feature that delays the timely reimbursement of claims by the reinsurer (regardless of whether the ceding company earns a return on such unreimbursed amounts), the contract may not indemnify the ceding company against loss or liability and, therefore, does not qualify for reinsurance accounting.

As used in this context, "timely" refers solely to the length of time between the payment of underlying reinsured claims and the reimbursement to the ceding company from the reinsurer (ASC 944-20-15-48).

3.3.2 Determination of a significant loss

Excerpt from Accounting Standards Codification

Insurance Activities

Scope and Scope Exceptions

Significant Loss — Short-Duration Contracts

944-20-15-49

The ceding entity's evaluation of whether it is reasonably possible for a reinsurer to realize a significant loss from the transaction shall be based on the present value of all cash flows between the ceding and assuming entities under reasonably possible outcomes, without regard to how the individual cash flows are characterized. The same interest rate shall be used to compute the present value of cash flows for each reasonably possible outcome tested. To be reasonable and appropriate, that rate shall reflect both of the following:

a. The expected timing of payments to the reinsurer

b. The duration over which those cash flows are expected to be invested by the reinsurer.

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[4] Accumulating retentions could result when the amount of ceded premiums paid by the ceding entity is determined as a percentage of ceded losses and the reinsurance coverage provided to the ceding entity for losses incurred on the business ceded decreases as the loss ratio increases.

944-20-15-50

All cash flows are included in the calculation in the preceding paragraph because payments that effectively represent premiums or refunds of premiums may be described in various ways under the terms of a reinsurance contract. The way a cash flow is characterized does not affect whether it should be included in determining the reinsurer's exposure to loss. Only cash flows between the ceding and assuming entities are considered, therefore precluding consideration of other expenses of the reinsurer (such as taxes and operating expenses) in the calculation.

944-20-15-51

Significance of loss shall be evaluated by comparing the following:

a. The present value of all cash flows (determined as described in paragraph 944-20-15-49)

b. The present value of the amounts paid or deemed to have been paid to the reinsurer

Determining (for purposes of [b]) the amounts paid or deemed to have been paid for reinsurance requires an understanding of all contract provisions. For example, payments and receipts under a reinsurance contract may be settled net. The ceding entity may withhold funds as collateral or may be entitled to compensation other than recovery of claims. Gross premiums shall be used—expenses shall not be deducted from premiums in evaluating the significance of a reasonably possible loss.

944-20-15-52

Because the present value of cash flows shall be determined over the period in which cash flows are reasonably expected to occur, unless commutation (**termination**) is expected in the scenario being evaluated, commutation shall not be assumed in the calculation. Further, the assumptions used in a scenario shall be internally consistent and economically rational for that scenario's outcome to be considered reasonably possible.

A ceding company's evaluation of whether the reinsurer may realize a significant loss should be based on the present value of all cash flows (i.e., premiums, commissions and allowances, losses, and any other receipts or payments of cash) between the ceding company and assuming company under reasonably possible outcomes (ASC 944-20-15-49 through 15-52).

Reasonably possible outcomes are those situations where the probability of the outcome occurring is *more than remote*. The assessment of *more than remote* is applied to the particular scenario, not to the individual assumptions used to develop that scenario. Accordingly, a scenario cannot be a reasonably possible outcome if the likelihood of the entire set of assumptions occurring together is not reasonably possible.

When developing the reasonably possible cash flow outcomes, the ceding company should consider historical premium and loss information, as well as planned changes in mixes of business. If historical information is not available for the type of business ceded, the ceding company should use loss estimates that are supported by actuarial projections using industry data and likely exposure profiles related to the ceding company's operations.

When determining whether a potential loss is significant, the ceding company should evaluate possible cash flows related to the reinsurance contract and compare the present value of that potential loss to the present value of the amounts expected to be paid or deemed to be paid to the reinsurer by the ceding company. Relationships that might be appropriate to consider in measuring significance in other contexts (e.g., relating the present value of the potential loss to the surplus of either the ceding company or assuming company, relating the present value of a potential loss to the present value of a potential gain) are not appropriate for measuring significance of a loss to the reinsurer.

In the context of the FASB's use of the term "significant loss," ASC 944 does not provide a benchmark for measuring "significant," nor does any other relevant authoritative accounting literature. Therefore, the ceding company must use judgment to determine whether it is reasonably possible for the assuming company to realize a significant loss.

Although "significant" is not defined in the FASB's Accounting Standards Codification, there was a footnote to paragraph 8 of FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts for Realized Gains and Losses from the Sale of Investments*, that defined the term "insignificant" as "having little or no importance; trivial." While there is a spectrum of adjectives that can fit between the extremes of insignificant and significant, ceding companies may find that definition of insignificant to be useful in determining whether a significant loss is reasonably possible.

After FASB Statement No. 113 was issued, some insurance practitioners debated whether a threshold could be used when determining whether a potential loss to the reinsurer (in relation to the present value of the amounts deemed to be paid to the reinsurer by the ceding company) is or is not significant. While not authoritative, those discussions have suggested that a potential loss of some percentage, say 10% or greater, should presumptively qualify as significant, and potential losses that are lower than that percentage would require additional analysis to determine whether the potential loss is significant.

In accordance with ASC 944-20-15-49, the ceding company must only include reasonably possible outcomes when evaluating scenarios to determine a contract's potential for a significant loss to be realized by the reinsurer. The analysis performed to support this evaluation should consider the number of reasonably possible scenarios where the reinsurer would experience a loss relative to the number of reasonably possible scenarios where there would be a gain to the reinsurer. For example, if the analysis of a contract indicates only a single reasonably possible loss scenario among a number of gain scenarios, and that loss scenario demonstrates a loss of less than 10%, it might be reasonable to conclude the scenario does not represent a significant risk under the contract such that a reasonable possibility of a significant loss does not exist. Instead, if there are many reasonably possible loss scenarios and only a few or no gain scenarios, the conclusion might be different. The effect of any risk-limiting features included in the terms of the reinsurance contract have to also be carefully considered in the evaluation of reasonably possible scenarios, especially when there is an increased potential for these features to limit the risk of the reinsurer incurring a loss.

Companies should carefully consider the actuarial techniques used when determining whether the reinsurer may realize a significant loss to make sure they are consistent with the overall requirements of the accounting guidance. For example, the value-at-risk actuarial technique is a statistical measurement that quantifies the extent of potential losses over time, while the expected reinsurer deficit (ERD) actuarial technique incorporates the present value of underwriting loss frequency and severity into a single measure. The objective of the ERD technique is to define risk as the product of frequency and severity of net economic loss, and often results in identification of low-probability, high-severity risks. However, the fundamentals of the ERD technique often do not meet the US GAAP requirement for the ceding company's risk transfer evaluation because the likelihood of the entire set of assumptions occurring together often is not reasonably possible.

The above considerations for the determination of a significant loss also apply when evaluating a risk transfer in accordance with statutory accounting principles (i.e., SSAP No. 62R).

3.3.2.1 Cash flow analyses

To evaluate the determination of a significant loss, ceding companies need to use a financial model that schedules and calculates the present value of all cash flows between the ceding company and assuming company. Developing such a financial model for contracts with fixed terms should not be as difficult as developing models for contracts with adjustable features, such as adjustable premiums, sliding scale

commission rates, reinstatement premiums,[5] and experience accounts. Some ceding companies probably will not even have to prepare cash flow analyses for contracts that have fixed premiums and provide reinsurance coverage that cannot be adjusted. In this situation, the ceding company is obtaining protection against an uncertainty for a fixed price.

When cash flow analyses are necessary, the interrelationship between claims incurred under the contract and the adjustable features of the contract may require companies to develop specifically tailored financial models for such reinsurance contracts. ASC 944-20-15-50 indicates that only cash flows between the ceding company and assuming company should be considered in the analysis. Therefore, any other expenses (e.g., taxes, general operating expenses) of the reinsurer that are only indirectly related to a reinsurance contract should not be used in the determination of the present value of cash flows for that contract.

Excerpt from Accounting Standards Codification

Insurance Activities

Scope and Scope Exceptions

Reinsurance of Short-Duration Contracts

944-20-15-45

Contracts that reinsure risks arising from short-duration contracts shall meet the definition of a short-duration contract in paragraph 944-20-15-2 to be accounted for as reinsurance, because reinsurance of short-duration contracts is inherently short-duration. Contracts that reinsure short-duration insurance risks over a significantly longer period are, in substance, financing transactions, because any of the following conditions exist:

a. Premiums are deferred over a period beyond the term of the underlying insurance contracts.

b. Losses are recognized in a different period than the period in which the event causing the loss takes place.

c. Both events (a) and (b) occur at different points in time.

An important consideration when developing cash flow analyses is to determine the period of time that the reinsurance contract will be in force. The guidance states that a short-duration contract is one that provides insurance protection for a fixed period of short duration and enables the insurer to cancel the contract or to adjust the provisions of the contract at the end of any contract period, such as adjusting the amount of premiums charged or coverage provided. Accordingly, contracts that reinsure short-duration insurance risks over a significantly longer term or indefinitely would generally not qualify as reinsurance contracts and would instead be considered financing transactions due to the timing of recognition of the underlying cash flows. Contract terms that either defer premiums or recognize losses over a different period than the term of the underlying insurance contracts generally indicate a financing transaction.

This guidance does not preclude from classification as reinsurance multiple-year retrospectively rated contracts where the period of the reinsurance coverage is aligned with the term of the underlying contracts, which generally include experience rating components. In contrast, retrospectively rated

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[5] A reinstatement premium is a feature common in multiple-year retrospectively rated and excess of loss reinsurance contracts where the coverage provided by the contract is absorbed by losses incurred, and the contract allows for the ceding entity to pay an additional premium to reinstate the coverage for the remainder of the contract period. This feature could prevent the ceding entity from meeting the significant loss requirement of ASC 944-20-15-41(b) if the additional amount to be paid by the ceding entity for the additional coverage to be provided under the reinsurance contract does not represent a market rate for the relative exposure to the risk of loss accepted by the reinsurer.

contracts that provide coverage for contracts written over multiple years generally would be classified as financing transactions, as the cash flows from contracts written in one year are affecting the cash flows from contracts written in a different year. See section 3.8 for further discussion on the criteria for these types of contracts.

Frequently, a reinsurance contract will be entered into by a ceding company with the intent to commute the contract before all of the claims relating to the underlying insurance policies are settled and paid. When preparing the present value cash flow analyses, the ceding company should use its best estimate of the period that it expects the contract to remain in force. This point is illustrated as follows:

Illustration 3-3

A company reinsures a line of business that has an expected 15-year payout period for the underlying policy losses. The ceding company has estimated that 75% of the underlying losses will be paid within the first five years, and the contract permits the ceding company to commute the contract after five years. At contract inception, the ceding company's intent is to commute the contract after five years.

When preparing the cash flow analyses, the ceding company should use the expected cash flows during the five-year period and, consistent with the company's intent, it also should include the contemplated commutation settlement in the analysis.

ASC 944-20-15-49 requires that the same interest rate, which reflects both the expected timing of payments to the reinsurer and the duration in which cash flows are expected to be invested by the reinsurer, should be used to compute the present value of cash flows for each of the reasonably possible outcomes. However, it does not provide guidance on determining that interest rate, and judgment is required to identify a reasonable and appropriate interest rate. Because the timing of loss payments under the different reasonably possible outcomes will vary (i.e., a higher portion of claims could be paid in the early years or in the later years of the settlement period) perhaps significantly, ceding companies may have to determine a reasonable and appropriate interest rate that reflects when the cash flows are expected to occur.

The method that a ceding company uses to determine an appropriate interest rate varies depending on the circumstances, but generally it would involve determining one of the following: a yield curve, a weighted average or a simple average. When using a method, the ceding company must use the same interest-rate base (i.e., the cost of capital, investment portfolio return or risk-free rate of return) when applying that method to the cash flows of each of the reasonably possible outcomes. Once a company has selected an appropriate method, that method should be used for all contracts executed at approximately the same time. For reinsurance contracts that become effective at different times during the year or in subsequent fiscal years, a company will need to determine a new interest rate.

For example, in evaluating whether a contract subjects the assuming company to a significant loss, a ceding company has determined that there are two reasonably possible outcomes. Under one outcome, the majority of the losses are paid within 10 years. Under the other outcome, the majority of the losses are paid somewhat ratably over 15 years. Assuming that the current risk-free rates of return for 10 and 15 years are 3% and 4%, respectively, the ceding company may elect to use a simple average rate of 3.5% in determining the present value of the cash flows.

Although using a simple average may be an acceptable method, many companies probably will elect to use a weighted average method. Under that approach, a company might use various durations (e.g., two, four, six, eight, 10, 15 years) and place more emphasis on the years that have the higher expected claim settlements. For example, if 40% of the claims are paid in years one and two, 30% in years three and four, and 5% in each of the remaining six years of a 10-year payout, a company could reasonably be expected to elect to weight the cash flow interest rates based on those expected claim payout percentages.

Illustration 3-4: Preparing a cash flow analysis

For many reinsurance contracts, the actual contract provisions may not be as straightforward as the assumptions used for the cash flow analysis in this example, which are, on a collective basis, deemed to result in scenarios that represent reasonably possible outcomes and are summarized as follows:

- *Gross premium*: A $10 million gross premium is paid to the reinsurer in equal quarterly installments over a one-year period. The contract does not include any features that adjust the premium in subsequent years.
- *Ceding commission*: A 15% ceding commission on the gross premium is paid to the ceding company when the reinsurer receives the gross premiums. There are no features in the contract that adjust the ceding commission.
- *Expected claims*: Using its historical claim data, the ceding company has determined that the claims reinsured could be either $9 million (i.e., a 90% loss ratio) or $10 million (i.e., a 100% loss ratio).
- *Reinsurance recovery period*: The historical payout pattern for the underlying policies has ranged from a minimum of 10 years to a maximum of 15 years. Therefore, the ceding company elected to use only those two extreme payment patterns in its cash flow analysis.

The cumulative percentage of the total reinsurance recoveries expected to be received as of the end of each year under the contract, for those two payment patterns, is as follows:

Year	10-Year Period	15-Year Period
1	40%	15%
2	70%	40%
3	80%	55%
4	87%	70%
5	91%	75%
6	95%	80%
7	97%	83%
8	98%	85%
9	99%	90%
10	100%	91%
11		92%
12		93%
13		95%
14		97%
15		100%

- *Interest rate*: Based on the two reasonably possible claim payment patterns, a composite interest rate of 3.5% was determined to be the most appropriate. For simplification purposes, the same composite rate was used for all periods, and recoveries are assumed to occur at the end of each year.

Using the foregoing assumptions, the ceding company determined that the present value of the cash flows is as follows:

	10-Year recovery period		15-Year recovery period	
	90% Loss ratio	100% Loss ratio	90% Loss ratio	100% Loss ratio
(in 000's)				
Gross premiums	$ 9,788	$ 9,788	$ 9,788	$ 9,788
Less:				
Ceding commission	(1,468)	(1,468)	(1,468)	(1,468)
Reinsured claims	(8,295)	(9,217)	(7,795)	(8,661)
Reinsurer's estimated profit (loss)	$ 25	$ (897)	$ 525	$ (341)
Profit (loss) as a percent of premiums	0.3%	(9.2%)	5.4%	(3.5%)

After completing its cash flow analysis, the ceding company must determine whether the largest reasonably possible loss to the reinsurer is significant by comparing the largest reasonably possible loss to the present value of the amounts deemed to be paid.

In the foregoing example, the ceding company would compare the present value of the largest potential loss (i.e., $897,000) in the cash flow analysis to the present value of the gross premium (i.e., $9,788,000). ASC 944 does not provide guidance on what constitutes a significant loss, therefore, management's judgment becomes a major factor in determining whether the $897,000 loss is significant.

As previously mentioned in the context of a hypothetical loss threshold to a reinsurer, on a present-value basis, a potential loss that is 10% or greater than the gross premium would likely be considered presumptively significant. Further, a potential loss that is less than 10% may be viewed as significant when considering other factors (e.g., underwriting variability, the potential profit to the reinsurer under favorable scenarios, the number and range of reasonably possible outcomes).

In determining whether the 9.2% potential loss in the foregoing example is significant for purposes of the 41b test, the ceding company also may want to consider, among other things:

- The number and significance of reasonably possible loss scenarios to the reinsurer at the 100% loss ratio, using other likely claim payment patterns between the two assumed extremes (i.e., if the recoveries are received somewhere between the 10-year and 15-year periods illustrated)
- The likelihood of higher loss ratios and/or faster payment patterns than are evident from historical ratios and patterns
- The effect of current pricing and exposure profiles on historical loss ratios and claim payment patterns
- The relationship of historical profits and losses between the ceding company and the reinsurer

3.3.2.2 Amounts paid to the reinsurer

ASC 944-20-15-51 requires that, in addition to identifying all of the anticipated future cash flows, a ceding company must identify the total present value of all amounts *deemed* to be paid to the assuming company as consideration (premium) for the reinsurance coverage. The payment for reinsurance premiums will be included in the terms of the reinsurance contract, but it can be affected by the terms of other arrangements (e.g., investment management agreements) between the ceding company and the reinsurer or its affiliates. When such arrangements exist, the ceding company must consider whether any of these payments effectively represent premiums (or a refund of premiums) that are not characterized as such in the reinsurance contract.

Judgment is required when determining amounts deemed paid to the assuming company, but gross premiums are used when evaluating significant loss. However, because the way actual premium payments are made under a contract may vary (e.g., on a gross basis before ceding commissions and expense allowances, on a net basis after ceding commissions and expense allowances, on a funds-held basis), a ceding company must identify all amounts that should be considered to constitute a "payment" to the reinsurer. Even if not actually paid, amounts considered to be payments should be used for purposes of determining the present value of amounts paid to the reinsurer.

Reinsurance contracts (especially excess-of-loss contracts) sometimes are structured so that the ceding company does not receive a ceding commission. Instead, the "gross" premium is implicitly net of a credit for an amount that is equivalent to a ceding commission. Constructing a contract in which the gross premium is reduced to implicitly give effect to a ceding commission could influence the determination of what constitutes a significant loss to the reinsurer. For example, contracts that determine reinsurance

premiums without any explicit ceding commission generally require a smaller premium to be paid to the reinsurer compared with contracts that provide an explicit ceding commission. As a result, the same potential loss for a contract without a ceding commission will appear more significant in relation to the premium paid if that loss is related to "net" premiums rather than gross premiums. This should be considered in analysis of risk transfer. This point is illustrated as follows:

Illustration 3-5: Analysis of significant loss — contracts without explicit ceding commissions

Assume that two contracts are essentially identical, except that one contract includes an explicit ceding commission while the other contract does not. The gross reinsurance premium for the contract that includes an explicit ceding commission is larger than that for the other contract.

Further assume that the estimated present value of the gross premium, the ceding commission, and the claims incurred for the two contracts are as follows:

	Contract with ceding commission	Contract without ceding commission
Gross premiums	$ 12,000	$ 9,000
Ceding commission	(3,000)	–
Claims incurred	(10,000)	(10,000)
Reinsurer's estimated loss	$ (1,000)	$ (1,000)
Estimated loss to gross premiums on a present-value basis	(8.3%)	(11.1%)

Although the present value of the net cash flows (i.e., a negative $1,000) from both contracts is identical, the present value of the premium paid by the ceding company under the contract that settles on a net premium basis is smaller, and that contract appears to expose the reinsurer to a higher possibility of a significant loss.

Despite the identical economic result, if the aforementioned hypothetical 10% threshold were used to determine whether the reinsurer in this example could possibly incur a significant loss, the contract with an explicit ceding commission would not appear to expose the reinsurer to the possibility of significant loss, whereas the contract that does not include an explicit ceding commission would expose the reinsurer to the possibility of a significant loss. Therefore, for contracts without explicit ceding commissions, it may be appropriate to use a higher threshold in assessing whether risk transfer has occurred.

3.3.2.3 Exception to reasonable possibility of significant loss

Excerpt from Accounting Standards Codification

Insurance Activities

Scope and Scope Exceptions

Significant Loss — Short-Duration Contracts

944-20-15-53

If, based on the comparison in paragraph 944-20-15-51, the reinsurer is not exposed to the reasonable possibility of significant loss, the ceding entity shall be considered indemnified against loss or liability relating to insurance risk only if substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts has been assumed by the reinsurer. That condition is met only if insignificant insurance risk is retained by the ceding entity on the reinsured portions of the underlying insurance contracts. The assessment of that condition shall be made by comparing both of the following:

a. The net cash flows of the reinsurer under the reinsurance contract

b. The net cash flows of the ceding entity on the reinsured portions of the underlying insurance contracts

If the economic position of the reinsurer relative to the insurer cannot be determined, the contract shall not qualify under the exception in this paragraph.

944-20-15-54

The extremely narrow and limited exemption in the preceding paragraph is for contracts that reinsure either an individual risk or an underlying book of business that is inherently profitable. To qualify under that exception, no more than trivial insurance risk on the reinsured portions of the underlying insurance contracts may be retained by the ceding entity. The reinsurer's economic position shall be virtually equivalent to having written the relevant portions of the reinsured contracts directly.

Generally, when a ceding company concludes that the reinsurer is not exposed to a reasonable possibility of significant loss, the contract would not be deemed to indemnify the ceding company against loss or liability relating to insurance risk and, as such, the contract would not qualify for reinsurance accounting. However, ASC 944-20-15-53 and 15-54 provide an "extremely narrow and limited exemption" to the significant loss requirement that permits the ceding company to consider itself indemnified when substantially all of the insurance risk relating to the reinsured portions of the underlying insurance policies has been assumed by the reinsurer, and the reinsurer's economic position is virtually equivalent to having written the insurance contracts directly. This is sometimes referred to as the "stepping in the shoes" provision.

The exemption to the significant loss requirement would also permit the ceding company to consider itself indemnified when it is reasonably self-evident that the potential loss to the reinsurer is much greater than the consideration (i.e., premium) paid by the ceding company. This situation typically applies to the evaluation of excess of loss reinsurance contracts.

The exemption from the requirement to demonstrate that the reinsurer is exposed to the reasonable possibility of significant loss can be applied to individual risks or blocks of business that are inherently profitable, consistent with the provisions of ASC 944-20-15-54. The following example illustrates a contract to which the exemption would apply:

Illustration 3-6: Analysis of significant loss — exemption

Assume that Company A cedes, on a 50/50 quota-share basis, insurance contracts that historically have produced an underwriting gain of between 5% and 15% of premiums. The reinsurance contract does not include any adjustable features that would reduce the 50% portion ceded to the reinsurer. Assume further that Company A has obtained the reinsurance because its statutory surplus is low in relation to its expected level of premium writings.

Based on these circumstances, under all reasonably possible outcomes, the reinsurer is not expected to incur a significant loss because the underlying insurance contracts are expected to be profitable. However, because the reinsurer assumes all the insurance risk relating to the reinsured portion of the underlying policies, the contract qualifies for reinsurance accounting treatment.

To determine whether the reinsurer has assumed substantially all of the insurance risk related to the reinsured policies under the foregoing quota-share treaty, ASC 944-20-15-53 clarifies the ceding company can retain "no more than trivial risk" on the reinsured portion of the contract. This might require the ceding company to compare the net cash flows of the reinsurer to its net cash flows for the portion of the policies reinsured. Specifically, if the economic benefit (i.e., the potential gain divided by the related premium) to the reinsurer is not in the same proportion (i.e., "virtually equivalent") as the ceding company's economic benefit for its respective portions of the underlying policies, the contract does not qualify for the "significant loss" exception. As such, the inclusion of any adjustable feature or other complex provision (e.g., sliding scale commission, loss corridor, loss ratio cap) within a reinsurance contract often prevents the use of this exception since it results in economic benefits that are not virtually equivalent.

Furthermore, the contract does not qualify for the "significant loss" exemption if the economic benefit to the reinsurer cannot be determined. The comparison of net cash flows may be relatively easy for quota-share reinsurance arrangements, because the premiums and losses generally are the same as those on the reinsured portions of the underlying policies. However, in other types of reinsurance, determining the reinsurer's net cash flows relative to the ceding company is likely to be substantially more difficult.

3.4 Distinguishing between prospective and retroactive contracts

Excerpt from Accounting Standards Codification

Insurance Activities

Scope and Scope Exceptions

Reinsurance Contracts

944-20-15-34B

The distinction between prospective and **retroactive reinsurance** contracts is based on whether the contract reinsures future or past insured events covered by the underlying contracts. For example, in occurrence-based insurance, the insured event is the occurrence of a loss covered by the insurance contract. In claims-made insurance, the insured event is the reporting to the insurer, within the period specified by the policy, of a **claim** for a loss covered by the insurance contract. A claims-made reinsurance contract that reinsures claims asserted to the reinsurer in a future period as a result of insured events that occurred before entering into the reinsurance contract is a retroactive contract.

944-20-15-34C

Reinsurance contracts may include both prospective and retroactive provisions. For example, a reinsurance contract that reinsures liabilities relating to contracts written during one or more prior years also may reinsure losses on contracts to be written during one or more future years. Reinsurance also may be acquired some time after the reinsured contract has been written, but before the close of the **coverage period** for that contract, and be made effective as of the beginning of the **contract period**. This may result in a reinsurance contract with prospective and retroactive provisions that relate to a single contract year. It is not uncommon for a reinsurance arrangement to be initiated before the beginning of a policy period but not finalized until after the policy period begins. Whether there was agreement in principle at the beginning of the policy period and, therefore, the contract is substantively prospective depends on the facts and circumstances.

Revenue Recognition

Recognition

Reinsurance of Short-Duration Contracts

Distinguishing Prospective Provisions from Retroactive Provisions

944-605-25-21

If practicable, prospective and retroactive provisions included within a single contract shall be accounted for separately. The Reinsurance Contracts Subsections of this Subtopic do not require any specific method for allocating reinsurance premiums to the prospective and retroactive portions of a contract. However, separate accounting for the prospective and retroactive portions of a contract may take place only when an allocation is practicable. Practicability requires a reasonable basis for allocating the reinsurance premiums to the risks covered by the prospective and retroactive portions of the contract, considering all amounts paid or deemed to have been paid regardless of the timing of payment. If separate accounting for prospective and retroactive provisions included within a single contract is impracticable, the contract shall be accounted for as a retroactive contract provided the conditions for reinsurance accounting are met. Impracticable is used to mean that the prospective and retroactive

provisions cannot be accounted for separately without incurring excessive costs. Practicability is a dynamic concept: what is practicable for one entity might not be for another; what is not practicable in one year might be in another.

To determine the proper accounting for revenues and costs of a reinsurance arrangement that indemnifies the ceding company, the ceding company must categorize the arrangement as a prospective contract, a retroactive contract or a combination contract. The distinction between prospective and retroactive reinsurance is based on the insured events covered by the underlying policies subject to the reinsurance arrangement. Ceding companies should carefully consider what constitutes the ultimate insured event in the underlying policies to determine whether the arrangement is prospective or retroactive reinsurance.

A combination contract is one that includes both prospective and retroactive elements. An entity is required to bifurcate short-duration reinsurance contracts with both retroactive and prospective features, if practicable (i.e., contract amounts should be allocated between the retroactive and prospective elements). However, if an allocation to the separate elements is not practicable, the entire contract must be accounted for as a retroactive reinsurance contract, even if the predominant characteristics of the contract are prospective in nature.

Excerpt from Accounting Standards Codification

Insurance Activities

Implementation Guidance

Prospective or Retroactive Reinsurance Coverage of Short-Duration Insurance Contracts

944-20-55-42

This implementation guidance discusses the definition of past insurable events that governs whether reinsurance **coverage** of short-duration insurance policies is prospective or retroactive. As described in paragraph 944-20-15-34B, the distinction between prospective and **retroactive reinsurance** is based on whether a contract reinsures future or past insured events covered by the underlying insurance contracts. The form of the reinsurance—whether claims-made or occurrence-based—does not determine whether the reinsurance is prospective or retroactive.

944-20-55-43

Most reinsurance contracts covering calendar-year incurred losses combine coverage for insured events that occurred before entering into the reinsurance contract with coverage for future insured events and, therefore, include both prospective and retroactive elements.

944-20-55-44

A contract may be considered to have been substantively entered into even though regulatory approval of that contract has not taken place. The absence of agreement on significant terms, or the intention to establish or amend those terms at a later date based on experience or other factors, generally indicates that the parties to the contract have not entered into a reinsurance contract, but rather have agreed to enter into a reinsurance contract at a future date. If contractual provisions under a contract substantively entered into at a future date cover insurable events before that date, that coverage is retroactive.

Contract to Reinsure a Short-Duration Contract Entered into After the Contract's Effective Date

944-20-55-46

This implementation guidance addresses classification of a contract to reinsure short-duration policies entered into after the contract's effective date. The portion of the contract related to the period of time between the effective date of the contract and the date the contract was entered into is retroactive because it covers insured events that occurred before entering into the reinsurance contract.

In the Basis for Conclusions of FASB Statement No. 113, the FASB rejected the view that prospective or retroactive classification must be based on the event covered by the reinsurance contract and clarified that the significant distinction in reinsurance contracts is whether an insured event has occurred under the underlying insurance contracts. The FASB noted that the nature of the risks assumed by the reinsurer is fundamentally different when an insured event has already occurred. If the underlying insurance policies cover future insured events, the coverage is prospective. If the policies cover past insured events, the coverage is retroactive.

ASC 944-20-55-42 further reinforces the concept linking the classification of coverage as prospective or retroactive to the insured event of the underlying policy, regardless of the form of the reinsurance arrangement. ASC 944-20-55-43 provides an example of an arrangement providing calendar-year coverage for incurred losses, noting that because losses incurred in any given calendar year are split between new claims and development of past claims, these types of arrangements are generally viewed as combination contracts. This is due to the retrospective nature of the development of past claims. Alternately, claims-made reinsurance contracts covering underlying claims-made policies would generally be viewed as prospective contracts, since the coverage relates to future insured events.

ASC 944-20-55-44 and 55-46 describe considerations related to the timing of when the ceding company enters into a reinsurance arrangement, noting a contract entered into after its initial effective date often results in a combination contract. Furthermore, unless there is persuasive information documenting an agreement in principle before the initial effective date of the contract in accordance with ASC 944-20-15-34C, the reinsurance coverage provided for the period between the contract's initial effective date and inception date (i.e., date of agreement) is considered retroactive because it applies to insured events for the underlying policies that occurred before entering into the contract (ASC 944-20-55-46).[6]

3.5 Prospective contracts

Excerpt from Accounting Standards Codification

Revenue Recognition

Reinsurance of Short-Duration Contracts

Prospective Reinsurance

Recognition

944-605-25-20

Amounts paid for **prospective reinsurance** of short-duration contracts that meet the conditions for reinsurance accounting shall be reported as **prepaid reinsurance premiums**.

Subsequent Measurement

944-605-35-8

Prepaid reinsurance premiums recognized under paragraph 944-605-25-20 shall be amortized over the remaining **contract period** in proportion to the amount of insurance protection provided. If the amounts paid are subject to adjustment and can be reasonably estimated, the basis for amortization shall be the estimated ultimate amount to be paid.

[6] For statutory accounting purposes, SSAP No. 62R establishes a bright line and indicates that any agreement that has not been finalized in signed, written form within nine months after the commencement of the policy period covered by the reinsurance agreement is accounted for as a retroactive agreement.

Amounts paid to a reinsurer under a short-duration reinsurance contract that is deemed to be prospective (i.e., related to future insurable events) are reported by the ceding company as prepaid reinsurance premiums and are recognized over the contract period in proportion to the amount of insurance protection provided. The basis for recognition of the prepaid reinsurance premium ceded should be the estimated ultimate amount to be paid, provided that such amounts are reasonably estimable (ASC 944-605-25-20 and ASC 944-605-35-8).

Assuming that the risk transfer and significant loss criteria are met, if, following the initiation of a reinsurance contract, the ceding company can reasonably estimate the ultimate amount to be paid, the ceding company would recognize a "catch-up" adjustment. That adjustment, which must be recognized in the period in which the ultimate amount becomes reasonably estimable, would adjust the amount previously recognized to an amount that equals the amount that would have been recognized if the ceding company had been able to estimate the expected ultimate amount at the time that the reinsurance contract was initiated.

Illustration 3-7

Assume that Company A enters into a reinsurance contract on 1 January 20X1 that indemnifies it from losses in excess of $500,000 for the underlying individual policies written ratably between 1 January 20X1 and 31 December 20X1. In addition, assume:

- The individual policies have a coverage period of one year.
- The reinsurance premium for such coverage is 15% of Company A's written premium, subject to a minimum premium of $1,500,000.
- The $1,500,000 reinsurance premium paid is reported by the ceding company as prepaid reinsurance and recognized over the one-year coverage period of the underlying policies reinsured (that coverage period would encompass two calendar years — 20X1 and 20X2).

If the reinsurance premium included an adjustment (e.g., a reduction of the ceded premium rate to 12.5% if written premium exceeds $12 million), Company A would calculate the recognition of the prepaid reinsurance premium using its best estimate of the ultimate reinsurance premiums to be paid under the contract.

Accordingly, if the ceding company estimated the total written premium to be $15 million, it recognizes $1,875,000 (i.e., $15 million multiplied by 12.5%) of reinsurance premium over the coverage period.

If Company A cannot reasonably estimate the ultimate premium, it would initially recognize the actual premium paid (i.e., in this example, the minimum premium of $1,500,000) over the coverage period.

In subsequent periods, Company A will adjust the actual premium paid to its best estimate when it had significant information to reasonably estimate the ultimate premium.

Illustration 3-7a

Assume the same facts as in Illustration 3-7 and that the underlying policies were written ratably over the year.

The first two columns of the following table show the amortization, using the "rule of 24ths," of the prepaid reinsurance premium, using both a $1,500,000 and a $1,875,000 reinsurance premium. The "rule of 24ths" is a method of estimating metrics such as premiums or exposures by assuming all policies were written on the mid-point of the period.

The third column shows the amortization pattern as if Company A had initially assumed a $1,500,000 reinsurance premium and then adjusted that estimate in the fourth quarter of 20X1 to $1,875,000.

Reinsurance premium amortization

	$ 1,500,000	$ 1,875,000	Adjusted Estimate
		(in 000's)	
20X1			
1st quarter	$ 47	$ 59	$ 47
2nd quarter	141	176	141
3rd quarter	234	293	234
4th quarter	328	410	516*
20X2			
1st quarter	328	410	410
2nd quarter	234	293	293
3rd quarter	141	176	176
4th quarter	47	58	58
Total	$ 1,500	$ 1,875	$ 1,875

* As indicated, there is a "catch-up adjustment" in the recorded amortization in the period that the estimate of ultimate premium is revised upward. However, as a practical matter, except in instances where the revised estimate of the ultimate premium causes either the minimum or maximum reinsurance premium to be applicable, such amortization should correlate to the corresponding increase in the ceding company's gross earned premiums.

Below is a summarization of the financial statement effect on Company A's balance sheet and income statement based on the initial assumption of $1,500,000 in reinsurance premium and a catch-up adjustment recorded in the 4th quarter:

	Balance sheet		Income statement	
	Debit	**Credit**	**Debit**	**Credit**
		(in 000's)		
At 1 January 20X1:				
Prepaid reinsurance premiums	$ 1,500			
Cash		$ 1,500		
Reinsurance activity through 30 September 20X1:				
Earned premiums ceded			$ 422	
Prepaid reinsurance premiums		422		
Reinsurance activity from 1 October through 31 December 20X1 (catch-up adjustment):				
Earned premiums ceded			516	
Prepaid reinsurance premiums		516		

While not illustrated in the journal entries above, as claims covered by the reinsurance arrangement are incurred, Company A will credit incurred claims expense (i.e., a reduction to the expense account) and debit a reinsurance recoverable asset after making the normal journal entries for the incurred claims.

Although the Reinsurance Contracts Subsections of ASC 944 require ceding companies to develop reasonably possible outcomes to determine whether the reinsurer could be exposed to a significant loss, the likelihood that any of those outcomes will occur may be no greater than the likelihood that some other outcome will occur. As discussed, ceding companies must use their best estimate of the ultimate premium to determine the amount to amortize over the contract period. However, it can be difficult to determine the best estimate of the ultimate premium for contracts that have reasonably possible outcomes resulting in significantly different ultimate premiums due to adjustable premium provisions.

When evaluating contracts that include adjustable premium features, the provisional reinsurance premium paid should be used as the ceding company's best estimate when none of the reasonably possible outcomes has a higher likelihood of occurring than the other outcomes. When the ultimate premium becomes estimable, a "catch-up" adjustment is recognized.

Similarly, the contract period over which the reinsurance premiums are recognized may be adjusted in subsequent periods. For example, many catastrophic coverage contracts are structured so that the ceding company pays upfront reinsurance premiums for coverage if catastrophic events occur in a given period (often a calendar year). If a catastrophic loss event occurs and all of the coverage is used, a reinstatement premium would be required to reinstate coverage for a second catastrophic event. In this circumstance, consistent with ASC 944-605-35-8, matching the recognition of prepaid reinsurance premiums with the proportion of coverage provided requires that any remaining prepaid reinsurance premium (i.e., from the initial catastrophic coverage) be immediately recognized.

3.6 Retroactive contracts

Excerpt from Accounting Standards Codification

Claim Costs and Liabilities for Future Policy Benefits

Reinsurance Contracts

Recognition

944-40-25-33

Reinsurance contracts do not result in immediate recognition of gains unless the reinsurance contract is a legal replacement of one insurer by another and thereby extinguishes the ceding entity's liability to the policyholder.

Revenue Recognition

Reinsurance of Short-Duration Contracts

Retroactive Reinsurance

Recognition

944-605-25-22

Amounts paid for **retroactive reinsurance** of short-duration contracts that meets the conditions for reinsurance accounting shall be reported as **reinsurance recoverables** to the extent those amounts do not exceed the recorded liabilities relating to the underlying reinsured contracts. If the recorded liabilities exceed the amounts paid, reinsurance recoverables shall be increased to reflect the difference and the resulting gain deferred.

944-605-25-23

If the amounts paid for retroactive reinsurance for short-duration contracts exceed the recorded liabilities relating to the underlying reinsured short-duration contracts, the ceding entity shall increase the related liabilities or reduce the reinsurance recoverable or both at the time the reinsurance contract is entered into, so that the excess is charged to earnings.

As defined in the ASC Master Glossary, retroactive reinsurance is reinsurance that reimburses a ceding company for liabilities incurred due to past insurable events covered by the underlying policies reinsured. The recognition of revenues and costs related to retroactive reinsurance contracts is significantly different from that for prospective reinsurance contracts. The accounting that is required at the inception of retroactive contracts that qualify for reinsurance accounting can be described as "balance sheet" accounting. Although the income statement is affected under certain circumstances, the majority of the cash flow activity at the inception date for such a contract will be reported in the balance sheet.

At the inception of a retroactive reinsurance contract, the amount of consideration paid to a reinsurer is not accounted for as reinsurance premiums ceded by the ceding company. The amount paid by the ceding company for the retroactive coverage can be greater than, equal to, or, as is typically the case for reserves that are not discounted, less than the related liabilities reinsured. The ceding company recognizes a "reinsurance recoverable" asset in its balance sheet for the amount paid to the reinsurer.

At any point when the retroactive reinsurance contract is in effect, the reinsurance recoverable amount should equal the reported amount of the direct liabilities covered by the reinsurance contract. The ceding company's recognition of revenues and costs depends on the relationship of the consideration paid to the liabilities reinsured and whether the estimated liabilities reinsured change after the effective date of the contract.

The amount of consideration paid is determined based on the fair value of assets (e.g., cash and investments) transferred to the reinsurer. If those assets include specifically identified available-for-sale (AFS) debt securities, the ceding company must apply the accounting requirements applicable to the underlying investments and recognize the gain or loss on those investments at the date the assets are transferred, which generally occurs when the transaction closes.

If, at an interim reporting period, a transaction has not yet closed (e.g., all necessary regulatory approvals for the reinsurance transaction are not obtained) but is probable to close, the ceding company may need to recognize an impairment in earnings with a corresponding adjustment to the amortized cost basis of the specific security in an unrealized loss position in accordance with ASC 326-30. This guidance applies when an entity intends to sell an impaired AFS debt security or it is more likely than not that the entity will be required to sell such a security before recovering its amortized cost basis. See our Financial reporting developments (FRD), ***Certain investments in debt and equity securities***, for further discussion.

When there is a lag between the inception of the contract (i.e., the effective date of coverage indicated in the reinsurance arrangement) and date the contract is executed, the ceding entity will need to roll forward the amounts stated in the contract (e.g., the fair value of consideration paid and the recorded liabilities relating to the underlying policies) to the closing date of the reinsurance transaction.

The accounting for the reinsurance transaction is performed subsequent to the accounting for the investments transferred to the reinsurer. That is, if the consideration paid by the ceding company includes investments, the resulting gain or loss will be based on the fair value of the investments transferred to the reinsurer. If the fair value of consideration paid by the ceding company to the reinsurer (i.e., reinsurance recoverable) equals the ceded liabilities (i.e., reserves for unpaid claims), there is no gain or loss recognized at the inception of the reinsurance contract.

ASC 944-40-25-33 prohibits the immediate recognition of gains for the reinsurance transaction unless the ceding company's liability to its policyholders is extinguished. If the fair value of consideration paid by the ceding company to the reinsurer is less than the related ceded liabilities at the time that the retroactive reinsurance contract is initiated, the excess of the reinsurance recoverable over the amounts paid is deferred and amortized into income over the estimated remaining settlement period of the ceded unpaid claims.

If the fair value of consideration paid by the ceding company to the reinsurer is greater than the related ceded liabilities at the time that the retroactive reinsurance contract is initiated, the ceding company incurs an immediate charge to income equal to the excess amount (944-605-25-23). Based on the facts and circumstances, the ceding company could increase its liability for unpaid claims, decrease its asset for reinsurance recoverable, or record a combination of both to recognize the charge to income.

Illustration 3-8: Recognition of retroactive contracts

Assume that Company A has reported claim liabilities, including reserves for IBNR claims, of $10 million and purchases reinsurance coverage for those claim liabilities for $10 million. The amount paid ($10 million) is reported as reinsurance recoverable. Because the fair value of the consideration paid is equal to the reported claim liabilities, no charge to income and no deferred gain would be reported at the inception of the contract.

Assume the same facts as above, except that the amount paid was $7 million. In this situation, the reinsurance recoverable would be reported as $10 million, on a basis consistent with the underlying reinsured liabilities, and the $3 million difference would be reported as a deferred credit (i.e., the "deferred gain") and amortized to income over the related settlement period of the unpaid claims.

Finally, assume the same facts as above, except that the amount paid was $12 million. Assume further that Company A increased its liability for unpaid claims for the excess amount paid. Company A's liability for unpaid claims would then be reported as $12 million and its reinsurance recoverable also would be $12 million. Company A also would have incurred a $2 million charge to income from recognizing the increase in its liability for unpaid claims.

Conversely, if Company A determined that the $10 million liability for unpaid claims was appropriate, it would report $10 million as its reinsurance recoverable and record a charge to income for $2 million (i.e., the difference between the fair value of the consideration paid of $12 million and the estimated reinsured liability of $10 million). ASC 944 does not provide guidance on the income statement account to which the $2 million amount should be charged. Therefore, the $2 million charge to income could be reported as either earned premiums ceded or incurred claims.

3.6.1 Accounting when the liabilities reinsured exceed the amounts paid

Excerpt from Accounting Standards Codification

Revenue Recognition

Reinsurance of Short-Duration Contracts

Retroactive Reinsurance

Subsequent Measurement

944-605-35-9

Any gain deferred under paragraph 944-605-25-22 shall be amortized over the estimated remaining **settlement period**. If the amounts and timing of the reinsurance recoveries can be reasonably estimated, the deferred gain shall be amortized using the effective interest rate inherent in the amount paid to the **reinsurer** and the estimated timing and amounts of recoveries from the reinsurer; that is, the interest method. Otherwise, the proportion of actual recoveries to total estimated recoveries (the recovery method) shall determine the amount of amortization.

944-605-35-10

Amortization of deferred amounts arising from **retroactive reinsurance** under both the interest method and the recovery method is based on the ceding entity's estimates of the expected timing and total amount of cash flows. The timing of changes in those estimates shall not alter the recognition of

the revenues and costs of reinsurance. Therefore, changes in estimates of the amount recoverable from the reinsurer shall be accounted for consistently both at the inception of and after the reinsurance transaction.

When the liabilities (i.e., loss reserves) reinsured under a retrospective contract exceed the fair value of the consideration paid, the ceding company is not permitted to immediately recognize the gain related to the difference between those two amounts. Instead, it is required to defer and amortize that gain over the estimated settlement period of the liabilities reinsured (ASC 944-605-35-9). In that situation, the initial reinsurance recoverable amount is increased by the amount of the deferred gain, and the unamortized portion of the deferred gain is reported as a deferred credit on the ceding company's balance sheet.

Generally, we would not expect the reinsurer to recognize a loss at the inception of a reinsurance contract that corresponds with the ceding company's gain. It would be considered unusual for a reinsurer to enter into an agreement with the expectation that it will incur a loss based on the facts and circumstances of the transaction. Recognition of an immediate loss at inception of the reinsurance contract would often be inconsistent with the economics of the transaction, and it would generally be more appropriate for a reinsurer to record loss reserves equal to the fair value of the consideration paid.

The settlement period of the unpaid claims subject to reinsurance is used for purposes of amortizing the deferred gain because, in a retroactive reinsurance contract, the period(s) for which the underlying policies provided coverage to the insured generally are closed (i.e., the period of time that the insurance coverage was provided for those reinsured policies has expired). ASC 944-605-35-9 describes two methods for a ceding company to amortize the deferred gain for retroactive reinsurance contracts: the interest method and the recovery method.

The method chosen to amortize the deferred gain will depend on whether the amounts and timing of the reinsurance recoveries can be reasonably estimated. The ceding company must use the interest method when the amounts and timing of ultimate reinsurance recoveries can be reasonably estimated. The interest method uses the effective interest rate inherent in the calculation of the amount paid to the reinsurer and the estimated timing and amount of recoveries from the reinsurer.

The ceding company must use the recovery method when the timing and amount of the reinsurance recoveries are not reasonably estimable. The recovery method uses the proportion of actual recoveries to total estimated recoveries for determining the amount of deferred gain amortization in any given accounting period. The recovery method is generally consistent with the amortization methodology under statutory accounting principles. If the differences between the two methods are not material, some companies elect to use the recovery method to increase consistency in their financial reporting.

Illustration 3-8a: Retroactive contracts — reinsured liabilities exceed amounts paid

Assume that, on 31 December 20X3, Company A enters into a contract to reinsure losses that pertain to past insurable events (i.e., a retroactive contract). Company A has determined that the contract meets the risk transfer conditions and, therefore, should be accounted for as reinsurance. Before entering into the contract, Company A reported a $10 million reserve for unpaid claims for the policies reinsured. Company A paid $9 million for the reinsurance coverage.

Company A was unable to reasonably estimate the timing of when the recoveries will be received and, therefore, elected to use the recovery method to amortize the deferred gain created by this reinsurance contract. In 20X4, Company A received $6 million in reinsurance recoveries under the reinsurance contract.

Below is a summarization of the financial statement effect on Company A's balance sheet and income statement of the consideration paid, determined based on the fair value of the assets transferred to the reinsurer, and the recovery of reinsured claims for the underlying policies :

	Balance sheet		Income statement	
	Debit	Credit	Debit	Credit
	(in 000's)			
At 31 December 20X3:				
Recognition of consideration paid:				
Reinsurance recoverable	$ 10,000			
Cash		$ 9,000		
Deferred reinsurance gain		1,000		
Activity during 20X4:				
Cash	6,000			
Reinsurance recoverable		6,000		
Deferred reinsurance gain*	600			
Incurred claims or earned premiums ceded				$ 600

* The $600 is determined using the recovery method ($6,000 ÷ $10,000 = 60% x $1,000 = $600). The actual recoveries of $6,000 are determined as a percentage of $10,000, as this continues to represent the Company's best estimate of the total recoveries that will ultimately be collected under the contract.

The illustration above demonstrates how a deferred gain is amortized over the settlement period in which the ceding company expects to recover amounts due. If a reinsurer prepays its obligation under the contract, it may be appropriate for the ceding company to recognize the deferred gain over the prepayment period. However, all of the facts and circumstances of the transaction must be considered to determine whether the reinsurer has substantively settled its obligation to the ceding company or the ceding company has made concessions to the reinsurer.

3.6.2 Accounting when the amounts paid exceed the liabilities reinsured

When the fair value of the consideration paid for retroactive reinsurance exceeds the liabilities reinsured under the contract, the ceding company should charge current period income for the difference between the consideration paid and the liabilities reinsured. In the Basis for Conclusions of FASB Statement No. 113, the FASB characterized the amounts paid by the ceding company in excess of the reported liabilities as "the minimum liability" for potential future adverse development that should be accrued.

As described in ASC 944-605-25-23, the ceding company is permitted to either reduce the reinsurance recoverable or increase the related liabilities to recognize that difference. Ceding companies should evaluate the facts and circumstances relating to the contract to determine whether to reduce the recoverable, increase the liabilities, or both. For retroactive reinsurance contracts, increasing the liabilities typically would be the most appropriate method when recognizing the charge to current period income.

Illustration 3-8b: Retroactive contracts — amounts paid exceed reinsured liabilities

Assume that, on 31 December 20X3, Company A enters into a contract to reinsure losses that pertain to past insurable events (i.e., a retroactive contract). Company A has determined that the contract meets the risk transfer conditions and, therefore, should be accounted for as reinsurance. Before entering into the reinsurance contract, Company A reported a $10 million reserve for unpaid claims for the policies reinsured. Company A paid $14 million for the reinsurance coverage, which represents the reinsurer's assessment as to the ultimate development of the reinsured business.

In 20X4, Company A received $3 million of recoveries under the contract.

Below is a summarization of the financial statement effect on Company A's balance sheet and income statement of the consideration paid, determined based on the fair value of the assets transferred to the reinsurer, and the recovery of losses for the policies reinsured:

	Balance sheet		Income statement	
	Debit	**Credit**	**Debit**	**Credit**
		(in 000's)		
At 31 December 20X3:				
Recognition of consideration paid:				
Reinsurance recoverable	$ 14,000			
Cash		$ 14,000		
Recognition of the understated liability:				
Incurred claims			$ 4,000	
Reserve for unpaid claims		4,000		
Activity during 20X4:				
Cash	3,000			
Reinsurance recoverable		3,000		

Assume the same fact pattern as above, except the reinsurance agreement reinsures Company A for losses that pertain to past insurable events and also reinsures Company A on an 80 percent coinsurance basis for adverse development that exceeds the reserve liability currently recorded. That is, the contract includes a "tiered" coinsurance rate structure where Company A is reinsured for the current reserves of $10 million at 100% and for 80% of loss development that exceeds $10 million. Below is a summarization of the financial statement effect on Company A's balance sheet and income statement of the consideration paid, determined based on the fair value of the assets transferred to the reinsurer, and the recovery of the reinsured losses for the policies reinsured:

	Balance sheet		Income statement	
	Debit	**Credit**	**Debit**	**Credit**
		(in 000's)		
At 31 December 20X3:				
Recognition of consideration paid:				
Reinsurance recoverable	$ 14,000			
Cash		$ 14,000		
Recognition of the understated liability:				
Incurred claims			$ 5,000	
Reserve for unpaid claims		5,000		

Company A still records a debit of $14 million to the reinsurance recoverable, since that is the amount paid to the reinsurer at the contract's inception and represents the amount of reinsurance recoverable expected under the arrangement. However, due to the tiered coinsurance rate structure in which only 80% of losses exceeding $10 million will be reimbursed, the $14 million recoverable represents a different measurement of the understated liability. Under the terms of the agreement, in order for Company A to receive the entire $14 million reinsurance recoverable, losses that pertain to the past insurable events would need to reach $15 million [($10 million x 100%) + ($5 million x 80%)].

As such, if Company A determines the liability related to the arrangement is understated and should be increased proportionately to the amount of reinsurance recoverable, an increase to the recorded reserves of $5 million is required.

3.6.3 Accounting for a change in the estimate of the liabilities reinsured

Excerpt from Accounting Standards Codification

Revenue Recognition

Subsequent Measurement

Retroactive Reinsurance

944-605-35-11

Changes in the estimated amount of the liabilities relating to the underlying reinsured contracts shall be recognized in earnings in the period of the change.

944-605-35-12

Reinsurance recoverables shall reflect the related change in the amount recoverable from the reinsurer, and a gain to be deferred and amortized, as described in paragraph 944-605-25-22, shall be adjusted or established as a result. Decreases in the estimated amount of the liabilities shall reduce the related amount recoverable from the reinsurer and accordingly reduce previously deferred gains.

944-605-35-13

When changes in the estimated amount recoverable from the reinsurer or in the timing of receipts related to that amount occur, a cumulative amortization adjustment shall be recognized in earnings in the period of the change so that the deferred gain reflects the balance that would have existed had the revised estimate been available at the inception of the reinsurance transaction. However, if the revised estimate of the liabilities is less than the amounts paid to the reinsurer, a loss shall not be deferred. The resulting difference shall be recognized in earnings immediately, as described in paragraph 944-605-25-23.

Subsequent changes in the estimated timing and amount of recoveries from the reinsurer must be recognized in income in the period of the change as a "catch-up" adjustment. Consequently, the amount of the gain, if any, that was deferred at the inception of the retroactive reinsurance contract is to be adjusted as if the revised information had been available at the inception date of the reinsurance contract. ASC 944-605-55-6 through 55-9 provides an example of the effect of a catch-up adjustment on revenue recognition.

However, the corresponding change in the amount of the reinsurance recoverable may not be immediately recognized in the income statement. Under ASC 944-605-35-12, when the change in the reserves for unpaid claims results in an increase in the amount recoverable from the reinsurer, that recovery may have to be deferred and amortized over the remaining settlement period of the underlying reinsured policies. In essence, ceding companies are required to immediately recognize a charge to income for the increase in reserves but are not able to immediately recognize the corresponding increase in the benefit from the reinsurance contract. That provision prevents ceding companies from permanently avoiding charges to income for under-reserved policies through retroactive reinsurance arrangements.

Below are examples of how a ceding company is required to recognize changes in the estimated liabilities of policies reinsured under a retroactive reinsurance contract.

Illustration 3-10a

Assume that, on 1 January 20X3, Company A purchases reinsurance for $8 million to cover reserves for unpaid claims of $10 million, including reserves for incurred but not reported losses. The reinsurance recoverable would be reported by Company A as $10 million, on a basis consistent with the underlying liabilities, and the $2 million difference would be deferred and amortized to income over the related settlement period of the unpaid claims.

Assume further that Company A could not reasonably predict the timing or amounts of reinsurance recoveries and therefore is required to use the recovery method of amortization. If, at the end of 20X3, Company A had settled reported reinsured losses of $3 million and had received recoveries of $3 million under the contract, both the reserve for unpaid claims and the related reinsurance recoverable asset would be reduced to $7 million. Company A also would amortize $600,000 (i.e., $3 million of reinsurance recoveries divided by $10 million, multiplied by the $2 million deferred gain) of the deferred gain into income in 20X3.

Below is a summarization of the financial statement effect on Company A's balance sheet and income statement:

			20X3	
	Balance sheet		Income statement	
	Debit	Credit	Debit	Credit
		(in 000's)		
At 1 January 20X3:				
Reinsurance recoverable	$ 10,000			
Cash		$ 8,000		
Deferred reinsurance gain		2,000		
Activity during 20X3:				
Payment of underlying claims:				
Reserve for unpaid claims	3,000			
Cash		3,000		
Recovery of reinsured claims:				
Cash	3,000			
Reinsurance recoverable		3,000		
Amortization of deferred reinsurance gain:				
Deferred reinsurance gain	600			
Incurred claims or earned premiums ceded				$ 600

Illustration 3-10b

Continuing with the fact pattern in Illustration 3-10a, assume further that, at the end of the first quarter of 20X4, there were no additional settlements but, as a result of adverse loss development, Company A increased its estimate for reserves for unpaid claims from $7 million (i.e., the original $10 million less the $3 million paid in 20X3) to $11 million. The additional provision of $4 million would be reported as a charge to income in 20X4, with a corresponding increase in the reported liabilities.

Consistent with the related liabilities, the reported reinsurance recoverable would be increased by $4 million, resulting in an additional deferred gain of $4 million. However, the $1.4 million of unamortized deferred gain has to be adjusted to reflect that the amortization calculation should have been based on a $6 million deferred gain instead of the $2 million as originally estimated. The adjustment is referred to as the "catch-up" gain amortization adjustment and would be reported in Company A's 20X4 operations.

To determine the amount of the catch-up adjustment, Company A would recalculate the amount that should have been amortized by changing the estimated ultimate recovery to $14 million and the deferred gain to $6 million. Using those revised estimates, the amount of gain that should have been amortized in 20X3 would be approximately $1,285,000 (i.e., the $3 million divided by $14 million multiplied by $6 million). Accordingly, a "catch-up" gain amortization adjustment of $685,000 (i.e., the $1,285,000 less the $600,000 amortized in 20X3) would be reported by the ceding company in the first quarter of 20X4.

Below is a summarization of the financial statement effect on Company A's balance sheet and income statement from the 20X4 increase in reserve for unpaid claims:

	Balance sheet		20X4 Income statement	
	Debit	**Credit**	**Debit**	**Credit**
		(in 000's)		
Activity in first quarter of 20X4:				
Increase in reserves for unpaid claims:				
Incurred claims			$ 4,000	
Reserve for unpaid claims		$ 4,000		
Recognition of increase in deferred reinsurance gain:				
Reinsurance recoverable	$ 4,000			
Deferred reinsurance gain		4,000		
Catch-up adjustment for amortization of deferred reinsurance gain:				
Deferred reinsurance gain	685			
Incurred claims or earned premiums ceded				$ 685

Illustration 3-10c

Assume the same facts as in Illustration 3-10a, except that, in the first quarter of 20X4, the reserves for the remaining unpaid claims are re-estimated to be $3 million rather than $7 million, and there were no additional settlements. Under those assumptions, the original $8 million of consideration paid, which was determined based on the fair value of the assets transferred to the reinsurer at the closing date of the reinsurance transaction, exceeds the revised $6 million estimate of the reinsured claims as of the inception date. As a result, concurrent with the revised reserve estimate, Company A would report a reduction in reported liabilities of $4 million with a corresponding increase in income (i.e., a credit to incurred claims).

Company A also would have to record an adjustment to reduce the reinsurance recoverable amount by $4 million. The adjustment to reduce the reinsurance recoverable asset would consist of a $2 million charge for reinsurance premium ceded, which is the difference between the original $8 million paid and the revised estimate of the reinsured claims of $6 million, a $600,000 charge to income representing the reversal of the previously recognized deferred gain amortization reported in 20X3, and a $1.4 million write-off of the unamortized portion of the deferred gain.

Thus, at the end of 20X4, the reinsurance recoverable of $3 million would be equal to the unpaid claim reserves of $3 million that are reinsured under the contract, and the deferred gain would be zero. The income statement effect in 20X4 would be a $1.4 million increase to income. That increase consists of a $4 million increase for the reduction of the reserve for unpaid claims and a decrease of $2.6 million for the recognition of the $2 million of reinsurance premium ceded and the reversal of the $600,000 deferred gain reported in 20X3.

Below is a summarization of the financial statement effect on Company A's balance sheet and income statement from the 20X4 decrease in reserve for unpaid claims:

	Balance sheet		20X4 Income statement	
	Debit	**Credit**	**Debit**	**Credit**
	(in 000's)			
Activity in first quarter of 20X4:				
Decrease in reserves for unpaid claims:				
Reserve for unpaid claims	$ 4,000			
Incurred claims				$ 4,000
Adjustment to reflect amount paid to reinsurer exceeded the revised estimate of liabilities reinsured:				
Deferred reinsurance gain	1,400			
Earned premiums ceded			$ 2,000	
Incurred claims or earned premiums ceded			600	
Reinsurance recoverable		$ 4,000		

The foregoing examples illustrate effects from revenue and cost recognition for retroactive reinsurance contracts. Generally, amounts paid to the reinsurer will not be reported in the income statement; instead, only the balance sheet will be affected. The revenue and cost provisions prevent ceding companies from immediately recognizing any benefit for retroactive contracts and, under certain circumstances (e.g., a subsequent increase in the reserves for reinsured policies), the ceding company has to immediately recognize a loss.

3.6.4 Amortization of deferred gains — interest method compared to the recovery method

There are two methods for amortizing deferred gains of short-duration retroactive reinsurance arrangements: the interest method and the recovery method. ASC 944-605-35-9 indicates the interest method should be used if the amounts and timing of reinsurance recoveries can be reasonably estimated. Otherwise, insurers should use the recovery method.

The interest method is used to account for, among other things, the amortization of discount or premium on investments in bonds, the amortization of DAC for universal life-type policies, and the amortization of loan fees and costs under ASC 310, *Receivables*. ASC 310-20-35-18 describes the objective of the interest method as follows:

> *The objective of the interest method is to arrive at periodic interest income (including recognition of fees and costs) at a constant effective yield on the net investment in the receivable (that is, the principal amount of the receivable adjusted by unamortized fees or costs and purchased premium or discount). The difference between the periodic interest income so determined and the stated interest on the outstanding principal amount of the receivable is the amount of periodic amortization.*

Because there is no stated interest rate that pertains to a reinsurance recoverable balance, the effective interest rate inherent in the determination of the amounts paid to the reinsurer should be used to amortize the deferred gain when the recoveries are reasonably estimable.

Illustration 3-11: Amortization of deferred gains — effective interest method

Assume that Company A enters into a retroactive contract that cedes $30 million of loss reserves for a consideration of $26,975,000. The $3,025,000 difference represents the gain on the transaction that is deferred. Assume further that the amounts and timing of the reinsurance recoveries can be reasonably estimated. The interest method will be used to determine the amortization of the deferred gain, and the recoveries are assumed to be received timely throughout the settlement years. In this example, the interest rate that was used to determine the premium was 6%.

Below is a summarization of the amortization of the deferred gain, using the interest method with an effective interest rate of 6%:

	(a)	(b)	(c)	(d)	(e)
Year	Beginning reinsurance recoverable	Beginning deferred gain	Expected reinsurance recoveries	Amortization of deferred gain	Ending reinsurance recoverable
			(in 000's)		
1	$ 30,000	$ 3,025	$ 12,000	$ 1,258	$ 18,000
2	18,000	1,767	9,000	704	9,000
3	9,000	1,063	3,000	386	6,000
4	6,000	677	2,100	256	3,900
5	3,900	421	1,200	173	2,700
6	2,700	248	1,200	111	1,500
7	1,500	137	600	64	900
8	900	73	300	40	600
9	600	33	300	25	300
10	300	8	300	8	0
		Total	$ 30,000	$ 3,025	

Computations:

(a) — Reinsurance premium plus deferred gain at inception less total reinsurance recoveries to date.

(b) — Column (b) less column (d) for the prior year.

(c) — Expected reinsurance recoveries at end of year, as estimated by the ceding company.

(d) — Column (a) less [column (b) and one half of column (c)] multiplied by the effective interest rate (6%).

(e) — Column (a) less column (c).

Illustration 3-12 delineates how the amortization of the deferred gain would be determined using the recovery method instead of the interest method. As mentioned earlier, the recovery method can only be used when the amount and timing of the reinsurance recoveries cannot be reasonably estimated. However, if the expected differences between the recovery method and the interest method are not material, some companies elect to use the recovery method. The recovery method uses the proportion of actual recoveries to total estimated recoveries to determine the amount of deferred gain amortization in any given accounting period. The assumptions in the following example are the same as in the previous example and the actual reinsurance recoveries received are assumed to be identical to the expected recoveries.

Illustration 3-12: Amortization of deferred gains — recovery method

Assume the same facts as in the preceding example, except that the deferred gain is amortized using the recovery method instead of the interest method.

Below is a summarization of the amortization of the deferred gain:

Year	(a) Beginning reinsurance recoverable	(b) Beginning deferred gain	(c) Actual reinsurance recoveries	(d) Amortization of deferred gain	(e) Ending reinsurance recoverable
			(in 000's)		
1	$ 30,000	$ 3,025	$ 12,000	$ 1,210	$ 18,000
2	18,000	1,815	9,000	908	9,000
3	9,000	907	3,000	303	6,000
4	6,000	604	2,100	212	3,900
5	3,900	392	1,200	121	2,700
6	2,700	271	1,200	121	1,500
7	1,500	150	600	60	900
8	900	90	300	30	600
9	600	60	300	30	300
10	300	30	300	30	0
		Total	$ 30,000	$ 3,025	

Computations:

(a) — Reinsurance premium plus deferred gain at inception less total reinsurance recoveries to date.

(b) — Column (b) less column (d) for the prior year.

(c) — Actual reinsurance recoveries, as experienced over the duration of the reinsurance arrangement.

(d) — Column (c) divided by reinsurance recoverable at inception ($30 million) multiplied by the deferred gain at inception ($3,025,000).

(e) — Column (a) less column (c).

In Illustrations 3-11 and 3-12, the amortization of the deferred gain recognized under both the interest and recovery methods is fairly comparable because there were significant reinsurance recoveries in the earlier years of the contract, which reduces the effect of the present-value calculations. If the foregoing illustrations had assumed that the recoveries would be smaller in the earlier years, there would have been a significant difference in the amortization of the deferred gain between the two methods. The following example illustrates how the amortization would differ between the two methods if the recoveries were smaller in the earlier years.

Illustration 3-13

Assume that Company A enters into a retroactive contract that cedes $30 million of loss reserves for a consideration of $23,737,000. The $6,263,000 difference represents the gain on the transaction that is deferred.

Below is a summarization of the amortization of the deferred gain using the interest method, with an effective interest rate of 6%, and using the recovery method:

Interest method

Year	Beginning reinsurance recoverable	Beginning deferred gain	Expected reinsurance recoveries	Amortization of deferred gain	Ending reinsurance recoverable
			(in 000's)		
1	$ 30,000	$ 6,263	$ 1,000	$ 1,394	$ 29,000
2	29,000	4,869	1,500	1,403	27,500
3	27,500	3,466	3,000	1,352	24,500
4	24,500	2,114	10,000	1,043	14,500
5	14,500	1,071	9,000	536	5,500
6	5,500	535	2,000	238	3,500
7	3,500	297	1,200	156	2,300
8	2,300	141	1,200	94	1,100
9	1,100	47	800	39	300
10	300	8	300	8	0
		Total	$ 30,000	$ 6,263	

Recovery method

Year	Beginning reinsurance recoverable	Beginning deferred gain	Actual reinsurance recoveries	Amortization of deferred gain	Ending reinsurance recoverable
			(in 000's)		
1	$ 30,000	$ 6,263	$ 1,000	$ 209	$ 29,000
2	29,000	6,054	1,500	313	27,500
3	27,500	5,741	3,000	626	24,500
4	24,500	5,115	10,000	2,088	14,500
5	14,500	3,027	9,000	1,879	5,500
6	5,500	1,148	2,000	417	3,500
7	3,500	731	1,200	251	2,300
8	2,300	480	1,200	251	1,100
9	1,100	229	800	167	
10	300	62	300	62	
		Total	$ 30,000	$ 6,263	

As shown in Illustration 3-13, the timing of recognition of the deferred gain by the ceding company can be significantly different under the two methods when recoveries are realized in the later years of the settlement period of the reinsured policies.

3.7 Contracts with both prospective and retroactive provisions

Reinsurance contracts for short-duration insurance policies may include both prospective and retroactive coverage provisions.

For example, assume that a calendar-year stop-loss reinsurance contract has both prospective and retroactive characteristics because it provides reinsurance to the ceding company if the ceding company's calendar-year losses incurred exceed a predetermined amount or a predetermined loss ratio. Because prior-year losses may develop adversely, and such development is reported as calendar-year losses incurred when the loss reserve estimates are changed, this contract has a retroactive element. However, this contract also has a prospective element because it reinsures future losses (i.e., current-year losses incurred).

Under ASC 944-605-25-21, ceding companies, when practicable, should account separately for the prospective and retroactive elements of reinsurance contracts (i.e., bifurcate the contract). A ceding company would account for the prospective element using the guidance for prospective contracts, and for the retroactive element using the guidance for retroactive contracts. Determining the allocation between the retroactive and prospective elements of a single reinsurance contract is a matter of judgment that requires the consideration of all facts and circumstances of the transaction. Although the FASB acknowledged the difficulties associated with such a determination, the Reinsurance Contracts Subsections of ASC 944 does not provide detailed guidance or criteria for bifurcating a reinsurance contract.

One approach for making such an allocation could be to bifurcate the reinsurance premium by estimating what the pricing would have been if the prospective and retroactive elements were separate contracts (e.g., for the retroactive element of the contract, an estimate would be made of the present value of the estimated loss recoveries plus an appropriate risk charge). Because the actual pricing of the combination reinsurance contract generally will assume that all possible negative events do not occur at the same time, the pricing of the combined contract may be lower than the combined estimated pricing of the prospective and retroactive elements. Accordingly, to bifurcate the premium for a combination contract, the ceding company may need to apply a ratio (e.g., a pro rata amount) to the separate pricing elements of the single premium.

Below is an example of how a ceding company could record the reinsurance premium for a combination contract that could be bifurcated.

Illustration 3-14

Assume that a reinsurance contract includes both prospective and retroactive elements. At the inception of the contract, a $10 million reinsurance premium was paid, consisting of $4 million for the prospective element and $6 million for the retroactive element. The liabilities reinsured under the retroactive element of the contract were $7 million, and that amount represents a reasonable estimate of the reported unpaid incurred losses as of the inception date of the contract.

Below is a summarization of the financial statement effect on the ceding company's balance sheet and income statement at the inception of that contract:

	Balance sheet		**Income statement***	
	Debit	**Credit**	**Debit**	**Credit**
		(in 000's)		
Recognition of prospective element:				
Prepaid reinsurance	$ 4,000			
Cash		$ 4,000		
Recognition of retroactive element:				
Reinsurance recoverable	7,000			
Deferred reinsurance gain		1,000		
Cash		6,000		

* At the inception of the contract, there are no income statement effects that result from the foregoing set of assumptions.

The subsequent accounting for each element of the foregoing combination contract would follow the respective guidance for prospective and retroactive contracts.

Contracts that have both prospective and retroactive elements are frequently not designed to permit a ceding company to easily determine the applicable portion of the amount paid for reinsurance (i.e., the fair value of the assets transferred to the reinsurer) that should be attributed to its prospective and retroactive elements. In those situations, it may not be practicable to bifurcate the contract, therefore the entire contract must be accounted for as a retroactive contract in accordance with ASC 944-605-25-21. This requirement can have a significant effect on the recognition of revenues and costs. That concept is illustrated below.

Illustration 3-15

Assume the same facts in Illustration 3-14, except that it is not practicable to bifurcate the contract. Under ASC 944-605-25-23, the $3 million difference between the amount paid and the related liabilities ceded is charged to income, and the combined reinsurance recoverable/prepaid reinsurance assets are reduced from $10 million to $7 million.

In this example, the ceding company concluded that, because the liability for unpaid losses was fairly stated at the inception of the contract, reducing the recoverable was the most appropriate method to charge income for the difference.

Below is a summarization of the financial statement effect on the ceding company's balance sheet and income statement of the reinsurance premium for the ceded losses related to the policies reinsured under this combination contract:

	Balance sheet		Income statement	
	Debit	**Credit**	**Debit**	**Credit**
		(in 000's)		
Recognition of consideration paid:				
Reinsurance recoverable	$ 10,000			
Cash		$ 10,000		
Recognition of the excess premium paid:				
Earned premiums ceded			$ 3,000	
Reinsurance recoverable		3,000		

The ceding company incurs a $3 million charge to income even though that amount may relate to the prospective portion of the reinsurance contract, and the ceding company has not yet recognized any revenue from the underlying policies. That accounting will result in a mismatching of revenues and expenses by the ceding company because the ceding company is required to recognize the revenues from the underlying policies reinsured over the contract period. The illustration highlights the potential negative effect on a ceding company's financial statements at the inception of a combined contract if the contract cannot be bifurcated.

3.8 Multiple-year retrospectively rated contracts

Excerpt from Accounting Standards Codification

Insurance Activities

Overview and Background

Multiple-Year Retrospectively Rated Reinsurance Contract

944-20-05-41

Many short-duration insurance and reinsurance contracts have retrospective rating provisions. A retrospectively rated contract is a multiple-year contract in which events in one period of the contract create rights and obligations in another. For example, if losses above a certain level occur in one contract year, premiums increase in future years unless the ceding entity compensates the reinsurer through a settlement adjustment. The ceding entity has an obligation because it must pay either the settlement adjustment or the higher future premiums.

944-20-05-42

An insurer (ceding entity) may enter into a multiple-year retrospectively rated reinsurance contract with a reinsurer (assuming entity). Examples of these contracts may include transactions referred to as funded catastrophe covers. These contracts include a retrospective rating provision that provides for at least one of the following based on contract experience:

a. Changes in the amount or timing of future contractual cash flows, including premium adjustments, settlement adjustments, or refunds to the ceding entity

b. Changes in the contract's future **coverage**.

944-20-05-43

A critical distinguishing feature of these contracts is that part or all of the retrospective rating provision is obligatory such that the retrospective rating provision creates future rights and obligations as a result of past events. Therefore, a retrospectively rated contract that could be cancelled without further obligation (because it does not create rights and obligations that will be realized in a future period) is excluded.

A multiple-year retrospectively rated reinsurance contract (RRC) is commonly referred to as a "funded cover" or "funded catastrophe cover." The guidance addresses the appropriate accounting for the adjustable features when those contracts qualify for reinsurance accounting. A critical distinguishing feature of such contracts is that part or all of one or more retrospective rating provisions (e.g., adjustments to premium or amount of coverage based on loss experience) is obligatory and, therefore, creates future rights and obligations as a result of past events that cannot be avoided by cancellation of the contract.

Considerations for multiple-year contracts include the following:

- Should a ceding company accrue a liability when it records recoveries under a reinsurance contract but is obligated to make future payments to the reinsurer because the recoveries cause adjustable features of the reinsurance contract to be invoked?
- Should a ceding company record an asset if there is favorable experience under the reinsurance contract and the assuming company is or will be obligated to make a payment to the ceding company because of the favorable experience?
- How should the ceding and assuming companies account for adjustments to the level of reinsurance coverage provided if specified experience under a contract is either exceeded or not met?

3.8.1 Conditions for reinsurance accounting

Excerpt from Accounting Standards Codification

Insurance Activities

Scope and Scope Exceptions

Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Entities

944-20-15-55

To be accounted for as reinsurance, a contract that reinsures risks arising from short-duration insurance contracts must meet all of the following conditions:

a. The contract shall qualify as a short-duration contract under paragraph 944-20-15-7.

b. The contract shall not contain features that prevent the risk transfer criteria in this Subsection from being reasonably applied and those risk transfer criteria shall be met.

c. The ultimate premium expected to be paid or received under the contract shall be reasonably estimable and allocable in proportion to the reinsurance protection provided as required by paragraphs 944-605-25-2 and 944-605-35-8.

If any of these conditions are not met, a deposit method of accounting shall be applied by the ceding and assuming entities.

RRCs that do not satisfy all three of the conditions indicated in ASC 944-20-15-55 are to be accounted for by both the ceding and assuming companies using deposit accounting. Section 5 of this publication contains a description of deposit accounting.

The first condition requires the reinsurance contract to qualify as a short-duration contract. A short-duration contract is a contract that "provides insurance protection for a fixed period of short duration" (ASC 944-20-15-7). Thus, if the period of coverage is not fixed (i.e., the term of coverage cannot be determined at inception), the reinsurance contract must be accounted for as a deposit.

Although it may be relatively simple to determine that some RRCs provide insurance for a fixed period, other RRCs (e.g., those where the term is stated as "continuous" or "cancelable by either party on 90 days' notice") require further analysis. Conversely, a reinsurance contract may have a stated fixed term of one year, but other contractual provisions may make it unlikely that the reinsurance contract would not be renewed each subsequent year.

For example, when a ceding company controls whether a reinsurance contract is or is not renewed (i.e., the renewal is not obligatory), such a contract could be viewed as a definite-term contract from the ceding company's perspective; however, if other contractual provisions (e.g., the contract has a profit-sharing provision that does not coincide with the contract period) suggest that renewal would be probable, the classification of that contract as a definite-term contract may be inappropriate. In such instances, the reinsurance contract may, in substance, be a multiyear contract despite the stated one-year term.

The second condition addresses situations in which the timing and/or amount of cash flows under an RRC necessary to perform the "risk transfer tests" cannot be reasonably estimated at the inception of the contract. At a minimum, that condition requires at least one scenario with a reasonably possible outcome in which termination of the coverage will occur such that a definite contract period can be used for evaluating compliance with the "risk transfer tests."

The third condition relates to RRCs in which the adjustable features result in an inability, at the inception of the RRC, to reasonably estimate the timing and amount of premiums and the amount of reinsurance coverage provided under the contract, which are both necessary to amortize the reinsurance premium over the contract period. Although that condition can exist in fixed-term RRCs, the estimation process is complicated by the introduction of reinsurance contracts that have no stated termination and have adjustable features that incorporate all periods for which the contract is in force.

A significant amount of judgment is required to conclude whether an RRC will meet all three conditions. However, the absence of a fixed term generally would preclude indefinite-term RRCs from meeting all of the three conditions, and those types of contracts would not qualify for reinsurance accounting.

3.8.2 Recognition of obligatory assets and liabilities

Excerpt from Accounting Standards Codification

Insurance Activities

Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Entities

Recognition

944-20-25-4

For contracts that meet all of the conditions described in paragraph 944-20-15-55:

a. The **ceding entity** shall recognize a liability and the assuming entity shall recognize an asset to the extent that the ceding entity has an obligation to pay cash (or other consideration) to the **reinsurer** that would not have been required absent experience under the contract (for example, payments that would not have been required if losses had not been experienced).

b. The ceding entity shall recognize an asset and the assuming entity shall recognize a liability to the extent that any cash (or other consideration) would be payable from the assuming entity to the ceding entity based on experience to date under the contract.

Subsequent Measurement

944-20-35-3

The amount recognized under paragraph 944-20-25-4 in the current period shall be computed, using a with-and-without method, as the difference between the ceding entity's total contract costs before and after the experience under the contract as of the reporting date, including costs such as premium adjustments, settlement adjustments and impairments of **coverage**.

944-20-35-4

The amount of premium expense related to impairments of coverage shall be measured in relation to the **original contract** terms. Future experience under the contract (that is, future losses and future premiums that would be paid regardless of past experience) shall not be considered in measuring the amount to be recognized.

With respect to ASC 944-20-25-4a, the amount recognized in the current period should be determined using a "with-and-without" approach and should equal the difference between the ceding company's actual contract costs as of the reporting date (including premium adjustments, settlement adjustments, and impairment of coverage) before and after the loss experience under the contract. Future experience under the contract (i.e., future losses and future premiums that would be paid regardless of past experience) should not be considered in measuring the amount to be recognized. The asset and liability amounts would be determined at each reporting date and would not be discounted.

Excerpt from Accounting Standards Codification

Subsequent Measurement

Multiple-Year Retrospectively Rated Contract Terminated by the Ceding Entity

944-20-35-17

The following paragraph applies to contracts having both of the following characteristics:

a. The ceding entity could terminate the contract before the end of its term.

b. Termination would change the amounts paid—for example, if terminating the contract would cost less than continuing the contract in force.

944-20-35-18

The liability resulting from a contract having the characteristics in the preceding paragraph shall be measured as follows:

a. If a decision to terminate has been made, the measurement shall be based on an assumption of termination and experience to date.

b. If a decision to terminate has not been made, the measurement shall be based on the lesser of the following:

    1. The total incremental cost that would be paid based on the with-and-without calculation assuming experience to date and assuming termination—that is, excluding the effects of future losses and future premiums that would have been paid regardless of experience to date

    2. The total incremental cost that would be paid based on the with-and-without calculation assuming experience to date and assuming no termination—that is, excluding the effects of future losses and future premiums that would have been paid regardless of experience to date.

With-and-Without Method

944-20-35-19

As indicated in paragraph 944-20-35-18, if a decision to terminate a contract has been made, the measurement of the liability shall be based on the assumption of **termination** and experience to date. Otherwise, the measurement of the liability shall be based on the lesser of the following:

a. The total incremental cost that would be paid based on the with-and-without method assuming experience to date and assuming termination

b. The total incremental cost that would be paid based on the with-and-without method assuming experience to date and assuming no termination

The effects of future losses and future premiums that would have been paid regardless of experience to date shall be excluded from both calculations. Costs associated with the decision not to terminate shall be recognized in the period in which the future coverage is provided because those costs are associated with that future coverage.

If, after a loss is ceded under the contract, the ceding company has more than one course of action (e.g., the ceding company could either keep the contract in force for the remaining term and pay all required contract costs or terminate the contract and pay a cancellation amount), and no decision has been made about which alternative to follow, the liability of the ceding company and the asset of the assuming company should be determined based on the alternative that is least costly for the ceding company.

Thus, if the cancellation of the reinsurance contract requires an amount to be paid that is less than the sum of the additional premium payments for the remaining contract term, the amounts reported by the ceding and assuming companies would be determined as though the contract were being terminated.

However, if a decision to cancel the contract has been made, the liability or asset that should be reported would be based on the termination payment regardless of whether it is less than the sum of additional premiums due to the reinsurer. If the decision to terminate the contract is based on an agreement between the ceding company and the reinsurer to enter into a new replacement contract, the two contracts are in effect the same contract for purposes of measuring assets and liabilities. That is, the cancellation of the existing agreement is not accounted for as a termination if either party would not have agreed to the cancellation unless the parties entered into a new contract.

The following illustration summarizes some of the features of a catastrophe RRC. Actual catastrophe reinsurance arrangements generally are far more complex, and their evaluation would require a considerable amount of judgment.

Illustration 3-16

For purposes of illustrating the issues related to RRCs, this example is based on the following assumptions:

- The contract coverage is $10 million in excess of $3 million for each and every event
- The contract covers three consecutive calendar-year periods and can be canceled by either party with 90 days' notice
- The first-year premium is set at 5.25% of the subject premium with a maximum premium of $2 million
- The premium for each subsequent year (as well as the maximum annual base premium) is determined by a formula that is set in advance
- The contract provides for an automatic reinstatement premium that is pro-rata as to time and amount
- The experience account includes 88% of premiums and 100% of incurred ceded losses (consideration of interest has been omitted from this example)
- If the contract is canceled by either party when the experience account is positive, the ceding company receives the balance. If the contract is canceled by the reinsurer when the experience account is negative, the ceding company has no liability. If the contract is canceled by the ceding company when the experience account is negative, the reinsurer is to be reimbursed by the ceding company for 70% of the negative experience account balance.
- At the expiration of the contract, any positive balance in the experience account is returned to the ceding company and any deficit is forgiven
- An $8 million loss is incurred in the first year of the contract of which $5 million is ceded to the reinsurer, with no incurred losses being ceded in the following two years
- The reinstatement premium in year one of the contract amounts to $273,000 (as calculated in accordance with the pre-determined formula)
- The maximum annual premium of $2 million is assumed to be reached each year and, when applicable, there is a premium adjustment of 20% of the negative experience account balance at the end of the preceding treaty year
- The contract is deemed to meet the pertinent "transfer of risk" criteria for purposes of this example

Given the assumptions, the premiums and experience account balances are as follows:

	Contractual cash reinsurance premiums	Experience account*
	(in 000's)	
Balance 1-Jan-20X1		$ –
Year one premium	$ 2,000	1,760
Loss ($8,000 – $3,000)		(5,000)
Reinstatement premium	273	240
Experience account deficit at 31-Dec-20X1		(3,000)
Year two premium	2,600**	2,288
Experience account deficit at 31-Dec-20X2		(712)
Year three premium	2,142***	1,885
Experience account balance at 31-Dec-20X3		$ 1,173
Total premium	$ 7,015	

* 88% of all premiums are included in the experience account.

** $2,000 + (20% of $3,000).

*** $2,000 + (20% of $712).

Based on the amounts in the foregoing example and assuming no intent to cancel by either party, the reinsurance premium amounts for each year and related balance sheet asset/liability amounts at the end of the respective years would be as follows:

Year	Assuming and ceding company premiums		Asset (Liability) -at end of year-	
	Cash basis	Accrual basis	Assuming company	Ceding company
	(in 000's)			
20X1	$ 2,273	$ 3,367***	$ 1,094*	$ (1,094)
20X2	2,600	1,648	142**	(142)
20X3	2,142	827	(1,173)	1,173
	7,015	5,842		
20X4	(1,173)	–	–	–
	$ 5,842	$ 5,842		

* (20% of $3,000) + 20% [$3,000 – (88% of $600)].

** (20% of $712).

*** ($2,000 + $273 + $1,094).

In Illustration 3-16, the ceding company has to accrue an additional premium in 20X1 beyond the cash-basis premium because the experience account at 31 December 20X1 is in a deficit position and neither the ceding company nor the assuming company has any intention to terminate the reinsurance contract. The accrual for that additional 20X1 premium is the lesser of the cancellation payment that would have to be made at the end of 20X1 if the contract were canceled by the ceding company or the amount determined using the "with-and-without" approach. The 20X1 expense accrual for the additional premium determined under the "with-and-without" approach at 31 December 20X1 is $1,094,000, which amount represents a $600,000 additional premium in 20X2 and a $494,000 estimated additional premium in 20X3 (there are no estimated additional premiums subsequent to 20X3 since the contract period expires on 31 December-20X3). The $600,000 amount represents 20% of the $3 million experience account deficit at 31 December 20X1. The $494,000 amount represents 20% of the projected experience account deficit at 31 December 20X2 of $2,472,000 ($3 million minus 88% of $600,000), after giving effect to only the payment of the 20X2 additional premium of $600,000 and excluding any future base premiums. The $1,094,000 premium accrual at 31 December 20X1 excludes the effects on the experience account of any future reinsurance losses and any future contractual premiums because including such effects would imply anticipating future catastrophe experience.

In other words, at 31 December 20X1, the 20X2 and 20X3 annual $2 million base premiums are needed to purchase coverage for potential future losses and therefore are not available to be used at 31 December 20X1 as a pro forma offset to any estimated additional premiums to be paid based on experience to date. At 31 December 20X2, using the same "with-and-without" approach, the remaining 20X1 accrual of $494,000 for the 20X3 additional cash premium is reduced to $142,000 to give effect to the absence of any reinsured loss activity in 20X2 (and the additional 20X2 base premiums received). Finally, because no reinsured losses were incurred in 20X3 and the experience account has turned positive in 20X3, the 20X3 accrual-basis premium expense represents the $2 million base premium reduced by the ending positive balance in the experience account at 31 December 20X3, the expiration date of the contract.

Illustration 3-16 (continued)

If the reinsured loss that was assumed to have occurred in 20X1 in the foregoing illustration had occurred in 20X2 rather than 20X1, the reinsurance premium amounts, assuming the same reinstatement premium as in the original example, for each year and the related balance sheet asset/liability amounts at the end of the respective years would be as follows:

	Assuming and ceding company premiums		Asset (Liability) –at end of year–	
Year	Cash basis	Accrual basis	Assuming company	Ceding company
		(in 000's)		
20X1	$ 2,000	$ 240	$ (1,760)*	$ 1,760
20X2	2,273	4,281	248**	(248)
20X3	2,248	1,262	(738)***	738
	6,521	5,783		
20X4	(738)	–		
	$ 5,783	$ 5,783		

* 88% of $2,000.

** 20% [88% ($2,000 + $2,273) − $5,000].

*** 88% ($6,521) − $5,000.

In the original example, if the ceding company had decided to cancel the contract at 31 December 20X1, the additional accrual would have been $2,100,000 (70% of $3 million), representing the cancellation payment. Also, if the illustration's fact pattern was different and the contract terms were changed to require the ceding company to pay 70% of any experience account deficit at contract expiration, the additional accrual at 31 December 20X1 would have been $2,100,000. That $2,100,000 amount represents the cancellation payment, and it would be recognized because it is less than the amount ($2,520,000) determined in the with-and-without calculation, as follows (in 000's):

20X2 additional premium = 20% of $3,000 =	$ 600
20X3 additional premium = 20% [$3,000 − (88% of $600)] =	494
20X3 expiration payment = 70% [$3,000 − 88% ($600 + $494)] =	1,426
	$ 2,520

Under ASC 944-20-25-4b, if a ceding company is entitled to receive a payment from the reinsurer based on experience to date (e.g., a profit commission based on experience or a refund of premiums if the losses ceded under the contract are less than anticipated), an asset should be recognized by the ceding company and a liability should be recognized by the reinsurer, with a corresponding credit and charge to earnings, respectively.

Excerpt from Accounting Standards Codification

Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Entities

Changes in Coverage

944-20-35-9

The ceding entity and the assuming entity shall account for changes in coverage in the same manner as changes in other contract costs.

944-20-35-10

For example, the effects of decreases in coverage without a commensurate reduction in premium shall be recognized as a loss by the ceding entity and as a gain by the assuming entity when the event causing the decrease in coverage takes place.

944-20-35-11

Changes in either the probability or amount of potential future recoveries are considered a change in coverage. For example, if the contract limit stayed the same, but the ceding entity could not receive any recoveries unless losses for the industry as a whole reached a certain level, coverage has been reduced. What matters is not the specific contract provisions regarding coverage, but whether the probability or amount of potential future recoveries has increased or decreased as a result of those provisions.

Changes in coverage (generally thought of in the context of reductions in coverage) should be treated similar to changes in other contract cash flows considered in ASC 944-20-25-4a. Therefore, the effects of a decrease in coverage without a commensurate reduction in premium should be recognized as a loss by the ceding company and a gain by the assuming company.

The recognition of the effects of such a decrease in coverage requires that some cost be assigned to that reduced coverage. Although a pro-rata approach was used in an example prepared by the FASB staff (ASC 944-20-55-62 through 55-64) to calculate that loss or gain, the guidance does not mandate a particular approach to assigning a cost to reduced coverage.

Some reinsurance contracts may be structured such that layers of coverage are associated with specific premiums. In those cases, the use of a pro-rata approach within coverage layers might produce a reasonable result. However, many contracts are not segmented in that way, and the valuation of reduced coverage probably would require support from underwriters or actuaries. One approach could be to reprice the reinsurance contract on a pro-forma basis as though the reduced level of coverage for the period subsequent to the loss year was known at the inception of the reinsurance contract. The amount recognized could then be based on the difference between the original premium and the pro forma premium.

Although the foregoing accounting conclusions are intended to apply to both ceding and assuming companies, the results reported by the ceding and assuming companies on a particular contract may not correspond at every reporting date, because of the differences in judgment related to the estimated amount of claims incurred as of the reporting date, among other factors.

4 Long-duration contracts

4.1 Reinsurance of long-duration contracts

The accounting for reinsurance of long-duration contracts is based on determining the "cost of reinsurance," recording that amount, and amortizing that cost over the entire period that the underlying reinsured policies are in force. Amortization over the period that the underlying policies are in force maintains an appropriate matching of revenues and expenses in a similar manner to that used to amortize the DAC. Although not specifically defined in ASC 944, "cost of reinsurance" is a term that is used to describe the net cash flows between the ceding and assuming companies. Those net cash flows include, among other items, reinsurance premiums, ceding commissions, claim reimbursements, investment income, and experience refunds.

In addition to providing guidance on determining the cost of reinsurance, the Reinsurance Contracts Subsections of ASC 944 provide limited guidance on several other issues related to the accounting for reinsurance of long-duration contracts. Some of the questions that insurance companies will have to address when applying the reinsurance guidance for long-duration contracts are:

- When does a contract indemnify a ceding company against loss or liability for insurance risk?
- What is the "cost of reinsurance" for the reinsurance contract?
- How should the cost of reinsurance be recognized over the period that the reinsured policies are in force?
- When is a contract that reinsures long-duration policies considered to be short duration in nature?
- When the consideration paid by the ceding company includes investments, has the accounting for the reinsurance transaction been performed subsequent to the accounting for the investments transferred to the reinsurer?

4.1.1 Indemnification of ceding company

Excerpt from Accounting Standards Codification

Insurance Activities

Reinsurance of Long-Duration Contracts

Scope and Scope Exceptions

944-20-15-59

Indemnification of the ceding entity against loss or liability relating to insurance risk in reinsurance of long-duration contracts requires the reasonable possibility that the reinsurer may realize significant loss from assuming insurance risk.

944-20-15-14

The guidance in the Long-Duration Subsections of this Subtopic does not apply to **investment contracts** issued by an insurance entity that do not incorporate significant **insurance risk** and shall not be accounted for as insurance contracts. See paragraph **944-825-25-2** for investment contracts.

944-825-25-2

Payments received by the insurance entity from an investment contract shall be reported as liabilities and accounted for in a manner consistent with the accounting for interest-bearing or other financial instruments.

The indemnification of the ceding entity against loss or liability in reinsurance of long-duration contracts requires the reasonable possibility that the reinsurer may realize a significant loss from assuming insurance risk. Long-duration contracts that do not subject the insurer to mortality or morbidity risks are investment contracts and should not be accounted for as insurance contracts (ASC 944-20-15-14). Consequently, an arrangement with an assuming entity to "reinsure" those contracts would not indemnify the ceding entity against insurance risk and is not considered reinsurance. Furthermore, these types of arrangements should be accounted for as separate investment contracts (ASC 944-825-25-2) and should not be accounted for as deposits under ASC 340-30.

4.1.2 Evaluating transfer of risk

The evaluation of risk transfer for the reinsurance of long-duration policies requires the ceding company to determine whether the contract indemnifies it against insurance risk. Specifically, ASC 944-20-15-59 requires that the reinsurer be exposed to the reasonable possibility of incurring a significant loss from the assumed insurance risk.

Although there is no specific guidance on evaluating whether insurance risk has been assumed by the reinsurer in a long-duration reinsurance contract, ASC 944-20-05-5 states that "the primary purpose of insurance is to provide economic protection from identified risks occurring or discovered within a specified period." For example, ASC 944-20-10-2 states that "life insurance coverage encompasses the concepts of amounts at risk and the relative probability of mortality and morbidity events."

Excerpt from Accounting Standards Codification

Insurance Activities

Reinsurance of Long-Duration Contracts

Scope and Scope Exceptions

944-20-15-60

Consistent with the definition of **investment contract**, a contract that does not subject the reinsurer to the reasonable possibility of significant loss from the events insured by the underlying insurance contracts does not indemnify the ceding entity against insurance risk.

944-20-15-61

The evaluation of **mortality risk** or **morbidity** risk in contracts that reinsure universal life-type policies shall be consistent with the criteria in paragraphs 944-20-15-16 through 15-19. Evaluation of the presence of insurance risk in contracts that reinsure other long-duration contracts (such as those that reinsure ordinary life contracts or contracts that provide benefits related only to illness, physical injury, or disability) also shall be consistent with those criteria.

Paragraph 39 of the Basis for Conclusions of FASB Statement No. 97 specifically states that "contracts issued by insurance enterprises that do not incorporate significant risk from the death or disability of policyholders (mortality or morbidity risk) are more comparable to financial or investment instruments issued by other financial institutions than to the insurance contracts contemplated by Statement 60." This clarification was based on the FASB's conclusion that, to be considered insurance, a contract should subject the insurer to mortality or morbidity risk. Accordingly, a reinsurance contract should subject the reinsurer to the same insurance risks (i.e., mortality or morbidity) to which the ceding company is

exposed. Therefore, a contract that reinsures investment contracts, as defined (i.e., contracts that do not subject the insurer to mortality or morbidity risks) would not satisfy the indemnification condition and would not qualify for reinsurance accounting. While the reinsurer is required to reassess the underlying policies for other-than-nominal mortality or morbidity risk (ASC 944-20-15-61), only in rare circumstances would the reinsurer's conclusion deviate from the conclusion of the underlying policies.

The determination of whether a reinsurer is subject to the same risks as the ceding company will require an evaluation of the reinsurance contract's features, as well as the overall substance of the contract. Ceding companies are required to use the same guidance to determine whether there is insurance risk in the underlying policies subject to the reinsurance when evaluating whether the reinsurer has assumed mortality or morbidity risks. ASC 944-20-15-16 states that "a mortality and morbidity risk is present if, under the terms of the contract, the entity is required to make payments or forego required premiums contingent on the death or disability (in the case of life insurance contracts) or the continued survival (in the case of annuity contracts) of a specific individual or group of individuals."

Generally, YRT, coinsurance, and facultative reinsurance of the following types of insurance policies would subject the reinsurer to mortality risk and/or morbidity risk:

- Whole life
- Annual renewable term
- Universal life
- Variable life
- Immediate annuities with life contingencies
- Guaranteed renewable or noncancelable accident and health
- Disability

Even though the reinsurer is subject to mortality risk and/or morbidity risk, the ceding company is required to determine whether the amount of mortality risk and/or morbidity risk is significant. Because there is limited guidance in that area, judgment by management will be necessary to determine whether the reinsurer is exposed to the reasonable possibility of a significant loss from the insurance risk assumed.

Significance should be based on the present value of economic results of the reinsurance contract, and not on the reinsurer's overall economic results. For example, a contract may expose the reinsurer to a possible present value loss of $500,000 that is not significant to either the overall financial results or financial position of the reinsurer. However, that possible loss may be significant compared to the reinsurance premium that the reinsurer received. If that is the case, the contract has exposed the reinsurer to the possibility of a significant loss. Generally, if the ceding company's experience for the business reinsured is worse than the reinsurance pricing assumptions, and the reinsurer would be expected to have a commensurate loss, the "significant loss" test likely would be met.

Surplus relief transactions

Historically, life insurance companies have used surplus relief transactions (also referred to as financial reinsurance or surplus enhancement) to increase or maintain statutory surplus for the ceding company. These contracts are commonly entered into during periods of rapid premium growth, which in the earlier years of the policies written often results in a strain on the statutory surplus required. These types of contracts generally have been permitted to be accounted for as reinsurance under statutory accounting principles if certain conditions (as specified in the guidance) were met. However, under US GAAP, these types of reinsurance contracts generally do not receive reinsurance accounting treatment.

The NAIC's *Accounting Practices & Procedures Manual* includes excerpts from a model law for life/health reinsurance agreements (in Appendix A-791, *Life and Health Reinsurance Agreements*) that specifies the conditions that are required (none of which include a quantitative assessment of significant insurance risk) to be met to permit ceding companies to recognize either reinsurance reserve credits or reinsurance recoverables resulting from financial reinsurance contracts.

4.1.3 Reinsurance contracts that are short duration in nature

Excerpt from Accounting Standards Codification

Insurance Activities

Scope and Scope Exceptions

Instruments

944-20-15-34A

Determining whether a contract that reinsures a long-duration insurance contract is long-duration or short-duration in nature is a matter of judgment, considering all of the facts and circumstances. For example, some contracts described as yearly renewable term may be, in substance, long-duration contracts, depending on their terms and how they are priced.

944-20-15-35

Paragraphs 944-605-30-4 and 944-605-35-14 through 35-15 state that reinsurance of long-duration contracts can be either short- or long-duration. The fact that no similar guidance is provided for short-duration contracts is intentional, because it is not possible to reinsure more risk than was originally insured under the primary insurance contracts.

Certain reinsurance contracts covering long-duration policies may be deemed to be short duration in nature (e.g., certain annually renewable life insurance policies). To be classified as short duration, the contract must provide reinsurance for a fixed period of short duration (e.g., one year). Determination of the nature of the contract is a matter of judgment, and because some contracts with descriptions that appear to be short duration may actually be long duration in nature, it is important for companies to consider all of the facts and circumstances that relate to a reinsurance contract when determining the nature of the contract.

Although ASC 944-20-15-34 and 15-34A distinguishes between contracts that are long duration and short duration in nature, few reinsurance contracts related to long-duration policies will qualify as short duration in nature. For example, a YRT reinsurance contract generally is entered into with the expectation that it will be in force over the entire period that the underlying policies reinsured are in force. However, the pricing of the reinsurance premium for each year that the contract is in force is based on one-year term rates and may be adjusted by the reinsurer subject to contractually defined maximum rates. The YRT contract has short-duration characteristics (e.g., pricing on the basis of one-year term rates), but it generally would be deemed to be long duration in nature because (1) the reinsurer must continue to provide coverage on the underlying policies once covered, (2) the contract is expected to be in force for a number of years and (3) the maximum pricing for those subsequent years is established at the inception of the contract.

See section 4.3.2 for separate examples of YRT reinsurance contracts determined to be both short and long duration in nature.

4.2 Cost of reinsurance

Identifying the cost of reinsurance

The cost of reinsurance is not defined in ASC 944 and generally is not specifically identified in the reinsurance contract. Therefore, ceding companies have to estimate that cost using financial models that are usually developed by the company's actuaries. Those models are based on the expected cash flows under the reinsurance contract.

The Actuarial Standards Board issued Actuarial Standards of Practice (ASOP) 11, *Financial Statement Treatment of Reinsurance Transactions Involving Life or Health Insurance*. ASOP 11 does not specifically refer to the cost of reinsurance but says the cash flows between the ceding company and the assuming company consist of "premiums, allowances, investment income, expenses, modified coinsurance reserve adjustments, benefits, experience refunds, risk fees, and volume or other bonuses including any contingent payments."

Although not specifically defined, each of these items generate cash flows between the ceding company and the assuming company, which should be considered in the determination of the cost of reinsurance. Therefore, the cost of reinsurance would often include any reimbursement from the reinsurer that may be intended to directly offset expenses incurred in obtaining or maintaining the underlying policies reinsured.

Recognizing the cost of reinsurance should not be considered a substitute for recognizing reinsurance premiums, recoverable benefits and expense reimbursements. Instead, it can best be described as an adjustment to those amounts to recognize the appropriate cost of reinsurance in any particular year of the contract. That adjustment is necessary because the net cash flows (e.g., premiums, claims, commission) that occur between the ceding company and the assuming company in any particular year do not necessarily reflect the ultimate net cost that the ceding company will incur for the reinsurance coverage.

For example, because of large ceding commissions, expense allowances or the absence of a reinsurance premium in the first year of a reinsurance contract, reinsurance of long-duration policies generally does not result in a negative cash flow to the ceding company in the first year of such a contract. However, in subsequent years, because the ceding commission is less than the reinsurance premium or because the ceding company pays a reinsurance premium that is greater than the recoveries, the net cash flows between the ceding company and the assuming company generally will be negative to the ceding company. Consistent with the matching principle, a portion of the future negative cash flows should be recognized as an expense in the first year of the contract to coincide with the recognition of revenues from the underlying policies reinsured and preclude the recognition of any gain by the ceding company.

Expense reimbursements

If expense reimbursements will be received on a level basis with expenses incurred by the ceding company, the ceding company may conclude that it is appropriate to exclude such cash flows from the determination of the cost of reinsurance and instead recognize the cash flows in the period in which they occur. The logic for such an exclusion is that those direct expenses are passed through to the reinsurer and the matching of expenses and revenues is best accomplished by excluding the expense reimbursement from the cost of reinsurance.

For example, mismatching could result because the cost of reinsurance should be amortized as a constant percentage of either the premium income recognized (for traditional long-duration products), a constant percentage of the expected gross profits (for universal life-type products) or a constant percentage of estimated gross margins (for traditional participating life insurance products) while the direct expenses incurred may be recognized in a different manner. In this case, recognizing expense reimbursement cash flows in the period in which they occur (i.e., recognized as an offset to expenses incurred) achieves level recognition of profits.

However, if a ceding company receives expense reimbursements that exceed actual expenses incurred, the ceding company generally should limit the recognition of that reimbursement to the amount necessary to reduce the actual expense incurred to zero. Any reimbursement or credit in excess of the actual expense incurred should be a component of the cost of reinsurance.

Initial measurement of the cost of reinsurance

The historical practice in the insurance industry has been to measure the cost of reinsurance as either of the following:

- The difference between the expected financial results if the policies had not been reinsured and the expected financial results after taking reinsurance into account
- The expected value of all transactions between the ceding and assuming companies

Under the first definition, because ceding companies do not expect to incur an overall loss from the issuance of long-duration contracts or policies, the effect of reinsurance on a ceding company's financial results generally is to reduce the amount of profit that the ceding company expects to recognize from the underlying policies reinsured. In other words, the net profit that the ceding company is foregoing for the reinsurance protection becomes the cost of reinsurance. Under the second definition, the cost of reinsurance would consist of the net amount of reinsurance premiums, claim reimbursements, commissions, experience refunds, administrative costs and allowances, and any other benefits or expenses reimbursed by the reinsurer.

Since ASC 944 does not specifically define the cost of reinsurance, either of the foregoing definitions would be appropriate. However, for reinsurance contracts that reinsure existing blocks of business, a required component of the cost of reinsurance is the difference between the amount of consideration paid by the ceding company (or, in the case of a coinsurance with funds withheld or a modified coinsurance arrangement, segregated from the general investment portfolio of the ceding company) for the reinsurance coverage and the amount of the liabilities relating to the underlying policies at the time that the reinsurance contract is executed (i.e., the closing date of the transaction). Including that difference in the cost of reinsurance effectively precludes the ceding company from recognizing a gain or loss at the inception of such a contract (see section 4.3.4 for further discussion).

The amount of consideration paid is determined based on the fair value of assets (e.g., cash and investments) transferred to the reinsurer. If those assets include specifically identified AFS debt securities, the ceding company must apply the investment accounting requirements applicable to the underlying investments and recognize the gain or loss on those investments at the date the assets are transferred, which generally occurs when the transaction closes.

If at an interim reporting period a transaction has not yet closed (e.g., all necessary regulatory approvals for the reinsurance transaction are not obtained) but is probable to close, the ceding company may need to recognize an impairment in earnings with a corresponding adjustment to the amortized cost basis of the specific security in an unrealized loss position in accordance with ASC 326-30. This guidance applies when an entity intends to sell an impaired AFS debt security or it is more likely than not that the entity will be required to sell such a security before recovering its amortized cost basis. See our FRD, ***Certain investments in debt and equity securities***, for further discussion.

The accounting for the cost of reinsurance only considers the fair value of the assets transferred to the reinsurer. Accordingly, any realized gain or loss on investments that are transferred to the reinsurer at the closing date of the transaction would be immediately recognized by the ceding company and not deferred as a component of the cost of reinsurance.

When there is a lag between the inception of the contract (i.e., the effective date of coverage indicated in the reinsurance arrangement) and date the contract is executed, the ceding entity will need to roll forward the amounts stated in the contract (e.g., the fair value of consideration paid and the recorded liabilities relating to the underlying policies) to the closing date of the reinsurance transaction. The resulting differences will be included in the cost of reinsurance calculation.

Presentation of the cost of reinsurance

Industry practice varies with respect to the balance sheet presentation of the cost of reinsurance asset or liability. Furthermore, consistent with ASC 944-30-35-64, insurers may proportionately offset the cost of reinsurance against the DAC asset (to the extent a component of the cost of reinsurance includes reimbursement of policy acquisition costs). See section 7 for further discussion regarding the presentation and disclosure of reinsurance cash flows.

4.3 Recognition of revenues and costs

Excerpt from Accounting Standards Codification

Claim Costs and Liabilities for Future Policy Benefits

Reinsurance Contracts

Recognition

944-40-25-33

Reinsurance contracts do not result in immediate recognition of gains unless the reinsurance contract is a legal replacement of one insurer by another and thereby extinguishes the ceding entity's liability to the policyholder.

The Reinsurance Contracts Subsections of ASC 944-605 take a simplistic approach to accounting for the recognition of revenues and costs relating to the reinsurance of long-duration policies. That approach is to determine the cost of reinsurance and, depending on the nature of the reinsurance contract (i.e., long or short duration), amortize that cost over the remaining life of the underlying policies reinsured (for reinsurance contracts that are long duration in nature) or over the contract period (for those reinsurance contracts that are short duration in nature). That approach prevents ceding companies from recognizing any immediate gain from a reinsurance contract at its inception.

The only exception to that accounting for the recognition of revenues and costs is for reinsurance contracts that extinguish the ceding company's legal liability to its policyholders. These types of contracts are often referred to as "assumption with novation" reinsurance treaties or novations, and the question of whether the liability to the policyholder has been extinguished is a legal one. For those contracts where extinguishment of the liability has been determined, ASC 944-40-25-33 permits the immediate recognition of gains because the ceding company's legal liability to its policyholders has been extinguished.

4.3.1 Accounting for the cost of reinsurance

Excerpt from Accounting Standards Codification

Revenue Recognition

Subsequent Measurement

Reinsurance of Long-Duration Contracts

944-605-35-14

Amortization of the estimated cost of reinsurance of long-duration contracts that meets the conditions for reinsurance accounting depends on whether the reinsurance contract is long-duration or short-duration. The cost shall be amortized over the remaining life of the underlying reinsured contracts if the reinsurance contract is long-duration, or over the contract period of the reinsurance if the reinsurance contract is short-duration.

944-605-35-15

The assumptions used in accounting for reinsurance costs shall be consistent with those used for the reinsured contracts.

Under ASC 944-605-35-14, the cost of reinsurance of long-duration contracts is amortized over the remaining life of the underlying insurance policies, unless the reinsurance contract is viewed as short duration in nature, in which case the cost of reinsurance is amortized over the reinsurance contract period. ASC 944-605-35-15 requires that the assumptions (e.g., mortality, expense, lapse) used in accounting for reinsurance costs be consistent with those used for the underlying policies. Other than these two paragraphs, no further guidance on the amortization method is provided in ASC 944, and, as a result, diversity in practice exists.

Amortization methods

Under one approach widely used in the industry for long-duration reinsurance contracts, the amortization of the cost of reinsurance is determined on a retrospective basis that includes both the inception-to-date actual and estimated future reinsurance cash flows in the estimated cost of reinsurance. Under this approach, the inception-to-date cost recognition for contracts that are long duration in nature should result in an inception-to-date charge to income that is either (1) a constant percentage of the inception-to-date premium income recognized for reinsurance of traditional long-duration products or (2) a constant percentage of the inception-to-date expected gross profits for reinsurance of universal life-type products or (3) a constant percentage of inception to date estimated gross margins for traditional participating life insurance products.

If a ceding company elects the retrospective method to amortize the cost of reinsurance, the company will need to closely monitor actual versus expected reinsurance cash flows to update the amortization of the cost of reinsurance, which should include a reconsideration of the assumptions regarding expected future reinsurance cash flows. Accordingly, if a company unlocks the assumptions associated with the underlying policies, the company will also need to unlock the assumptions used in accounting for the net cost of reinsurance.

Under another approach used for long-duration reinsurance contracts, the estimated cost of reinsurance is amortized on a prospective basis, and any variances between the actual and estimated reinsurance cash flows in a period are reflected currently in income. Any revisions in estimated future reinsurance cash flows are recognized prospectively. Consistent with the retrospective approach discussed above, assumptions regarding future reinsurance cash flows should be reevaluated and prospectively unlocked, when necessary. The variance from expected reinsurance cash flows may also need to be included in expected gross profits to prevent the recognition of a gain on reinsurance.

As noted previously, the acceptable definitions of both the cost of reinsurance and the method of amortizing that cost over the remaining life of the underlying insurance policies have evolved. These represent accounting policy elections that should be applied consistently each year.

Subsequent measurement

Regardless of the amortization method used, subsequent measurement of the cost of reinsurance (and the resulting amortization to be recognized) involves scheduling out the expected cash flows between the ceding company and assuming company and then discounting those cash flows. ASC 944-605-35-15 specifically requires the assumptions used in accounting for the cost of reinsurance to be consistent with those used for the underlying policies reinsured. As such, the cash flows should be consistent with the ceding company's assumptions (e.g., mortality rates, lapse rates, interest rates, maintenance costs) used to determine the expense and benefit reserves, estimated gross profits (EGPs) or estimated gross margins (EGMs), as applicable, for the underlying policies reinsured.

Many reinsurance contracts of long-duration policies include experience refund provisions that provide the ceding company with the opportunity to recoup some portion of the profits on the ceded business. Those provisions typically do not provide for the sharing of any loss, but they include loss carryforward provisions that are used to offset profits in future years.

ASC 944-605 does not provide any specific guidance on the recognition of potential refunds that may be received in future years. However, the concept of the cost of reinsurance is based on estimating all expected cash flows between the ceding company and the assuming company, which would include cash flows related to provisions such as experience refunds. Therefore, ceding companies should include an estimate for the receipt of any experience refunds in the estimate of cash flows used to determine the cost of reinsurance.

4.3.2 Accounting for YRT contracts

YRT reinsurance contracts provide reinsurance protection on mortality risk for a specified period. The mortality risk that is reinsured is the difference between the death benefit and the reserve reported by the ceding company.

For YRT reinsurance contracts, an important determination is whether the reinsurance contract is short or long duration in nature. Although current premium rates frequently are guaranteed by the reinsurer only for a relatively short period, and the ceding insurer may be permitted to terminate coverage without significant penalty, those contracts usually are entered into with the expectation that the contracts will be in force for a number of consecutive years. Therefore, reinsurers sometimes do not charge a reinsurance premium for the first year. If a first-year reinsurance premium is charged, that premium often is equal to the first-year ceding commission allowance. However, the reinsurance premiums in subsequent years are adjusted to take into consideration the economics of the contractual arrangement for the first-year reinsurance premium.

YRT reinsurance contracts also often have experience refund provisions. Contracts that have such characteristics are expected to be in force for multiple years and probably should be categorized as long duration in nature.

The following examples illustrate how a ceding company would account for a YRT reinsurance contract that is short duration in nature and a YRT reinsurance contract that is long duration in nature. We have illustrated the accounting when the cost of reinsurance is defined as all expected cash flows under the terms of the contract determined on a retrospective basis (i.e., expected future cash flows plus actual inception to date cash flows). As previously noted, there are other acceptable definitions and amortization approaches for the cost of reinsurance that would require modifications to this model.

Illustration 4-1

On 1 April 20X0, Company A decides to reinsure its net exposure on a $1 million whole life policy. Company A's net exposure on the policy is $990,000, the difference between the $1 million death benefit and Company A's reported statutory reserve of $10,000. The reinsurance premium paid to the reinsurer was $1,200. The contract has yearly renewable features, but the pricing of the reinsurance does not anticipate that the ceding company will renew the reinsurance.

Company A has determined that the reinsurance is short duration in nature, and the cost of reinsurance will be amortized over the specified period of the contract (i.e., one year). Assume that no death claim was expected to occur and none did occur in 20X0. The net cost of reinsurance is $1,200.

Below is a summary of the financial statement effect on the Company A's balance sheet and income statement:

	Balance sheet		Income statement	
	Debit	**Credit**	**Debit**	**Credit**
		(in 000's)		
At 1 April 20X0:				
Recognition of the consideration paid:				
Prepaid reinsurance	$ 1,200			
Cash		$ 1,200		
Activity during 20X0:				
Recognition of the cost of reinsurance:				
Premiums ceded			$ 900	
Prepaid reinsurance		900		

Illustration 4-2

Assume that Company A enters into a YRT reinsurance contract to reinsure a block of its universal life policies written in 20X0 and that the net cost of the YRT reinsurance of those policies should be a constant percentage, after considering the effect of the time value of money of the expected gross profits. The reinsurance contract is deemed to be long duration in nature. Assume further that the expected duration of the reinsurance contract will be for 30 years, at which time all policies either will have surrendered or will have resulted in a death claim.

Below is a summary of the expected undiscounted reinsurance cash flows (i.e., the net cost of reinsurance) between Company A and the reinsurer, using Company A's assumptions for mortality and lapses:

	(a)	(b)	(c) [(b)-(a)]
Year	**Reinsurance Premium**	**Expected Reinsurance Recoveries**	**Expected Cash Flows In (Out)**
20X0	$ -	$ 29,032	$ 29,032
20X1	48,038	27,380	(20,658)
20X2	44,695	30,191	(14,504)
20X3	42,384	32,111	(10,273)
20X4	41,475	32,458	(9,017)
20X5 -20Z9	1,282,978	1,197,602	(85,376)
Total	$ 1,459,570	$1,348,774	$(110,796)

To determine the amount of the net cost of reinsurance that should be charged to income in each year, Company A has to first determine the present value of the expected cash flows under the reinsurance contract and the present value of the expected gross profits (i.e., gross premiums plus net investment income less maintenance expenses, death benefits, and surrenders of the entire block of business) for the underlying policies reinsured.

Assuming a 6.5% interest rate, the present value of the expected cash flows to the reinsurer would be $90,803. The expected gross profits to the ceding company are $2,966,187 (see table below), and, on a present value basis, the expected gross profits are $1,726,867. After Company A determines the present value amounts, it would then calculate the percentage that the net cost of reinsurance would be in relation to the expected gross profits of the entire block of business. In the foregoing example, that percentage would be 5.258% ($90,803 ÷ $1,726,867).

Based on the relationship of the present value of the expected reinsurance cash flows to the present value of the expected gross profits (i.e., 5.258%), Company A would then determine the net valuation reinsurance premium (i.e., the net cost of reinsurance), the related reinsurance benefit reserve adjustments, and the change in the reinsurance benefit reserve adjustment for each year. Below is a summary of those amounts:

Year	Expected gross profits	(a) Net valuation reinsurance premium	(b) Reinsurance benefit reserve adjustment at end of year	(c) Change in reinsurance benefit reserve adjustment for the year
20X0	$ 287,576	$ 15,121	$ 45,566	$ 45,566
20X1	232,692	12,236	39,836	(5,730)
20X2	189,401	9,959	37,735	(2,101)
20X3	158,471	8,333	38,186	451
20X4	149,735	7,873	39,488	1,302
20X5 -20Z9	1,948,312	102,447	–	(39,488)
Total	$ 2,966,187	$ 155,969		$ –

Computations:

(a) Expected gross profits multiplied by 5.258% (i.e., present value of expected reinsurance cash flows, divided by present value of expected gross profits).

(b) Reinsurance benefit reserve adjustment at beginning of the year, plus [the current year net valuation premium, a full-year's interest on the reinsurance benefit reserve adjustment as of the beginning of the year, and a half-year's interest on the net valuation premium], less [the expected net reinsurance cash flow and a half-year's interest on those expected reinsurance cash flows].

(c) Reinsurance benefit reserve adjustment as of the end of the year less the reinsurance benefit reserve adjustment as of the beginning of the year.

To adjust the income effect of the cash flows between the ceding company and reinsurer, Company A will have to recognize the reinsurance benefit reserve adjustment and the change in the reinsurance benefit reserve adjustment. The reinsurance benefit reserve adjustment is reported as an adjustment to the reinsurance recoverable asset. That is, the reinsurance benefit reserve adjustment is essentially a contra-asset to the reinsurance recoverable asset (i.e., a reinsurance payable) and is the balance sheet representation of the cost of reinsurance. After recording the adjustment, the net cost of reinsurance (i.e., the reinsurance cash flows, the change in the reinsurance benefit reserve adjustment, and the interest on those two amounts) to Company A becomes a constant percentage of the gross profit.

Illustration 4-2 (continued)

The adjusted net cost of reinsurance, before considering interest to Company A, would be as follows:

Year	(a) Expected Cash Flows In (Out)	(b) Change in reinsurance benefit reserve adjustment	(c) [(b)-(a)] Adjusted net cost of reinsurance before interest
20X0	$ 29,032	$ 45,566	$ 16,534
20X1	(20,658)	(5,730)	14,928
20X2	(14,504)	(2,101)	12,403
20X3	(10,273)	451	10,724
20X4	(9,017)	1,302	10,319
20X5 -20Z9	(85,376)	(39,488)	45,888
Total	$ (110,796)	$ –	$ 110,796

Because the reinsurance benefit reserve adjustment includes an interest component, the adjusted net cost of reinsurance before considering interest will not be a constant percentage of the EGPs. Accordingly, when an interest component is added to the adjusted net cost of reinsurance, the resulting amount becomes a constant percentage of the gross profits.

Illustration 4-2 (continued)

Below is a summarization of the adjusted net cost of reinsurance, after considering interest:

Year	(a) Adjusted net cost of reinsurance before interest	(b) Interest component*	(c) [(a)+(b)] Adjusted net cost of reinsurance after interest	(d) Expected gross profits	(e) [(c)÷(d)] Percentage of adjusted net cost of reinsurance after interest to EGP
20X0	$ 16,534	$ (1,413)	$ 15,121	$ 287,576	5.258%
20X1	14,928	(2,692)	12,236	232,692	5.258
20X2	12,403	(2,444)	9,959	189,401	5.258
20X3	10,724	(2,391)	8,333	158,471	5.258
20X4	10,319	(2,446)	7,873	149,735	5.258
20X5 -20Z9	45,888	56,559	102,447	1,948,312	5.258
	$ 110,796	$ 45,173	$ 155,969	$ 2,966,187	

* The interest component is calculated as follows: One-half year's interest on the expected net reinsurance cash flows and on the net valuation premium plus a full-year's interest on the beginning balance of the reinsurance benefit reserve adjustment. Negative amounts represent implicit interest income to the ceding company and positive amounts represent implicit interest expense to the ceding company.

Although illustrating an amount for the interest component is necessary to demonstrate that the effect of the reinsurance benefit reserve adjustment is to levelize the net cost of reinsurance, Company A does not directly record an entry to account for the interest component. The interest component is recognized implicitly as the ceding company earns or foregoes investment income based on the funds available to invest from the expected cash flows and changes in the reinsurance benefit reserve.

In Illustration 4-2, the expected cash flows are adjusted so that the annual net cost of reinsurance charged to income in any given year becomes 5.258% of the expected gross profits.

Illustration 4-2 (continued)

Below is a summary of the effects of the net cost of reinsurance on Company A's balance sheet and 20X0 income statement:

	20X0			
	Balance sheet		Income statement	
	Debit	Credit	Debit	Credit
Recognition of the cash flows:				
Cash	$ 29,032			
Benefits incurred				$ 29,032
Recognition of the adjustment to net cost of reinsurance:				
Benefits incurred			$ 45,566	
Reinsurance payable		$ 45,566		

Although Illustration 4-2 amortizes the net cost of reinsurance based on the expected gross profits of the underlying business, which is consistent with the amortization of other costs (e.g., DAC), under certain circumstances, using the gross profits as the basis for amortization may not be appropriate. For example, when the underlying policies reinsured are priced such that the mortality risk margin is the largest component of the gross profits, amortizing the net cost of reinsurance based on the mortality risk margin may be appropriate. However, the ceding company would have to be able to demonstrate that the other components (e.g., interest, surrender charges, and expense charges) of the gross profit margin are not significant and losses or gains for those other components do not offset gains or losses in the mortality margin (i.e., the margins cannot be viewed independent of each other) in any one period.

4.3.3 Accounting for coinsurance contracts

Coinsurance is a form of reinsurance in which the ceding company and the reinsurer share agreed-on percentages of the premiums, claims, surrenders and other benefits related to the underlying policies.

ASC 944-605 requires the ceding company to determine the cost of reinsurance and to then amortize that amount over the remaining life of the policies reinsured. Below is an example of how a ceding company would account for a 50/50 coinsurance contract that reinsures future policies.

Illustration 4-3

Assume that, on 1 January 20X0, Company A enters into a 50% coinsurance contract to reinsure its whole life policies to be issued in 20X0. The reinsurance contract is deemed to be long duration in nature. Assume further that the expected duration of the reinsurance contract will be for 30 years, at which time all policies either will have surrendered or will have resulted in a death claim. The reinsurance contract does not include any profit-sharing arrangements (e.g., experience refund provisions).

Below is a summary of the expected undiscounted cash flows of the reinsurance premiums, ceding commissions, expense reimbursements, and benefit reimbursements (i.e., the net cost of reinsurance) between Company A and the reinsurer, using Company A's assumptions for mortality and lapses:

Year	(a) Reinsurance premium	(b) Ceding commission	(c) Expected reinsurance reimbursements	(d) [(c)-(a)+(b)] Expected Cash Flows In (Out)
20X0	$ 758,000	$ 682,200	$ 155,660	$ 79,860
20X1	454,432	45,443	99,316	(309,673)
20X2	385,877	38,588	103,000	(244,289)
20X3	339,161	33,916	115,622	(189,623)
20X4	304,808	30,481	124,216	(150,111)
20X5 -20Z9	3,377,300	103,421	5,222,325	1,948,446
	$ 5,619,578	$ 934,049	$ 5,820,139	$ 1,134,610

The charge to income for the net cost of reinsurance for a block of whole life policies should be a constant percentage, after considering the effect of interest, of the underlying policy's gross premiums.

To determine the amount of the net cost of reinsurance that should be charged to income in each year, Company A must first determine the present value of the expected reinsurance cash flows and the present value of the gross premiums of the entire block of business before reinsurance.

Illustration 4-3 (continued)

Assuming a 6.5% interest rate, the present value of the expected reinsurance cash flows would be a net cost of $529,558 to the ceding company; that net cost occurs even though the expected cash flows before giving effect to the time value of money (i.e., present value) is a benefit (i.e., cash inflow) of $1,134,610.

The present value of the direct gross premiums of $11,239,153 in the foregoing illustration would be $6,981,752.

After Company A determines those present value amounts, Company A would then calculate the percentage that the net cost of reinsurance would be in relation to the gross premiums of the entire block of business. In the foregoing example, that percentage would be 7.584% ($529,558 ÷ $6,981,752).

Based on the relationship of the present value of the expected reinsurance cash flows to the present value of the gross premiums (i.e., 7.584%), Company A would then determine the net valuation premium for the net reinsurance costs, the related reinsurance reserve adjustments, and the change in the reinsurance reserve adjustments for each year. A summary of those amounts is as follows:

Year	Expected direct gross premiums	(a) Net valuation premium	(b) Reinsurance reserve adjustment at end of year	(c) Change in reinsurance reserve adjustment for the year
20X0	$ 1,516,000	$ 114,987	$ 201,080	$ 201,080
20X1	908,863	68,936	(34,288)	(235,368)
20X2	771,753	58,537	(228,211)	(193,923)
20X3	678,321	51,450	(385,638)	(157,427)
20X4	609,616	46,239	(517,900)	(132,262)
20X5 -20Z9	6,754,600	512,329	–	517,900
Total	$ 11,239,153	$ 852,478		$ –

Computations:

(a) Expected direct gross premium multiplied by 7.584% (i.e., present value of expected reinsurance cash flows divided by present value of expected direct gross premiums).

(b) Reinsurance reserve adjustment at beginning of the year plus [the net valuation premium, a half-year's interest on the net valuation premium, and a full-year's interest on the reinsurance reserve adjustment as of the beginning of the year], less [expected reinsurance cash flows and a half-year's interest on the expected reinsurance cash flows].

(c) Reinsurance reserve adjustment as of the end of the year less the reinsurance reserve adjustment as of the beginning of the year.

The reinsurance adjustment is comprised of two components. Those components are a benefit reserve and an expense reserve, which are computed as follows:

Year	(a) Benefit reserve adjustment at end of year	(b) Expense reserve adjustment at end of year	(c) [(a)+(b)] Total reinsurance reserve adjustment at end of year
20X0	$ (315,065)	$ 516,145	$ 201,080
20X1	(518,243)	483,955	(34,288)
20X2	(687,803)	458,592	(228,211)
20X3	(826,039)	440,401	(385,638)
20X4	(942,834)	424,934	(517,900)
20X5 -20Z9	–	–	–

Computations:

(a) Direct gross premiums multiplied by 7.584% (present value of the expected reinsurance reimbursements, divided by present value of the direct gross premium), plus [a full-year's interest on the benefit reserve adjustment as of the beginning of the year and a half-year's interest on the net valuation premium of the reinsurance reimbursement], less the cash flows from the reinsurance reimbursements (i.e., net valuation premium of the reinsurance reimbursement).

(b) Direct gross premiums multiplied by (present value of the expected ceding commissions, divided by present value of the direct gross premium), plus [a full-year's interest on the expense reserve adjustment as of the beginning of the year and a half-year's interest on the net valuation premium of the ceding commissions], less the cash flow from the ceding commissions (i.e., net valuation premium of the ceding commission).

Company A should recognize the reinsurance benefit and expense reserve adjustments and the change in those adjustments to adjust the income effect of the reinsurance cash flows between the ceding company and reinsurer. The reinsurance benefit reserve adjustment is to be recorded as an adjustment to the reinsurance recoverable asset, while the expense reserve adjustment is to be recorded as an adjustment to the DAC asset.

After the adjustments are recognized, the net cost of reinsurance (i.e., the cash flows, the change in the reinsurance reserve adjustment, and the interest on those two amounts) to Company A becomes a constant percentage of the gross premiums.

Illustration 4-3 (continued)

The adjusted net cost of reinsurance, before considering interest to Company A, would be as follows:

Year	(a) Expected Cash Flows In (Out)	(b) Change in reinsurance reserve adjustments	(c) [(b)-(a)] Adjusted net cost of reinsurance before interest
20X0	$ 79,860	$ 201,080	$ 121,220
20X1	(309,673)	(235,368)	74,305
20X2	(244,289)	(193,923)	50,366
20X3	(189,623)	(157,427)	32,196
20X4	(150,111)	(132,262)	17,849
20X5-20Z9	1,948,446	517,900	(1,430,546)
Total	$ 1,134,610	$ –	$ (1,134,610)

Because the reinsurance reserve adjustments include an interest component, the adjusted net cost of reinsurance before considering interest will not be a constant percentage of the gross premiums. Accordingly, when an interest component is added to the adjusted net cost of reinsurance, the resulting amount becomes a constant percentage of the gross premiums.

Illustration 4-3 (continued)

A summary of the adjusted net cost of reinsurance, after considering interest, is as follows:

Year	(a) Adjusted net cost of reinsurance before interest	(b) Adjusted net interest component*	(c) [(a)+(b)] Cost of reinsurance after interest	(d) Expected gross premiums	(e) [(c)÷(d)] Adjusted net cost of reinsurance after interest to expected gross premiums
20X0	$ 121,220	$ (6,233)	$ 114,987	$ 1,516,000	7.584%
20X1	74,305	(5,369)	68,936	908,863	7.584
20X2	50,366	8,171	58,537	771,753	7.584
20X3	32,196	19,254	51,450	678,321	7.584
20X4	17,849	28,390	46,239	609,616	7.584
20X5 -20Z9	(1,430,546)	1,942,875	512,329	6,754,600	7.584
Total	$ (1,134,610)	$1,987,088	$ 852,478	$11,239,153	

* The interest component is calculated as follows: One-half year's interest on the expected reinsurance cash flows and on the net valuation premium plus a full-year's interest on the beginning balance of the reinsurance reserve adjustment.

Although illustrating an amount for the interest component is necessary to demonstrate that the effect of the reinsurance benefit reserve adjustment is to level the net cost of reinsurance, Company A does not record an entry to account for the interest component. The interest component is recognized implicitly as the ceding company earns or foregoes investment income based on the funds available to invest from the expected cash flows and changes in the reinsurance benefit reserve.

In Illustration 4-3 the expected reinsurance cash flows are adjusted so that the annual net cost of reinsurance charged to income in any given year becomes 7.584% of the expected gross reinsurance premiums.

Illustration 4-3 (continued)

Below is a summary of the effects of the net cost of reinsurance on Company A's balance sheet and 20X0 income statement:

	20X0			
	Balance sheet		Income statement	
	Debit	Credit	Debit	Credit
Recognition of the cash flows:				
Cash	$ 79,860			
Premiums ceded			$ 758,000	
Benefits incurred				$ 155,660
Amortization of acquisition costs				682,200
Recognition of the adjustment to net cost of reinsurance:				
Reinsurance recoverable	315,065			
Benefits incurred				315,065
Amortization of acquisition costs			516,145	
Deferred policy acquisition costs		$ 516,145		

4.3.4 Reinsurance of existing blocks of business

Excerpt from Accounting Standards Codification

Revenue Recognition

Initial Measurement

Reinsurance of Long-Duration Contracts

944-605-30-4

The difference, if any, between amounts paid for a **reinsurance** contract and the amount of the liabilities for policy benefits relating to the underlying reinsured contracts is part of the estimated cost to be amortized.

Companies frequently enter into reinsurance contracts that reinsure policies issued by the ceding company before the inception of the reinsurance contract. For contracts that reinsure existing blocks of business, the ceding company is required to include, in the calculation of the net cost of reinsurance, the difference between the amount paid for reinsurance (i.e., fair value of the assets transferred to the reinsurer) and the net amount of the expense and benefit reserves (i.e., recorded liabilities) relating to the underlying policies at the time that the reinsurance contract is executed (i.e., the closing date of the reinsurance transaction).

For example, if in Illustration 4-3, Company A reinsured an existing block of business with the identical expected cash flow activities and paid an initial reinsurance premium in cash that was $100,000 less than the net amount of the expense and benefit reserves for the policies that were reinsured, Company A would have to include that gain (i.e., the reinsurance cost was less than the recorded liabilities) in the net expected cash flows under the reinsurance contract. The inclusion of that amount in the net cost of reinsurance calculation results in the deferral of the gain over the remaining life of the underlying policies reinsured.

Similarly, if the consideration paid by Company A for the reinsurance coverage were in the form of specifically identified investments in AFS debt securities and the fair value of those investments were $100,000 less than the net amount of the expense and benefit reserves for the policies that were reinsured, Company A would include that gain in the net expected cash flows under the reinsurance contract in the net cost of reinsurance calculation. Any realized gain or loss on those investments would be immediately recognized by the ceding company and not included as a component of the net cost of reinsurance calculation.

Separately, if the AFS debt securities to be transferred to the reinsurer were in an unrealized loss position and at an interim reporting period the reinsurance transaction has not yet closed but is probable to close, Company A would need to determine whether an impairment in earnings should be recognized with a corresponding adjustment to the amortized cost basis of the specific security in accordance with ASC 326-30.

4.3.5 Accounting for coinsurance with funds withheld and modified coinsurance contracts

Arrangements structured as coinsurance with funds withheld are similar to regular coinsurance contracts in that the ceding company records a reinsurance recoverable for the reserves of the underlying policies. However, under a funds withheld arrangement, the assets backing the reserves are left on deposit with the ceding company as opposed to being transferred to the reinsurer. The assets on deposit create a hypothetical loan from the reinsurer to the ceding company, which is recorded as a liability on the ceding company's financial statements.

The terms of modified coinsurance (modco) contracts are similar to coinsurance with funds withheld, with the exception that the ceding company retains the reserves (i.e., no reinsurance recoverable is recorded) in addition to the supporting assets on the underlying policies reinsured. Like coinsurance with funds withheld, the assets typically are segregated from the general investment portfolio.

Regardless of whether the amounts are segregated, the ceding company is generally obligated, under the terms of the reinsurance contract, to credit interest to the reinsurer on the outstanding amount of those funds. Additionally, a reserve adjustment is determined as the change in reserves from one period to the next, less interest on the beginning period reserves, since the ceding company held the assets supporting the reserves. Although modco contracts can be structured to transfer risk to the reinsurer, they typically are established to enhance the statutory surplus of the ceding company and often do not meet the transfer of risk requirements of ASC 944.

With the exception of adjusting the expected cash flows under the contract, the accounting for modco contracts and arrangements structured as coinsurance with funds withheld contracts that meet the risk transfer requirements should be the same as the example above in section 4.3.3 of this publication.

Illustration 4-4

Company A enters into a coinsurance with funds withheld arrangement to reinsure a block of term life policies, under which Company A withholds the funds (i.e., the assets equal to the statutory reserves of the term life policies) from the reinsurer. The arrangement creates an obligation for Company A to pay the reinsurer at a later date but reduces Company A's credit exposure to the reinsurer.

At contract inception, Company A recognizes a funds withheld payable equal to the statutory reserves of the underlying policies. This payable to the reinsurer represents the future payment of a "principal" amount owed, plus a return that is based on Company A's fixed-rate debt investment securities backing the term life policies, so that the reinsurer receives its proportionate share of investment returns. Company A also recognizes a reinsurance recoverable equal to the US GAAP reserves of the term life policies ceded. Conversely, the reinsurer recognizes a funds withheld receivable from the ceding insurer, as well as a liability representing reserves for the insurance coverage assumed under the arrangement.

If Company A instead enters into a modco arrangement to reinsure the same block of term life policies, it would retain the assets backing the reserves of the underlying policies as well as the reserves themselves. Company A then determines one net balance that is measured as the difference between the payable to the reinsurer (representing the assets) and the receivable from the reinsurer (representing the reserves of the underlying policies). For subsequent measurement, reserve adjustments (i.e., ending reserves minus beginning reserves adjusted for interest accreted) are considered along with all other activity under the arrangement (e.g., investment returns, benefit payments), and the total is net settled between Company A and the reinsurer.

In accordance with ASC 815-15-25 (and the implementation guidance in ASC 815-15-55), modified coinsurance and coinsurance with funds withheld arrangements often result in an embedded derivative feature that is determined to not be clearly and closely related to the host contract. This determination is generally made because the funds are withheld by the ceding company, and a return on the funds is paid or credited to the reinsurer based on the ceding company's return on investments. The risk exposure of the ceding company's return on investments is not clearly and closely related to the risk exposure arising from the overall creditworthiness of the ceding company. See our FRD, ***Derivatives and hedging***, for further discussion.

Under statutory accounting principles, these types of arrangements are generally deemed to be an acceptable form of security because the ceding company has control of the assets and passes the investment risk to the reinsurer. The amount of the deposit should be at least equal to the reserve credit taken for the reinsurance arrangement.

4.3.6 Accounting for annuity contracts

An annuity contract can be classified as either an insurance product or an investment product under ASC 944. For example, immediate annuities without life contingencies, deferred annuities and certain variable annuities are considered investment contracts and are accounted for using methods applicable to comparable "interest-bearing obligations" of other types of financial institutions. These contracts are considered investment contracts because they do not have mortality or morbidity risk. Whether the contract is deemed to be an insurance product or an investment product will determine how the ceding company accounts for the reinsurance of those contracts.

ASC 944 established the benchmark for determining whether a contract is an insurance product or an investment product. When the underlying contract does not qualify as an insurance product, the reinsurance of that contract cannot be accounted as reinsurance. These arrangements are not characterized as reinsurance since there is no underlying insurance risk, and they should be accounted for as separate investment contracts in accordance with ASC 944.

5 Deposit accounting

5.1 Overview

Any reinsurance transaction that does not indemnify an insurer against loss or liability relating to insurance risk should be recorded under the deposit accounting method.

Excerpt from Accounting Standards Codification

Other Expenses

Insurance Costs

Recognition

720-20-25-1

To the extent that an insurance contract or **reinsurance** contract does not, despite its form, provide for indemnification of the insured or the ceding entity by the insurer or reinsurer against loss or liability, the premium paid less the amount of the premium to be retained by the insurer or reinsurer shall be accounted for as a deposit by the insured or the ceding entity. Those contracts may be structured in various ways, but if, regardless of form, their substance is that all or part of the premium paid by the insured or the ceding entity is a deposit, it shall be accounted for as such.

720-20-25-2

See Subtopic 340-30 for guidance on deposit accounting. In addition, the preceding paragraph requires that an entity determine whether insurance risk has been transferred through an insurance contract; entities may find the conditions in Section 944-20-15 useful in assessing whether an insurance contract transfers risk.

Under deposit accounting, the amount paid to the assuming company (or, in the case of a coinsurance with funds withheld or a modified coinsurance arrangement, segregated from the general investment portfolio of the ceding company) is generally treated as a deposit by the ceding company and reported on the balance sheet as an asset. This results in a reclassification of an asset from one balance sheet account to another.

The ceding company does not recognize any portion of the amount paid (or segregated from the general investment portfolio) as a component of current operations at the initiation of the contract, except for nonrefundable charges (i.e., any premiums or fees associated with the arrangement that the ceding company will not recoup, regardless of the experience of the contract). In future periods when funds are exchanged between the two parties, generally only the balance sheet accounts are affected, while the income statement generally is not affected, except for any risk charges under the terms of the contract.

5.2 Types of deposit arrangements

Contracts that do not meet the condition for reinsurance accounting should follow the guidance in ASC 340-30, which specifies four categories for deposit arrangements.

Excerpt from Accounting Standards Codification

Other Assets and Deferred Costs

Overview and Background

Insurance Contracts That Do Not Transfer Insurance Risk

340-30-05-2

The transfer of insurance risk requires transferring both **timing risk** and **underwriting risk**. Therefore, four possible categories for deposit arrangements have been identified as follows:

a. An insurance or reinsurance contract that transfers only significant timing risk.

b. An insurance or reinsurance contract that transfers only significant underwriting risk.

c. An insurance or reinsurance contract that transfers neither significant timing nor significant underwriting risk.

d. An insurance or reinsurance contract with an indeterminate risk.

An Insurance or Reinsurance Contract that Transfers Only Significant Timing Risk

340-30-05-3

For an insurance or reinsurance contract to be considered to have transferred significant timing risk, the timing of the loss reimbursement under the contract must be based on the timing of the loss event.

340-30-05-4

The timing of the loss reimbursement under an insurance contract would be based on the timing of the payment with respect to the loss event. For reinsurance contracts, the timing of the loss reimbursement under the contract would be based on the timing of payment by the insured (reinsured) of the underlying loss, as well as when recovery is expected from the reinsurer.

340-30-05-5

An insurance or reinsurance contract that transfers only significant timing risk limits the amount of underwriting risk to which the insurer or reinsurer is subject and is commonly entered into by the insured or **ceding entity** to provide liquidity. These limitations may result in an insufficient transfer of insurance risk. For example, insurance and reinsurance contracts that provide for **experience adjustments** may indicate that a sufficient amount of underwriting risk has not been transferred. The recovery of the amount of the initial deposit for a contract that transfers only significant timing risk is not substantially dependent on future loss experience of the insured.

An Insurance or Reinsurance Contract that Transfers Only Significant Underwriting Risk

340-30-05-6

For an insurance or reinsurance contract to be considered to have transferred significant underwriting risk, the probability of a significant variation in the amount of payments under the insurance or reinsurance contract must be more than remote. Such variation must also result from variation in the insured's losses, and it must be at least reasonably possible that the insurer will realize a significant loss from the transaction. An insurance or reinsurance contract that transfers only significant underwriting risk may be entered into to lessen the overall economic risks associated with the contract and permit a greater amount of coverage than would otherwise be obtainable for a comparable premium. Features in insurance or reinsurance contracts that transfer only significant underwriting risk limit the uncertainties about the timing of the receipt and payment of cash flow, thus limiting the amount of timing risk assumed by the insurer. A delayed reimbursement of losses by the insurer is a possible indication that timing risk has not been transferred. Unlike insurance and reinsurance contracts that transfer only significant timing risk, the recovery of the amount of the initial deposit for

an insurance or reinsurance contract that transfers only significant underwriting risk is substantially dependent on the future loss experience of the insured. Depending on such experience, the initial deposit may be recovered or the recovery may be significantly more or less than the original deposit.

An Insurance or Reinsurance Contract that Transfers Neither Significant Timing nor Significant Underwriting Risk

340-30-05-7

Insurance and reinsurance contracts that transfer neither significant timing nor significant underwriting risk are expected to be rare.

An Insurance or Reinsurance Contract with an Indeterminate Risk

340-30-05-8

These insurance and reinsurance contracts have uncertain terms, or there is insufficient information to reasonably estimate and allocate premiums in proportion to the protection provided. For example, certain insurance and reinsurance contracts allow the insured to obtain some degree of coverage for multiple years without exposing the insurer to a defined level of insurance risk each year. Uncertainties surrounding these insurance and reinsurance contracts are analogous to those often associated with foreign property and liability reinsurance as addressed in the Reinsurance Contracts Subsections of Subtopic 944-605.

Consistent with the ASC 944 framework, ASC 340-30 defines insurance risk as being comprised of both underwriting risk and timing risk. If both risks are not transferred under the arrangement, the deposit accounting method to be used under ASC 340-30 is determined based on the type of arrangement and which risks, if any, are transferred.

For contracts that transfer only significant timing risk, an approach consistent with the interest method must be used. This method must also be used for contracts that transfer neither significant timing risk nor significant underwriting risk (such contracts are expected to be rare). See section 5.2.1 for further details regarding this method.

For contracts that transfer only significant underwriting risk, the deposit should be initially measured based on the unexpired portion of the coverage provided. The deposit is then adjusted in future periods based on the actual loss experience of the insured (i.e., ceding company), as the loss experience affects the expected recovery of the deposit. See section 5.2.2 for further details regarding this method.

Contracts with indeterminate risk should follow the open-year method, which is not covered within this publication. See the guidance in ASC 340-30-25-3 through 25-7 for information on this method.

Excerpt from Accounting Standards Codification

Insurance Contracts That Do Not Transfer Insurance Risk

Deposit Asset or Liability Relating to Insurance and Reinsurance Contracts Accounted for Under Deposit Accounting

Recognition

340-30-25-1

At inception, a deposit asset or liability shall be recognized for insurance and **reinsurance** contracts accounted for under deposit accounting.

340-30-25-2

See Sections 340-30-30 and 340-30-35 for guidance relating to the measurement of insurance and reinsurance contracts that transfer:

a. Only significant timing risk

b. Neither significant timing nor significant underwriting risk

c. Only significant underwriting risk.

Initial Measurement

340-30-30-1

At inception, a deposit asset or liability shall be measured based on the consideration paid or received, less any explicitly identified premiums or fees to be retained by the insurer or reinsurer, irrespective of the experience of the contract. Accounting for such fees shall be based on the terms of the contract.

At the inception of any contract that does not transfer insurance risk, an initial deposit is recorded by the ceding company for the amount paid (or segregated to be paid) to the assuming company. In effect, the recognition of the transaction is a reclassification of balance sheet accounts, and the ceding company should not recognize any portion of the amount paid in the income statement except when nonrefundable charges are included in the arrangement.

If the transaction includes a ceding commission, the amount should be recognized as a component of the net cash flows for the deposit asset by the ceding company and not as a reduction of the DAC asset relating to the underlying business. The adjustment to the deposit asset for the ceding commission received could then be accreted or amortized using the effective yield method, similar to the recognition of premium or discount on a financial instrument (e.g., a structured note) in accordance with ASC 320-10-35-38 through 35-43.

The accounting treatment for the initial measurement of the deposit is consistent under all methods of deposit accounting (i.e., regardless of the conclusions reached on the transfer of underwriting risk or timing risk). However, the accounting treatment to measure the deposit in subsequent periods will depend on whether the arrangement transfers significant underwriting risk.

5.2.1 Contracts that do not transfer significant underwriting risk

Excerpt from Accounting Standards Codification

Insurance Contracts That Do Not Transfer Insurance Risk

Insurance and Reinsurance Contracts that Transfer Only Significant Timing Risk and Insurance and Reinsurance Contracts that Transfer Neither Significant Timing nor Significant Underwriting Risk

Subsequent Measurement

340-30-35-1

For insurance and reinsurance contracts that transfer only significant timing risk or that transfer neither significant timing nor significant underwriting risk, the amount of the deposit asset or liability shall be adjusted at subsequent reporting dates by calculating the effective yield on the deposit to reflect actual payments to date and expected future payments (as discussed in paragraph 340-30-35-3), with a corresponding credit or charge to interest income or expense (see Examples 1 through 3 [paragraphs 340-30-55-2 through 55-7]).

340-30-35-2

This approach is consistent with the interest method described in Subtopics 310-20 and 835-30.

340-30-35-3

The calculation of the effective yield shall use the estimated amount and timing of cash flows. Consistent with paragraph 310-20-35-26, if a change in the actual or estimated timing or amount of cash flows occurs, the effective yield shall be recalculated to reflect the revised actual or estimated cash flows. The deposit shall be adjusted to the amount that would have existed at the balance-sheet date had the new effective yield been applied since the inception of the insurance or reinsurance contract.

340-30-35-4

Significant changes in the expected amounts of aggregate cash flows are expected to occur infrequently because of the nature of these kinds of contracts. Should a significant change occur in the total amount of actual or estimated cash flows, the entity shall determine whether the change indicates that the contract does include significant underwriting risk and therefore shall be converted to the accounting for contracts that transfer only significant underwriting risk (see paragraphs 340-30-35-5 and 340-30-45-3 through 45-5). In addition, a contract that transfers only significant timing risk, which subsequently is determined also to transfer significant underwriting risk, cannot be accounted for under insurance or reinsurance accounting when the revised determination is made.

Other Presentation Matters

340-30-45-2

Changes in the carrying amount of the deposit shall be reported as interest income or interest expense.

For contracts that do not transfer significant underwriting risk, the revenues and expenses are attributable primarily to the time value of money. The deposit for these contracts will be measured using an approach consistent with the interest method. The amount of the initial deposit asset or liability should be adjusted by calculating the effective yield on the deposit based on actual payments to date and expected future payments. Changes to the deposit asset or liability at subsequent reporting periods are reported as interest income or interest expense.

Illustration 5-1: Deposit Accounting for a contract that does not transfer significant underwriting risk

Our illustration is based in part on the example provided at ASC 340-30-55-2 through 55-3.

Company A enters into an arrangement reinsuring a block of workers' compensation policies. It expects to pay the claims in equal amounts over a 10-year period. Under the terms of the arrangement, Company A will provide the reinsurer with an initial deposit of $10 million. The reinsurer charges a $250,000 premium and will reimburse Company A as claims are paid. After 10 years the reinsurer will repay Company A for any portion of the initial deposit that has not been reimbursed (less the reinsurance premium).

Initial deposit	$ 10,000,000
Reinsurance premium	$ 250,000
Coverage period	10 years
Expected recoveries	$1.3 million at the end of each year for 10 years

The implicit discount rate for these cash flows is 5.60%, which is the calculated discount rate that results in the present value of annual recoveries of $1.3 million to be equal to $9,750,000 (original deposit less the reinsurance premium).

Company A determines that the contract transfers neither significant timing risk nor significant underwriting risk, and as a result it should be recorded as a deposit. At contract inception, Company A records a $9,750,000 deposit and will also record a $250,000 prepaid asset related to the premium. Changes in the amount or timing of cash flows are not anticipated. Due to the lack of significant underwriting risk, subsequent measurement of the deposit should be determined using an approach consistent with the interest method, with changes in the deposit balance recorded to interest income.

Assuming there are no unexpected cash flows, the cash flows for the contract are recorded as follows:

	Interest Income (A)	Recoveries (B)	Deposit Balance (C)
Net Initial payment			$ 9,750,000
Year 1	$ 546,435	$ (1,300,000)	8,996,435
Year 2	504,202	(1,300,000)	8,200,637
Year 3	459,602	(1,300,000)	7,360,239
Year 4	412,502	(1,300,000)	6,472,741
Year 5	362,762	(1,300,000)	5,535,503
Year 6	310,235	(1,300,000)	4,545,738
Year 7	254,764	(1,300,000)	3,500,503
Year 8	196,184	(1,300,000)	2,396,687
Year 9	134,321	(1,300,000)	1,231,009
Year 10	68,991	(1,300,000)	-
Total	$ 3,250,000	$ (13,000,000)	$ -

(A) Prior year's deposit balance multiplied by the implicit discount rate (5.60%).

(B) Based on the Company's expectations.

(C) Prior year's deposit balance, plus interest income and less recoveries.

Assume the same fact pattern as the scenario above, except that Company A's expectation of cash flows changes after Year 6. Under Company A's revised expectations, the recoveries in Year 7 and Year 8 are expected to be $2.6 million, with no further recoveries after Year 8.

Under the revised expectations, the implicit discount rate for all cash flows expected over the life of the arrangement is 6.01%. When the revised future cash flows become known, Company A recalculates the measurement of the deposit balance as the present value of future cash flows discounted at the new implicit discount rate. In this scenario, the present value calculation is expected recoveries of $2.6 million over the next two years, discounted at the new implicit discount rate of 6.01%.

Company A will record the resulting change in the deposit balance as additional interest income (or interest expense in the event of a decreased balance). The increase in the deposit balance is reasonable, as expected recoveries have accelerated.

	Interest Income (A)	Recoveries (B)	Deposit Balance (C)
Net Initial payment			$ 9,750,000
Year 1	$ 546,435	$ (1,300,000)	8,996,435
Year 2	504,202	(1,300,000)	8,200,637
Year 3	459,602	(1,300,000)	7,360,239
Year 4	412,502	(1,300,000)	6,472,741
Year 5	362,762	(1,300,000)	5,535,503
Year 6	310,235	(1,300,000)	4,545,738
Adjustment (D)	220,634	-	4,766,372
Year 7	286,302	(2,600,000)	2,452,675
Year 8	147,325	(2,600,000)	-
Total	$ 3,250,000	$ (13,000,000)	$ -

(A) Prior year's deposit balance multiplied by the implicit discount rate. The implicit rate for Year 1 through Year 6 is 5.60% and the implicit rate for Year 7 and Year 8 is 6.01%.

(B) Based on the Company's expectations, which are revised after Year 6.

(C) Prior year's deposit balance, plus interest income and less recoveries.

(D) Calculated as the difference between the carrying value of the deposit balance at the time of revised cash flow expectations ($4,545,738) and the amount that would have existed on the reporting date had the new implicit rate been applied since the inception of the contract ($4,766,372).

Provided that the total amount of expected recoveries does not change, the total amount of interest income will remain unchanged, regardless of the timing of the recoveries, as demonstrated in both scenarios in this illustration. In accordance with ASC 340-30-35-3, Company A records a catch-up adjustment to interest income when there is a change in the estimated timing of cash flows (i.e., at the end of Year 6 in this scenario) to reflect the revised expectations for recoveries under the arrangement.

When a change in actual or expected cash flows is known, an insurer should recalculate the implicit discount rate using the revised cash flows back to contract inception (i.e., actual historical cash flows and updated future expected cash flows). A catch-up adjustment is recorded so that the deposit amount equals what it would have been at the reporting date had the revised implicit discount rate been applied since the inception of the contract. Alternately, the same amount can also be determined by calculating the present value of remaining cash flows using the revised rate.

In rare circumstances, a significant change in the actual or expected cash flows may cause an insurer to re-evaluate whether the contract includes significant underwriting risk. If re-evaluation is required and results in a change in conclusion (i.e., the contract is subsequently determined to include significant underwriting risk), the insurer should convert to an accounting method under which the deposit is measured based on the unexpired portion of coverage provided (see section 5.2.2). However, ASC 340-30-35-4 precludes an insurer from converting to reinsurance accounting if the contract was previously accounted for as a deposit due to a lack of significant underwriting risk being transferred.

5.2.2 Contracts that transfer only significant underwriting risk

Excerpt from Accounting Standards Codification

Insurance Contracts That Do Not Transfer Insurance Risk

Insurance and Reinsurance Contracts that Transfer Only Significant Underwriting Risk

Subsequent Measurement

340-30-35-5

Until such time as a loss is incurred that will be reimbursed under an insurance or reinsurance contract that transfers only significant underwriting risk, the deposit shall be measured based on the unexpired portion of the coverage provided. Once a loss is incurred that will be reimbursed under such a contract, then the deposit shall be measured by the present value of the expected future cash flows arising from the contract plus the remaining unexpired portion of the coverage provided (see Example 4 [paragraph 340-30-55-8]).

340-30-35-6

For the insured or **ceding entity**, the discount rate used to determine the deposit asset shall be the current rate on U.S. government obligations with similar cash-flow characteristics, adjusted for default risk. Consideration of the default risk, if any, shall be based on the assessment of the creditworthiness of the insurer. For the insurer or **assuming entity**, the discount rate used to determine the deposit liability shall be the current rate on U.S. government obligations with similar cash-flow characteristics. These rates shall be established at the date of each loss incurred and used for the remaining life of the contract and shall not be changed.

340-30-35-7

If numerous losses occur, the use of average rates is permitted because establishing individual rates might require detailed record keeping and computations that could be burdensome and unnecessary to produce reasonable approximations of the results.

Other Presentation Matters

340-30-45-3

Changes in the recorded amount of the deposit, other than the unexpired portion of the coverage provided, arising from an insurance or **reinsurance** contract that transfers only significant **underwriting risk** shall be recorded in an insured's income statement as an offset against the loss recorded by the insured that will be reimbursed under the insurance or reinsurance contract and in an insurer's income statement as an incurred loss.

340-30-45-4

Insurance entities shall record the reduction in the deposit related to the unexpired portion of the coverage provided as an adjustment to incurred losses.

For contracts that transfer only significant underwriting risk, subsequent measurement of the deposit is based on the unexpired portion of coverage provided (before any losses are incurred). If losses are incurred, the deposit should be measured as the present value of the expected future cash flows arising from the contract plus the remaining unexpired portion of the coverage provided.

The ceding company's subsequent measurement of a deposit that is in an asset position throughout the contract term will result in the consistent reduction of the deposit due to the expiration of the contract term, with periodic increases to the deposit as a result of losses incurred (or decreases in the event of a revised estimate of losses incurred). At the end of the contract term, the recorded deposit should represent the amount of recoveries expected to be received from the reinsurer.

The ceding company will record both reductions of the deposit due to the expired portion of coverage and changes to the deposit due to losses incurred to the same expense account used for the underlying insurance contract that will be reimbursed under the contract. Because the contract transfers significant underwriting risk, it is inappropriate to recognize the change in the present value of cash flows related to losses incurred as interest expense (or interest income).

For purposes of determining the present value of expected future cash flows arising from the contract (i.e., the recoveries a ceding company expects), ASC 340-30-35-6 indicates that discount rates should be determined at the date of each incurred loss and locked-in for the remainder of the contract period, based on a US government obligation discount rate with similar cash-flow characteristics. The ceding company should adjust this rate for default risk. In the event of multiple losses during the contract term, ASC 340-30-35-7 allows for the averaging of discount rates.

Illustration 5-2: Deposit Accounting for a Contract that Transfers Significant Underwriting Risk

Our illustration is based in part on the example provided at ASC 340-30-55-8 through 55-11.

Company B enters into a delayed reimbursement arrangement for a block of medical malpractice policies. It pays an initial premium of $12 million for a three-year arrangement. Under the terms of the arrangement, Company B will be reimbursed at the end of the contract period for any covered losses exceeding $5 million. The rate of a three-year US treasury adjusted for default risk is determined to be 5%.

Company B appropriately concludes the contract transfers significant underwriting risk but does not transfer significant timing risk.

At inception, Company B records a reinsurance deposit equal to the $12 million of initial reinsurance premium paid and records the following journal entries:

	Debit	Credit
Reinsurance Deposit	$ 12,000,000	
Cash		$ 12,000,000

At the end of Year 1, Company B incurs a covered loss of $8 million, which exceeds the contract attachment point of $5 million by $3 million. Company B increases the amount of the deposit by the present value of the expected recovery, which is calculated as $2,721,088. Company B also reduces the deposit by $4 million for the expired portion of the coverage ($12 million divided by 3 years = $4 million).

	Expired Portion of Deposit (A)	Expected Recoveries (B)	Deposit Balance (C)
Initial payment			$ 12,000,000
Year 1	$ (4,000,000)	$ 2,721,088	10,721,088

(A) $12 million initial deposit divided by 3 years = $4 million expired on an annual basis

(B) The present value of $3 million received after two years discounted at 5%. Since the loss occurred at the end of Year 1 and the recovery will occur at the end of Year 3, it is discounted two years.

(C) Prior year deposit balance − expired portion of deposits + expected recoveries

Company B records the following journal entries at the end of Year 1:

To record the expired portion of the coverage

Incurred Loss Expense	$ 4,000,000	
Reinsurance Deposit		$ 4,000,000

To increase the deposit for the expected recovery

Reinsurance Deposit	$ 2,721,088	
Incurred Loss Expense		$ 2,721,088

At the end of Year 2, Company B incurs an additional covered loss of $7 million, which exceeds the contract attachment point of $5 million by $2 million. Company B remeasures the present value of the expected future cash flows which represent expected recoveries. Company B has incurred two covered losses exceeding the attachment point by $3 million and $2 million, and the contract stipulates the reinsurer will reimburse Company B at the end of Year 3. Therefore, Company B's expected recoveries are $5 million in one year, the present value of which is calculated as $4,761,905.

Company B records an adjustment to the deposit so that it equals the updated present value of expected future recoveries ($4,761,905 less $2,721,088 previously recorded results in a $2,040,816 adjustment). In addition to the adjustment to the expected recoveries, Company B further reduces the deposit by $4 million for the portion of the coverage that expired in Year 2.

	Expired Portion of Deposit (A)	Expected Recoveries (B)	Deposit Balance (C)
Initial payment			$ 12,000,000
Year 1	$ (4,000,000)	$ 2,721,088	10,721,088
Year 2	(4,000,000)	2,040,816	8,761,905

(A) $12 million initial deposit divided by 3 years = $4 million expired on an annual basis

(B) The present value of updated expected future recoveries is $4,761,905, and this adjustment brings the expected recoveries equal to that amount ($4,761,905 − 2,721,088 that was previously recorded)

(C) Prior year deposit balance − expired portion of deposit + expected recoveries

Company B records the following journal entries at the end of Year 2:

To adjust the deposit for updated expectations of recoveries

Reinsurance Deposit	$ 2,040,816	
Incurred Loss Expense		$ 2,040,816

To record the expired portion of the coverage

Incurred Loss Expense	$ 4,000,000	
Reinsurance Deposit		$ 4,000,000

Company B incurs no additional covered losses in Year 3. Therefore, the recorded activity for Year 3 is the accrual of interest on the carrying amount of the deposit attributable to the incurred loss, the further reduction of the deposit for the expired portion of the coverage and the collection of recoveries at the end of Year 3.

	Expired Portion of Deposit (A)	Interest (B)	Expected Recoveries	Recoveries (C)	Deposit Balance (D)
Initial payment					$12,000,000
Year 1	$ (4,000,000)	$ -	$ 2,721,088	$ -	10,721,088
Year 2	(4,000,000)	-	2,040,816	-	8,761,904
Year 3	(4,000,000)	238,096		(5,000,000)	-

(A) $12 million initial deposit divided by 3 years = $4 million expired on an annual basis

(B) Interest accrues on any portion of the carrying amount of the deposit attributable to an incurred loss. The amount attributable to an incurred loss during Year 3 was $4,761,905 ($2,721,088 + $2,040,816), so the amount of interest in Year 3 is $238,096 ($4,761,905 x 5%).

(C) Represents the cumulative amount of incurred losses above the contract attachment point ($3 million at the end of Year 1 + $2 million at the end of Year 2)

(D) Prior year deposit balance — expired portion of deposit + interest accrued on prior year expected recoveries — recoveries

The guidance does not explicitly require the accrual of interest on the portion of the deposit attributable to an incurred loss. However, the guidance does require that subsequent measurement of the deposit include the present value of expected future cash flows related to actual incurred losses that are covered under the terms of the contract (ASC 340-30-35-5). If additional losses are not incurred, accruing interest on a previously recorded incurred loss accomplishes the same measurement objective as recalculating the present value of the previously recorded incurred loss to account for the passage of time. As additional losses occur, the ceding company should calculate the present value of cumulative expected future cash flows and adjust the deposit as needed, considering the requirement for discount rates to be determined at the date of the incurred loss or averaged in the event of multiple losses.

Company B records the following journal entries at the end of Year 3:

To accrue interest on the portion of the deposit attributable to incurred losses

Reinsurance Deposit	$ 238,096	
Incurred Loss Expense		$ 238,096

To record the expired portion of the coverage

Incurred Loss Expense	$ 4,000,000	
Reinsurance Deposit		$ 4,000,000

To record recoveries under the terms of the contract and settle the deposit

Cash	$ 5,000,000	
Reinsurance Deposit		$ 5,000,000

Conceptually, at any given reporting period the deposit balance for a contract that includes significant underwriting risk is attributable to two components. A portion of the deposit balance represents the proportionate amount of the initial deposit that is attributable to the remaining life of the contract. The remainder of the deposit balance represents the present value of expected future cash flows arising from the contract. Expected future cash flows are only recorded for actual incurred losses that are covered under the terms of the contract, which is a key distinction between contracts that do not transfer significant underwriting risk. Because the contract contains significant underwriting risk, the recovery may be significantly more or less than the original deposit, depending on the underlying experience.

5.3 Subsequent assessment of risk transfer

Excerpt from Accounting Standards Codification

Insurance Activities

Implementation Guidance and Illustrations

Reinsurance Contracts

Changes in Contract Classification

944-20-55-38

This implementation guidance addresses circumstances in which the assessment of risk transfer changes after the initial assessment at contract inception.

944-20-55-39

Paragraph 944-20-15-43 states that the status of a contract should be determinable at inception and, absent amendment, subsequent changes shall be very rare.

944-20-55-40

If the risk of significant loss was not deemed **reasonably possible** at inception, and a significant loss subsequently occurred, the initial assessment was not necessarily wrong, because **remote** events do occur. Likewise, once a reasonable possibility of significant loss has been established, such loss need not occur to maintain the contract's status as reinsurance.

944-20-55-41

This Subtopic does not preclude reclassification if the initial assessment is later deemed incorrect. However, careful consideration would need to be given to whether the reclassification represents the correction of an error (see Subtopic 250-10).

In certain circumstances, subsequent loss emergence may indicate that the ceding company will economically benefit from the reinsurance contract that was initially deemed to not qualify for reinsurance accounting. ASC 944-20 notes that this subsequent loss emergence does not necessarily indicate that the initial assessment was incorrect, specifically stating that "remote events do occur." Furthermore, the guidance indicates that, absent a contract amendment, subsequent changes to a company's evaluation of the determination of risk transfer should be "very rare."

6 Business combinations

6.1 Overview

ASC 805, *Business Combinations*, provides guidance for business combinations, and insurance-related guidance is codified in ASC 944-805.

6.2 Classification of a reinsurance contract

In a business combination, the classification of the contract as a reinsurance contract or a deposit contract should not be reassessed at the acquisition date unless there have been amendments to the original contract. If the amendments are more than trivial, the company is required under ASC 944-20-15-64 to reassess risk transfer and the classification of the contract.

6.3 Measurement

Excerpt from Accounting Standards Codification

Business Combinations

Insurance and Reinsurance Contracts Acquired

Initial Measurement

944-805-30-1

The acquirer shall measure at **fair value** the assets and liabilities recognized under paragraph 944-805-25-3. However, the acquirer shall recognize that fair value in components as follows:

a. Assets and liabilities measured in accordance with the acquirer's accounting policies for insurance and **reinsurance** contracts that it issues or holds. For example, the contractual assets acquired could include a **reinsurance recoverable** and the liabilities assumed could include a liability to pay future contract claims and claims expenses on the unexpired portion of the acquired contracts and a liability to pay incurred contract claims and claims expenses. However, those assets acquired and liabilities assumed would not include the acquiree's deferred **acquisition costs** and unearned premiums that do not represent future cash flows.

b. An intangible asset (or occasionally another liability), representing the difference between the following:

   1. The fair value of the contractual insurance and reinsurance assets acquired and liabilities assumed

   2. The amount described in (a).

944-805-30-2

Other related contracts that are not insurance or reinsurance contracts shall be measured at the date of acquisition in accordance with Topic 805.

Subsequent Measurement

944-805-35-1

After the business combination, the acquirer shall measure the intangible asset (or other liability) on a basis consistent with the related insurance or **reinsurance** liability.

944-805-35-2

For example, for most short-duration contracts such as many property and liability insurance contracts, **claim** liabilities are not discounted under generally accepted accounting principles (GAAP), so amortizing the intangible asset like a discount using an **interest method** could be an appropriate method.

944-805-35-3

For certain long-duration contracts such as most traditional life insurance contracts, using a basis consistent with the measurement of the liability would be similar to the guidance provided in paragraph 944-30-35-3, which requires that deferred **acquisition costs** be amortized using methods that include the same assumptions used in estimating the **liability for future policy benefits**.

The acquiring company should consider reinsurance contracts acquired in a business combination to be new contracts for measurement and accounting purposes at the acquisition date. The acquiring company is required to measure the assets and liabilities relating to the reinsurance contracts acquired in the business combination at fair value (ASC 944-805-25-3 and ASC 944-805-30-1) and recognize the resulting fair value adjustment through two components.

The first component is the assets and liabilities measured in accordance with the acquiring company's accounting policies for insurance and reinsurance contracts under ASC 944. The assets acquired and measured in accordance with the acquiring company's accounting policies would not include DAC or unearned premiums, because these do not represent future cash flows.

The second component is the difference between the fair value and the first component. US GAAP does not provide an official term for the second component, but in practice it is commonly referred to as value of business acquired (VOBA) or present value of future profits (PVFP). As a result, in practice, VOBA or PVFP represents the intangible asset value assigned to insurance or reinsurance contracts already in force. In future reporting periods, the balance is amortized on a basis consistent with the related insurance or reinsurance liability.

Excerpt from Accounting Standards Codification

Business Combinations

SEC Staff Guidance

944-805-S99-1

The following is the text of SEC Observer Comment: Accounting by the Purchaser for a Seller's Guarantee of the Adequacy of Liabilities for Losses and Loss Adjustment Expenses Acquired in a Purchase Business Combination.

The SEC Staff believes it is preferable to present the effects of the loss guarantee on a gross rather than net basis. Any receivable from the seller should not be netted against the related liability in the balance sheet or in supporting information such as footnotes or SEC Industry Guide 6 disclosures. The SEC Staff also expressed a preference that (1) any expense associated with increased reserves be reported as a component of other claim losses and loss adjustment expenses and (2) other claim losses and loss adjustment expenses not be reduced by the effect of the reserve guarantee.

The SEC Staff would not object to claim losses and loss adjustment expenses being reported net of the effect of the reserve guarantee in the income statement. A net presentation is appropriate only if the effects of the reserve guarantee are disclosed separately in the notes to the financial statements, in the SEC Industry Guide 6 disclosures including the reconciliation of claims reserves, and in the loss ratio information.

In an insurance business combination, reserve guarantees may often be provided by a seller to indemnify a purchaser for unanticipated increases in the liabilities for losses and loss adjustment expenses of the insurance contracts acquired. These arrangements are generally related to insurance contracts with long payout periods (i.e., long-tail coverage) for which the ultimate amount and timing of payout is difficult to estimate. As outlined in ASC 944-805-S99-1, an acquiring entity should recognize the effect of such an arrangement in the balance sheet on a gross basis (i.e., record an increase in the loss reserves and a related reinsurance recoverable). Net presentation in the income statement is appropriate if the effects of the guarantee are adequately disclosed elsewhere.

All other contracts should follow the guidance in ASC 805.

7 Presentation and disclosure

7.1 Balance sheet presentation

Excerpt from Accounting Standards Codification

Receivables

Reinsurance Recoverables

Recognition

944-310-25-2

Ceding entities shall report separately as assets estimated **reinsurance recoverables** arising from both of the following types of contracts:

a. **Reinsurance** contracts that are legal replacements of one insurer by another (often referred to as assumption and novation)

b. Reinsurance contracts in which a **ceding entity** is not relieved of the legal liability to its policyholder.

Other Presentation Matters

944-310-45-5

A **ceding entity** shall report an estimated **reinsurance recoverable** arising from those contracts described in paragraph 944-310-25-2 separately as an asset.

944-310-45-6

Although amounts recoverable on unasserted claims shall be reported as reinsurance recoverables, details of the amounts comprising reinsurance recoverables may be presented separately.

944-310-45-7

Amounts receivable and payable between the ceding entity and an individual **reinsurer** shall be offset only if a legal right of setoff exists as defined in Subtopic 210-20, even if the ceding entity and reinsurer are affiliated entities. However, if the ceding entity and reinsurer are affiliated entities, the amounts shall be eliminated in consolidation when the affiliated entities are included in consolidated financial statements.

Acquisition Costs

Reinsurance Contracts

Subsequent Measurement

944-30-35-64

Proceeds from **reinsurance** transactions that represent recovery of acquisition costs shall reduce applicable unamortized **acquisition costs** in such a manner that net acquisition costs are capitalized and charged to expense in proportion to net revenue recognized.

The FASB concluded that net presentation in the balance sheet is inconsistent with the conditions for offsetting established in ASC 210-20 and did not adequately present the credit risk associated with reinsurance transactions. The guidance requires that reinsurance recoverables (i.e., ceded reserves, including amounts related to IBNR) and prepaid reinsurance (i.e., ceded unearned premiums) be reported as separate assets rather than reductions of the related liabilities.

Illustration 7-1 contrasts the presentation of reinsurance-related amounts in the balance sheet on a gross basis and on a net basis for an insurer. It presents reinsurance recoverables from paid losses separately from amounts related to unpaid losses, including IBNR. Alternatively, all reinsurance recoverable amounts could be combined and presented as a single asset amount in the balance sheet. However, in accordance with ASC 944-30-35-64, DAC is reported net of the effects of reinsurance.

Illustration 7-1

	Gross	Net
Assets:		
Investments	$ 8,500	$ 8,500
Cash	20	20
Receivables	1,900	1,900
Reinsurance recoverable:		
Paid benefits and losses	100	100
Unpaid benefits, losses, and IBNR	1,300	–
Prepaid reinsurance premiums	250	–
Deferred policy acquisition costs	300	300
Other assets	1,400	1,400
Total Assets	$ 13,770	$ 12,220
Liabilities and Equity:		
Future policy benefits, claims, losses, and loss adjustment expenses	$ 7,600	$ 6,300
Unearned premiums	1,700	1,450
Other liabilities	2,300	2,300
Equity	2,170	2,170
Total Liabilities and Equity	$ 13,770	$ 12,220

7.2 Income statement presentation

Excerpt from Accounting Standards Codification

Revenue Recognition

All Reinsurance Contracts

Other Presentation Matter

944-605-45-1

The amounts of earned premiums ceded and recoveries recognized under **reinsurance** contracts shall either be:

a. Reported in the statement of earnings, as separate line items or parenthetically

b. Disclosed in the notes to financial statements under paragraph 944-605-50-1

The FASB concluded that a gross presentation of premiums ceded and recoverable losses in the income statement is preferable, but it did not mandate a gross income statement presentation. Therefore, earned premiums ceded and recoveries (i.e., benefits and losses ceded) may be presented as separate line items in the income statement, parenthetically in the income statement or disclosed in the footnotes to the financial statements.

In addition, entities that are subject to SEC Regulation S-X are required, under Article 7, to "include premiums from reinsurance assumed and deduct premiums on reinsurance ceded" (i.e., reported on a net basis) in the amounts disclosed on the face of the income statement.

Illustration 7-2 contrasts the presentation of reinsurance-related amounts in the income statement on a gross basis and on a net basis for an insurer.

Illustration 7-2

	Gross	**Net**
Revenues:		
Premiums earned	$ 3,350	
Premiums ceded earned	(450)	
Net premiums earned	2,900	$ 2,900
Net investment income	1,700	1,700
Other revenues	400	400
Total revenues	5,000	5,000
Expenses:		
Benefits, claims,		
losses, and loss adjustment expenses	2,200	
Benefits and losses ceded	(300)	
Net benefits, claims,		
losses, and loss adjustment expenses	1,900	1,900
Policy acquisition costs	1,450	1,450
Other expenses	1,150	1,150
Total expenses	4,500	4,500
Pre-tax income	$ 500	$ 500

Reinsurance amounts also may be presented in the income statement as parenthetical disclosures. For example:

Premiums earned (net of premiums ceded — $450)	$ 2,900
Benefits, claims, losses, and loss adjustment expenses (net of reinsurance recoveries — $300)	$ 1,900

Alternatively, disclosure of earned premiums ceded and benefits and losses ceded may be disclosed in the notes to the financial statements. Most entities elect to present the net amounts on the face financial statements and include the parenthetical disclosures on the face financial statements or in the notes to the financial statements.

7.3 Footnote disclosures

Insurance companies routinely enter into reinsurance arrangements for a variety of reasons:

- To reduce overall risk, including exposure to large losses or catastrophic events
- To provide greater diversification of business risks
- To provide additional capacity for growth
- To maintain certain statutory ratio relationships

However, because reinsurance transactions generally do not relieve the ceding company of its primary obligation to the policyholder, the ceding company remains liable to the policyholder in the event that the reinsurer does not fulfill its obligations under the reinsurance agreement.

Excerpt from Accounting Standards Codification

Insurance Activities

Reinsurance Contracts

Disclosure

944-20-50-3

All insurance entities shall disclose the nature, purpose, and effect of ceded **reinsurance** transactions on the insurance entity's operations.

944-20-50-4

Ceding entities also shall disclose the fact that the insurer is not relieved of its primary obligation to the policyholder in a reinsurance transaction.

944-20-50-5

Paragraph 944-310-45-6 states that, although amounts recoverable on unasserted claims shall be reported as **reinsurance recoverables**, details of the amounts comprising reinsurance recoverables may be presented separately.

944-20-50-6

Separate presentation or disclosure of servicing carrier activity is not precluded.

ASC 944-20 addresses the general disclosure requirements for reinsurance contracts. Insurers must provide a description of the nature, purpose and effect of ceded reinsurance transactions on their operations, including disclosure of the fact that the insurer is not relieved of its primary obligation to its policyholders. More specific disclosure requirements regarding revenue related to reinsurance arrangements are outlined in ASC 944-605.

Excerpt from Accounting Standards Codification

Revenue Recognition

All Reinsurance Contracts

Disclosure

944-605-50-1

All insurance entities shall disclose all of the following in their financial statements:

a. For all **reinsurance** contracts, both of the following:

   1. Methods used for income recognition on reinsurance contracts
   2. If not reported under paragraph 944-605-45-1 in the statement of earnings, as separate line items or parenthetically, the amounts of earned premiums ceded and recoveries recognized under reinsurance contracts.

b. For short-duration contracts, all of the following on both a written basis and an earned basis:

   1. Premiums from direct business

2. Reinsurance assumed

3. Reinsurance ceded.

c. For long-duration contracts, all of the following:

1. Premiums and amounts assessed against policyholders from direct business

2. Reinsurance assumed and ceded

3. Premiums and amounts earned.

d. For foreign reinsurance accounted for by the **open year method**, all of the following shall be disclosed for each period for which an income statement is presented:

1. The amounts of premiums, claims, and expenses recognized as income on closing underwriting balances

2. The additions to underwriting balances for the year for reported premiums, claims, and expenses.

e. The amounts of premiums, claims, and expenses in the underwriting account for each balance sheet presented.

944-605-50-2

Appropriate disclosure of both of the following items is encouraged:

a. The extent to which reinsurance contracts indemnify the **ceding entity** against loss or liability relating to **insurance risk**

b. Indemnification policies as part of the required disclosure in the preceding paragraph about the nature and effect of reinsurance transactions.

944-605-50-3

Disclosure in the financial statements of an insurance entity's accounting policies under Topic 250 shall include a description of the methods used to account for foreign reinsurance.

Ceding companies also should include a discussion of the methods used to recognize costs and expenses associated with reinsurance transactions, which may be included in the ceding company's summary of significant accounting policies.

In addition, the disclosure of the ceding company's reinsurance transactions should include quantification of the significance of reinsurance transactions. For short-duration contracts, the amounts presented should include premiums from direct business, reinsurance assumed and reinsurance ceded, on both a written basis and an earned basis when the difference between those amounts is significant. For long-duration contracts, the amounts presented by the ceding companies should include premiums and amounts assessed for direct business from policyholders, reinsurance assumed and reinsurance ceded, along with premiums and amounts earned.

Entities subject to SEC Regulation S-X are required under Article 7 to file Schedule IV for reinsurance as outlined in Section 210.12-17. This schedule requires disaggregated amounts for life insurance in force and premiums according to whether the amounts are a result of direct, assumed or ceded business. The schedule also requires that premiums be further disaggregated by life insurance, accident and health insurance, property and liability insurance and title insurance.

Excerpt from Accounting Standards Codification

Financial Instruments

Reinsurance Contracts

Disclosures about Concentrations of Credit Risk

944-825-50-1B

Under the provisions of Section 825-10-50, a ceding entity should disclose concentrations of credit risk associated with both of the following:

a. Reinsurance recoverables

b. Prepaid reinsurance premiums

944-825-50-2

Even if a ceding entity does not have a significant concentration of credit risk with a single reinsurer, concentration of credit risk disclosures may be required under the provisions of Section 825-10-50.

944-825-50-3

If a ceding entity is aware that reinsured risks have been retroceded to a diverse group of retrocessionaires, disclosures about concentrations of credit risk still shall be made under Section 825-10-50 because the assuming entity's rights under the retrocessions generally are not available to the ceding entity to mitigate its credit risk. That is, the ceding entity's concentration of credit risk from the assuming entity is unchanged.

ASC 944-825 requires additional reinsurance-related disclosures for the concentration of credit risk (under the provisions of ASC 825-10-50) associated with reinsurance recoverables and prepaid reinsurance premiums. A company should consider the requirements under ASC 825-10-50 even if the ceding entity does not have a significant concentration of credit risk with a single reinsurer or is aware of retrocession transactions entered into by the reinsurer.

ASC 825-10-50 also requires that companies disclose the fair value of financial instruments for which it is practicable to estimate that value. In addition, companies need to disclose the method(s) and significant assumptions used to estimate those fair values. However, certain assets and liabilities that otherwise meet the definition of a financial instrument, including "insurance contracts," are specifically exempted from the disclosure requirements (ASC 825-10-50-8). Accordingly, reinsurance recoverables related to unpaid claims for reinsurance contracts that are considered insurance contracts would appear to be exempt from the fair value disclosure requirements. ASC 825-10-50 does not specifically state whether the fair value disclosures would apply to amounts recoverable from reinsurers on paid losses and "funds held" balances.

Excerpt from Accounting Standards Codification

Other Assets and Deferred Costs

Insurance Contracts That Do Not Transfer Insurance Risks

Disclosure

Deposit Asset or Liability

340-30-50-1

Entities shall disclose a description of the contracts accounted for as deposits and the separate amounts of total deposit assets and total deposit liabilities reported in the statement of financial position.

Insurance and Reinsurance Contracts that Transfer Only Underwriting Risk

340-30-50-2

Insurance entities shall disclose the following information regarding the changes in the recorded amount of the deposit arising from an insurance or reinsurance contract that transfers only significant underwriting risk:

a. The present values of initial expected recoveries that will be reimbursed under the insurance or reinsurance contracts that have been recorded as an adjustment to incurred losses

b. Any adjustment of amounts initially recognized for expected recoveries. The individual components of the adjustment (meaning, interest accrual, the present value of additional expected recoveries, and the present value of reductions in expected recoveries) shall be disclosed separately.

c. The amortization expense attributable to the expiration of coverage provided under the contract.

ASC 340-30 requires additional disclosures related to insurance and reinsurance contracts that do not pass significant insurance risk, which is comprised of both underwriting and timing risk, to the reinsurer. These disclosures include a description of all contracts accounted for as deposits. Additional disclosures are required to address changes in the unexpired portion of coverage provided for contracts accounted for as deposits that transfer underwriting risk but not timing risk.

A Frequently asked questions

This appendix compiles the frequently asked questions that were included in EITF D-34, "Accounting for Reinsurance: Questions and Answers about FASB Statement No. 113" and EITF D-35, "FASB Staff Views on Issue No. 93-6," both of which are primarily codified in the Implementation Guidance and Illustration Sections (ASC 944-YY-55) of the Reinsurance Contracts Subsections of ASC 944.

I. Risk transfer

II. Accounting provisions

III. Disclosures

Risk transfer

Question 1 **Should risk transfer be reassessed if contractual terms are subsequently amended?**

Yes. Consistent with ASC 944-20-15-64, when contractual terms are amended, risk transfer should be reassessed. For example, a contract that, upon inception, met the conditions for reinsurance accounting could later be amended so that it no longer meets those conditions. The contract should be reclassified and accounted for as a deposit.

Question 2 **How should the risk transfer assessment be made when a contract has been amended?**

A particular method for assessing risk transfer in the event of a contract amendment is not prescribed. To determine whether an amended contract in substance transfers risk, all facts and circumstances in light of the risk transfer requirements must be considered. Judgment also is required to determine whether an amendment in effect creates a new contract.

Question 3 **For purposes of evaluating whether a contract with a reinsurer transfers risk, what constitutes a contract?**

ASC 944-20-55-27 through 55-35 describes what constitutes a contract but does not define what constitutes a contract, which is essentially a question of substance. It may be difficult in some circumstances to determine the boundaries of a contract. For example, the profit-sharing provisions of one contract may refer to experience on other contracts and, therefore, raise the question of whether, in substance, one contract rather than several contracts exist.

The guidance in the Reinsurance Contracts Subsections of ASC 944 limits the inconsistency that could result from varying interpretations of the term *contract* by requiring that features of the contract or other contracts or agreements that directly or indirectly compensate the reinsurer or related reinsurers for losses be considered in evaluating whether a particular contract transfers risk. Therefore, if agreements with the reinsurer or related reinsurers, in the aggregate, do not transfer risk, the individual contracts that make up those agreements also would not be considered to transfer risk, regardless of how they are structured.

Question 4 **If the assessment of risk transfer changes after the initial assessment at contract inception, how should the ceding company account for the change?**

ASC 944-20-55-38 through 55-41 discusses changes in contract classification. The status of a contract should be determinable at inception and, absent any amendments, subsequent changes should be very rare. If the risk of significant loss was not deemed reasonably possible at inception, and a significant loss subsequently occurred, the initial assessment was not necessarily wrong, because remote events do occur. Likewise, once a reasonable possibility of significant loss has been established, such loss need not occur to maintain the contract's status as reinsurance.

Nevertheless, this does not preclude reclassification if the initial assessment is later deemed incorrect. If the initial classification was deemed to be in error, the guidance in ASC 250 should be applied.

Question 5 **In reinsurance of short-duration insurance policies, reasonably possible outcomes should be evaluated to determine the reinsurer's exposure to significant loss. What factors should be considered in determining whether a scenario being evaluated is reasonably possible?**

The term *reasonably possible* is used in the context of ASC 450, *Contingencies*, to mean that the likelihood of the scenario occurring is more than remote. The test is applied to a particular scenario, not to the individual assumptions used in the scenario. Therefore, a scenario is not reasonably possible unless the likelihood of the entire set of assumptions used in the scenario occurring *together* is reasonably possible (ASC 944-20-15-44).

Question 6 **In determining the amount of the reinsurer's loss under reasonably possible outcomes, may cash flows directly related to the contract other than those between the ceding company and assuming company, such as taxes and operating expenses of the reinsurer, be considered in the calculation?**

No. ASC 944-20-15-50 states that the evaluation is based on the present value of all cash flows *between the ceding and assuming enterprises* under reasonably possible outcomes and therefore precludes considering other expenses of the reinsurer in the calculation.

Question 7 **In evaluating the significance of a reasonably possible loss under ASC 944-20-15-41b, should the reasonably possible loss be compared to gross premiums or net premiums?**

It should be compared to gross premiums. Expenses should not be deducted from premiums in evaluating the significance of a reasonably possible loss (ASC 944-20-15-51).

Question 8 **How does a commutation clause affect the period of time over which cash flows are evaluated for reasonable possibility of significant loss to the reinsurer?**

ASC 944-20-15-50 requires all cash flows to be assessed under reasonably possible outcomes. The present value of cash flows should be determined over the period in which cash flows are reasonably expected to occur. Therefore, unless commutation is expected in the scenario being evaluated, it should not be assumed in the calculation. Further, the assumptions used in a scenario must be internally consistent and economically rational in order for that scenario's outcome to be considered reasonably possible (ASC 944-20-15-52).

Question 9 **What interest rate should be used in each evaluated scenario to make the present value calculation?**

ASC 944-20-15-49 refers to a reasonable and appropriate interest rate. However, a reasonable and appropriate rate generally would reflect the expected timing of payments to the reinsurer and the duration over which those cash flows are expected to be invested by the reinsurer. As stated in paragraph 66 of the Basis for Conclusions of FASB Statement No. 113, the Board explicitly chose not to give further detailed guidance on the choice of rates.

Question 10 **ASC 944-20-15-40 refers to payment schedules and accumulating retentions from multiple years as features that delay timely reimbursement of claims. Does the presence of those features generally prevent a contract from meeting the conditions for reinsurance accounting?**

Yes. The examples referred to in ASC 944-20-15-40 are contractual features inherently designed to delay the timing of reimbursement to the ceding company. Regardless of what a particular feature might be called, ASC 944-20-15-46 states that *any* feature that can affect timely reimbursement violates the conditions for reinsurance accounting. As indicated in ASC 944-20-15-41a, transfer of insurance risk requires that the reinsurer's payments to the ceding company depend on and directly vary with the amount and timing of claims settled under the reinsured contracts. Contractual features that can affect timely reimbursement prevent this condition from being met. Therefore, any feature that may affect the timing of the reinsurer's reimbursement to the ceding company should be closely scrutinized (ASC 944-20-55-54).

Question 11 **What if a contract contains a feature such as a payment schedule or accumulating retention but could still result in the reasonable possibility of significant loss to the reinsurer?**

ASC 944-20-15-41 requires both of the following as conditions for reinsurance accounting:

a. Transfer of significant risk arising from uncertainties about both (1) the ultimate amount of net cash flows from premiums, commissions, claims and claim settlement expenses paid under a contract (underwriting risk) and (2) the timing of the receipt and payment of those cash flows (timing risk)

b. Reasonable possibility of significant loss to the reinsurer

As stated in ASC 944-20-15-41 and discussed in question 10, features that can affect timely reimbursement violate condition (a). Because both conditions must be met for a contract to qualify for reinsurance accounting, failure to transfer significant timing and underwriting risk is not overcome by the possibility of significant loss to the reinsurer (ASC 944-20-55-53).

Question 12 **Does the guidance permit evaluating timely reimbursement on a present value basis?**

No. As stated in ASC 944-20-15-48, the word timely is used in the ordinary temporal sense to refer to the length of time between payment of the underlying reinsured claims and reimbursement by the reinsurer.

While the test for reasonable possibility of significant loss to the reinsurer provides for a present-value-based assessment of the economic characteristics of the reinsurance contract, the concept of timely reimbursement relates to the transfer of insurance risk (condition (a)), not the reasonable possibility of significant loss (condition (b)). Accordingly, timely reimbursement should be evaluated based solely on the length of time between payment of the underlying reinsured claims and reimbursement by the reinsurer.

Question 13 **Are there any circumstances under which the conditions in ASC 944-20-15-41 for risk transfer of short-duration contracts do not need to be met?**

Yes. The Board provided an extremely narrow and limited exemption for contracts that reinsure either an individual risk or an underlying book of business that is inherently profitable. ASC 944-20-15-53 and 15-54 specifies that when substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts has been assumed by the reinsurer, the contract meets the conditions for reinsurance accounting. That is, no more than trivial insurance risk on the reinsured portions of the underlying insurance contracts may be retained by the ceding company, so the reinsurer's economic position is virtually equivalent to having written the relevant portions of the reinsured contracts directly (ASC 944-20-55-55).

Question 14 **In determining whether a reinsurance contract qualifies under the exception in ASC 944-20-15-53, how should the economic position of the reinsurer be assessed in relation to that of the ceding company?**

The assessment should be made by comparing the net cash flows of the reinsurer under the reinsurance contract with the net cash flows of the ceding company on the reinsured portions of the underlying insurance contracts. This may be relatively easy for reinsurance of individual risks or for unlimited-risk quota-share reinsurance, because the premiums and losses on these types of reinsurance generally are the same as the premiums and losses on the reinsured portions of the underlying insurance policies.

In other types of reinsurance, determining the reinsurer's net cash flows relative to the insurer is likely to be substantially more difficult. For example, it generally would be difficult to demonstrate that the ceding company's premiums and losses for a particular layer of insurance are the same as the reinsurer's premiums and losses related to that layer. If the economic position of the reinsurer relative to the insurer cannot be determined, the contract would not qualify under the exception in that paragraph (ASC 944-20-55-56).

Accounting provisions

Question 15 **How should adverse development occurring after the effective date be accounted for in retroactive reinsurance of short-duration insurance policies not subject to reinsurance accounting?**

Increases in amounts recoverable from the reinsurer are recognized immediately in the statement of earnings.

Question 16 **What is the definition of past insurable events that governs whether reinsurance coverage of short-duration insurance policies is prospective or retroactive? For example, could a reinsurance contract that covers losses from asbestos and pollution claims on occurrence-based insurance policies effective during previous periods be considered prospective if the reinsurance coverage is triggered by a court interpretation that a loss is covered within the terms of the underlying insurance policies?**

As described in ASC 944-20-15-34B, "the distinction between prospective reinsurance and retroactive reinsurance is based on whether a contract reinsures future or past insured events covered by the underlying insurance contracts." In the example above, the insured event is the occurrence of loss within the coverage of the underlying insurance contracts, not the finding of a court. Therefore, the fact that the asbestos exposure or pollution is covered under insurance policies effective during prior periods makes the reinsurance coverage in this example retroactive.

Question 17 **Would the answer to question 16 change if the reinsurance were written on a claims-made basis?**

No. The form of the reinsurance whether claims-made or occurrence-based does not determine whether the reinsurance is prospective or retroactive. ASC 944-20-15-34B states that "a claims-made reinsurance contract that reinsures claims asserted to the reinsurer in a future period as a result of insured events that occurred prior to entering into the reinsurance contract is a retroactive contract."

Question 18 **What is the effect of adjustments to future premiums or coverage in determining whether reinsurance of short-duration insurance policies is prospective or retroactive?**

Adjustments to future premiums or coverage may affect the accounting for a reinsurance contract. Whenever an adjustment results in a reinsurer providing new or additional coverage for past insurable events, that coverage is retroactive. Paragraphs 944-20-55-47 through 55-49 state "[f]or example, if subsequent years' premiums under a multiple accident year contract create additional coverage for previous accident years, the additional coverage is retroactive, even if the original coverage provided in the contract for those accident years was prospective. Likewise, if current losses under a multiple-year contract eliminate coverage in future periods, some or all of the premiums to be paid in those future periods should be charged to the current period."

Question 19 **A contract to reinsure short-duration policies is entered into after the contract's effective date. Is the coverage between the contract's effective date and the date the contract was entered into prospective or retroactive?**

ASC 944-20-55-46 states that "[t]he portion of the contract related to the period of time between the effective date of the contract and the date the contract was entered into is retroactive because it covers insured events that occurred prior to entering into the reinsurance contract."

Question 20 **How is the date the reinsurance contract was entered into determined?**

ASC 944-20-15-34C states that "[i]t is not uncommon for a reinsurance arrangement to be initiated before the beginning of a policy period but not finalized until after the policy period begins. Whether there was agreement in principle at the beginning of the policy period and, therefore, the contract is substantively prospective must be determined based on the facts and circumstances." For example, a contract may be considered to have been substantively entered into even though regulatory approval of that contract has not taken place.

ASC 944-20-55-44 states that "[t]he absence of agreement on significant terms, or the intention to establish or amend those terms at a later date based on experience or other factors, generally indicates that the parties to the contract have not entered into a reinsurance contract, but rather have agreed to enter into a reinsurance contract at a future date. If contractual provisions under a contract substantively entered into at a future date cover insurable events prior to that date, that coverage is retroactive."

Question 21 **Are contracts to reinsure calendar-year incurred losses on short-duration insurance policies considered contracts that have both prospective and retroactive elements?**

Yes. ASC 944-20-55-43 states that "[m]ost reinsurance contracts covering calendar-year incurred losses combine coverage for insured events that occurred before entering into the reinsurance contract with coverage for future insured events and, therefore, include both prospective and retroactive elements."

Question 22 **When the prospective and retroactive portions of a contract to reinsure short-duration insurance policies are being accounted for separately, how should premiums be allocated to each portion of the contract?**

As discussed in ASC 944-605-25-21, the Reinsurance Contracts Subsection of ASC 944 does not require any specific method for allocating reinsurance premiums to the prospective and retroactive portions of a contract. However, separate accounting for the prospective and retroactive portions of a contract may take place only when an allocation is practicable.

Practicability requires a reasonable basis for allocating the reinsurance premiums to the risks covered by the prospective and retroactive portions of the contract, considering all amounts paid or deemed to have been paid regardless of the timing of payment. If a reasonable basis for allocating the premiums between the prospective and retroactive coverage does not exist, the entire contract must be accounted for as a retroactive contract. ASC 944-605-25-21 states that "[i]mpracticable is used to mean that the prospective and retroactive provisions cannot be accounted for separately without incurring excessive costs."

Question 23 **Under ASC 944-605-25-22 and 25-23, gains arising from retroactive reinsurance must be deferred and losses must be charged to expense immediately. How is this requirement affected by ASC 944-605-35-13, which provides for a catch-up adjustment to reflect changes in estimates of amounts recoverable from reinsurers?**

For example, assume Company A pays $100 of premium in 20X3 for $150 limit of retroactive reinsurance and has recorded related liabilities of $110. Assuming a five-year settlement period, how would adverse development of $30, or favorable development of $15, be accounted for in the subsequent year?

At inception, Company A recorded a reinsurance recoverable of $110 and a deferred gain of $10.

If adverse development of $30 occurred in the first year, an adjustment is required under ASC 944-605-35-11 through 35-13 to bring the balance of the deferred gain to the balance that would have existed had the revised estimate been available at inception, less cumulative amortization. The balance that would have existed at inception is $40 ($140 reserves less $100 premium) and cumulative amortization to date is $8 ($40/5 years). Therefore, a net $32 deferred gain balance is required. Company A would defer $30 of additional gain ($40 less the $10 already recorded) and credit income for $8 amortization. (Straight-line amortization is used for simplicity of illustration rather than the interest or recovery methods required in ASC 944-605-35-9. See Case A in ASC 944-605-55-8.)

If favorable development of $15 occurred in the first year, the amount of ceded premiums ($100) would exceed the related revised liabilities ($95). ASC 944-605-35-11 and 13 state that decreases in the estimated amount of the liabilities reduce the related amount recoverable and reduce previously deferred gains. Further, if the revised estimate of the liabilities is less than the amounts paid to the reinsurer, the difference must be charged to earnings. Company A would therefore reduce the reinsurance recoverable by $15, reduce the $10 deferred gain to zero, and charge $5 to earnings (See Case B in ASC 944-605-55-9.)

Question 24 **A reinsurance contract contains a provision that provides the ceding company's policyholders and claimants with the right to recover their claims directly from the reinsurer. May the ceding company net the recoverable due from the reinsurer against the gross loss obligations on the underlying insurance contracts?**

No. As stated in ASC 944-20-40-3 through 40-4, reinsurance contracts in which a ceding company is not relieved of its legal liability to its policyholder do not result in the removal of the related assets and liabilities from the ceding company's financial statements. Amounts receivable and payable between the ceding company and a reinsurer may be offset only when a right of setoff exists, as defined in ASC 210-20 (ASC 944-605-55-1).

Question 25 **If the example in question 24 involved retroactive reinsurance of short-duration insurance policies that resulted in a gain to the ceding company, could that gain be recognized in income immediately?**

No. ASC 944-40-25-33 states that reinsurance contracts do not result in immediate recognition of gains unless the reinsurance contract is a legal replacement of one insurer by another and thereby extinguishes the ceding company's liability to the policyholder (ASC 944-605-55-2).

Question 26 **A ceding company enters into a retroactive contract to reinsure short-duration insurance policies that gives rise to a deferred gain. If the reinsurer prepays its obligation under the contract, may the ceding company recognize its deferred gain at the time the prepayment is received?**

ASC 944-605-20 defines the settlement period over which deferred gains arising from retroactive reinsurance transactions are to be amortized as "the estimated period over which a ceding entity expects to recover substantially all amounts due from the reinsurer under the terms of the reinsurance contract." Therefore, the amortization period is based on the period over which the reinsurer settles its obligations to the ceding company, and it may be appropriate to recognize the gain over the expected prepayment period.

However, all of the facts and circumstances must be considered to determine whether the reinsurer has substantively settled its obligation to the ceding company. For example, if the ceding company agrees to compensate the reinsurer for the prepayment, such as by crediting the reinsurer with investment income on prepaid amounts or balances held, the reinsurer has not, in substance, settled its obligation but rather has made a deposit with the ceding company that should be accounted for accordingly (ASC 944-605-55-4 through 55-5).

Question 27 **Under the definition of *settlement period* referred to above, if the ceding company does not expect to receive any recoveries because the reinsurer has agreed to reimburse claimants under the reinsured contracts directly, would the settlement period be considered to have ended on the effective date of the contract?**

No. As described in question 25, the proposed accounting treatment is prohibited by ASC 944-40-25-33. Unless the reinsurance contract results in legal replacement of one reinsurer by another, a gain may not be recognized at the inception of the contract. In the example given, the reinsurer is substantively acting as a disbursing agent for the ceding company. Therefore, the ceding company cannot be said to have recovered amounts due from the reinsurer before payment is made to the claimant (ASC 944-605-55-3).

Question 28 **Does the Reinsurance Contracts Subsection of ASC 944 provide any guidance to determine when an insurer's liability to the policyholder has been entirely extinguished?**

No. Whether the liability to the policyholder has been entirely extinguished essentially is a legal question, based on all of the facts and circumstances. ASC 405-20-40 addresses determining whether a liability has been extinguished (ASC 944-20-40-5).

Question 29 **ASC 944-310-45-7 states that amounts receivable and payable between a ceding company and reinsurer shall be offset only when a right of setoff exists. Is that true even when the ceding company and reinsurer are affiliated companies?**

Yes. Unless the legal right of setoff exists as defined in ASC 210-20, these amounts may not be offset. However, the amounts would be eliminated in consolidation when the affiliated companies are included in consolidated financial statements.

Disclosures

Question 30 **If a ceding company does not have a significant concentration of credit risk with a single reinsurer, are concentration of credit risk disclosures required?**

The disclosures may still be required even if a ceding company does not have a significant concentration of credit risk. Group concentrations may exist if several counterparties are engaged in similar activities and have similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions.

Question 31 **If the ceding company is aware that a reinsured risk or risks have been retroceded to a diverse group of retrocessionaires, must ASC 825-10-50 disclosures still be made for concentrations of credit risk?**

Yes. The assuming company's rights under the retrocessions generally are not available to the ceding company to mitigate its credit risk. Therefore, the ceding company's concentration of credit risk from the assuming company is unchanged (ASC 944-825-55-3).

B Abbreviations used in this publication

Abbreviation	*Standard*
ASC 210-20	FASB ASC Topic 210-20, *Offsetting*
ASC 250	FASB ASC Topic 250, *Accounting Changes and Error Corrections*
ASC 310	FASB ASC Topic 310, *Receivables*
ASC 320	FASB ASC Topic 320, *Investments — Debt Securities*
ASC 326	FASB ASC Topic 326, *Financial Instruments — Credit Losses*
ASC 340-30	FASB ASC Topic 340-30, *Insurance Contracts that Do Not Transfer Insurance Risk*
ASC 405	FASB ASC Topic 405, *Liabilities*
ASC 450	FASB ASC Topic 450, *Contingencies*
ASC 805	FASB ASC Topic 805, *Business Combinations*
ASC 815	FASB ASC Topic 815, *Derivatives and Hedging*
ASC 825	FASB ASC Topic 825, *Financial Instruments*
ASC 944	FASB ASC Topic 944, *Financial Services — Insurance*

Abbreviation	*Other Authoritative Standards*
SSAP No. 62R	Statement of Statutory Accounting Principles (SSAP) No. 62R, *Property and Casualty Reinsurance*

Abbreviation	*Non-Authoritative Standards*
EITF 93-6	EITF Issue No. 93-6, "Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises"
EITF D-34	EITF Appendix D, Topic 34, *Accounting for Reinsurance: Questions and Answers about FASB Statement No. 113*
EITF D-35	EITF Appendix D, Topic 35, *FASB Staff Views on Issue No. 93-6*, "Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises"
Statement 97	FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*
Statement 113	FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*
Statement 133	FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*

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944-605-25-23	3.6	Retroactive contracts
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944-605-35-8	3.5	Prospective contracts
944-605-35-9	3.6.1	Accounting when the liabilities reinsured exceed the amounts paid
944-605-35-9	3.6.4	Amortization of deferred gains — interest method compared to the recovery method
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944-605-35-11	3.6.3	Accounting for a change in the estimate of the liabilities reinsured
944-605-35-11 to 35-13	A	Frequently asked questions — Question 23
944-605-35-12	3.6.3	Accounting for a change in the estimate of the liabilities reinsured
944-605-35-13	3.6.3	Accounting for a change in the estimate of the liabilities reinsured
944-605-35-13	A	Frequently asked questions — Question 23
944-605-35-14	4.3.1	Accounting for the cost of reinsurance
944-605-35-15	4.3.1	Accounting for the cost of reinsurance
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944-605-55-1	A	Frequently asked questions — Question 24
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944-605-55-9	A	Frequently asked questions — Question 23
944-805-25-3	6.3	Measurement

ASC Paragraph	Section	Sub-heading
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944-805-35-1	6.3	Measurement
944-805-35-2	6.3	Measurement
944-805-35-3	6.3	Measurement
944-805-S99-1	6.3	Measurement
944-825-25-2	4.1.1	Indemnification of ceding company
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944-825-55-3	A	Frequently asked questions — Question 31

D Common reinsurance terms and features that should be considered in risk transfer analysis

Term	Definition
Reinsurance intermediary	An entity that facilitates reinsurance by bringing together ceding and assuming entities. The reinsurance intermediary may underwrite, design and negotiate the terms of the reinsurance arrangement, place the reinsurance coverage, accumulate and report information for the reinsurance transaction, distribute premiums and collect and settle claims.
Reinsurance pools or associations	Groups or syndicates of insurance entities organized to provide members with reinsurance protection and management for specialized high-risk coverage (such as individual health insurance for those with diagnosed illnesses).
Unauthorized reinsurer (also known as nonadmitted reinsurer)	A reinsurance company that is not authorized to do business in the ceding entity's state of domicile. A ceding entity is generally not permitted to take a statutory reserve credit for a reinsurance arrangement with an unauthorized reinsurer unless the reinsured balance is collateralized.
Indemnity reinsurance	Reinsurance agreements in which the ceding entity remains liable to the policyholder. Additionally, the ceding entity bears the risks that the reinsurer may be unable to meet its obligations for the risks assumed under the reinsurance agreement. The policyholder is generally not aware of any indemnity reinsurance transactions that may occur and continues to hold the original contract.
Assumption reinsurance	Reinsurance agreements that are legal replacements of one insurer by another and extinguish the ceding entity's liability to the contract holder. This is generally achieved through a novation, in which the policyholder must consent to releasing the ceding company from liability.
Fronting	A form of indemnity reinsurance agreement between two or more insurers whereby the fronting entity will issue contracts and then cede all or substantially all of the risk through a reinsurance agreement to the other insurer(s) for a ceding commission. Such arrangements must comply with any regulatory requirements applicable to fronting to make sure any illegal acts are avoided.
Special-purpose vehicle (also known as sidecar)	A professional reinsurer that is designated to allow its investors to assume the risk and earn the profit on a group of insurance policies (a book of business) ceded by a specific insurer or retroceded by a specific reinsurer. The ceding entity will usually only cede the premiums associated with a book of business to such an entity if the investors place sufficient funds in the vehicle to ensure that the sidecar can meet claims. Typically, the investors' exposure to loss is limited to the funds invested.

Term	Definition
Facultative reinsurance	A reinsurance contractual arrangement in which each risk or portion thereof is reinsured individually, with the reinsurer having the option to accept or reject each individual insurance contract.
Automatic or treaty reinsurance	A reinsurance contractual arrangement where an agreed-upon portion of business written (generally all contracts in a specified class in excess of the ceding entity's retention limit, or a percentage of all contracts issued) is automatically reinsured, thereby eliminating the need to submit each risk to the reinsurer for acceptance or rejection. The ceding entity agrees to reinsure, and the assuming entity agrees to accept all qualified business. This avoids the possibility of anti-selection against the assuming entity.
Loss portfolio transfer	The transfer of a portfolio through a cession of reinsurance through the reinsurance of a run-off block of business. Only policies in force (or losses outstanding) are reinsured, and no new or renewal business is included.
Proportional or "pro rata" reinsurance	A type of arrangement where the insurer and reinsurer share, on a predetermined basis, premiums and losses on a risk, class of risks or particular portion of the insurer's business. For a predetermined portion of the insurer's premium(s), the reinsurer agrees to pay a similar portion of claims and claim adjustment expenses incurred on the business reinsured. The reinsurer's participation percentage is set without regard to the actual frequency and severity of claims. Examples of proportional reinsurance include quota share or coinsurance arrangements.
Dual triggers	A coverage feature that requires the occurrence of both an insurable event and changes in a separate, pre-identified variable to trigger payment of a claim.
Reinstatement clause	A feature common in multiple-year retrospectively rated and excess of loss reinsurance contracts where coverage provided by the contract is absorbed by losses incurred and the contract provides for the ceding entity to reinstate coverage for the balance of the contract period for a stated additional premium. Contracts may provide for an unlimited or a specific number of reinstatements and can either be obligatory or optional.
Funds withheld	A provision in a reinsurance agreement under which the premium due to the reinsurer is withheld and not paid by the ceding entity.

Feature that should be considered in risk transfer analysis	Definition
Loss ratio caps	A coverage feature that is used to limit the reinsurer's aggregate exposure by imposing a dollar limit or a limit expressed as a percentage of premiums on the amount of claims to be paid by the reinsurer. For example, the reinsurer will not be responsible for losses in excess of 150% of the premium paid.
Loss corridor	A coverage feature that requires the ceding insurer to be responsible for a certain amount of the ultimate net loss above the ceding entity's designated retention, and below the designated limit, that would otherwise be reimbursed under the reinsurance agreement. A loss corridor is usually expressed as a loss ratio percentage of the reinsurer's earned premium or a combined ratio if the reinsurance agreement provides for a ceding commission to the ceding entity.
Payment schedule	A feature in a reinsurance arrangement that is designed to delay the timing of reimbursement of losses so that investment income mitigates exposure to insurance risk.
Experience-rated refunds	A feature in a reinsurance arrangement that is designed for the ceding entity to participate in the profits of the reinsured business. Generally, experience rated refunds have stated terms for calculation formulas and other factors to be included and are tracked in an experience account.
Profit commission	A commission feature similar to an experience-rated refund whereby the ceding entity is provided a commission based on the reinsurer's profitability under the reinsurance contract. One form of a profit commission is a no-claims bonus whereby the ceding entity receives a stated percentage of the premium ceded in the event no claims are ceded to the reinsurer.
Retrospectively rated premiums	Premiums determined after the inception of the agreement based on the loss experience under the agreement.
Sliding scale commissions	A commission adjustment on earned premiums whereby the actual ceding commission varies inversely with the loss ratio (e.g., increasing commission payments to the ceding company as losses decrease and decreasing commission payments to the ceding company as losses increase), subject to a maximum and a minimum.
Contingent commissions	A provision in a reinsurance agreement that provides a commission to an insurer contingent upon a specified event happening, intended to allow the ceding insurer to share in the profits or losses realized by the reinsurer on the business subject to the contract.
Commutation clause	Clause in a reinsurance agreement that provides for the valuation, payment and complete discharge of some or all of the obligations between the ceding entity and reinsurer, including current and future obligations for losses incurred under the reinsurance contract.
Drop-down clause	A coverage feature under which reinsurance coverage drops down (e.g., from 100% to 80%) if losses accumulate to a specified loss ratio.
Industry loss warranty	A type of dual trigger coverage feature under which coverage is not provided until industry losses exceed a specified amount and reporting entity losses exceed a stated nominal amount.

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