Statement of Financial Accounting Standards No. 113

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FAS113 Summary

Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts

December 1992

Financial Accounting Standards Board
of the Financial Accounting Foundation
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Statement of Financial Accounting Standards No. 113

Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts

an amendment of FASB Statement No. 60

December 1992

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FAS 113: Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts

FAS 113 Summary

This Statement specifies the accounting by insurance enterprises for the reinsuring (ceding) of insurance contracts. It amends FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises,* to eliminate the practice by insurance enterprises of reporting assets and liabilities relating to reinsured contracts net of the effects of reinsurance. It requires reinsurance receivables (including amounts related to claims incurred but not reported and liabilities for future policy benefits) and prepaid reinsurance premiums to be reported as assets. Estimated reinsurance receivables are recognized in a manner consistent with the liabilities relating to the underlying reinsured contracts.

This Statement establishes the conditions required for a contract with a reinsurer to be accounted for as reinsurance and prescribes accounting and reporting standards for those contracts. The accounting standards depend on whether the contract is long duration or short duration and, if short duration, on whether the contract is prospective or retroactive. For all reinsurance transactions, immediate recognition of gains is precluded unless the ceding enterprise's liability to its policyholder is extinguished. Contracts that do not result in the reasonable possibility that the reinsurer may realize a significant loss from the insurance risk assumed generally do not meet the conditions for reinsurance accounting and are to be accounted for as deposits.

This Statement requires ceding enterprises to disclose the nature, purpose, and effect of reinsurance transactions, including the premium amounts associated with reinsurance assumed and ceded. It also requires disclosure of concentrations of credit risk associated with reinsurance receivables and prepaid reinsurance premiums under the provisions of FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk.*

This Statement applies to financial statements for fiscal years beginning after December 15, 1992, with earlier application encouraged.

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INTRODUCTION

1. 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 (a premium), an insurance enterprise agrees to pay the policyholder if specified events occur or are discovered. Similarly, the insurance enterprise may obtain indemnification against claims [1] associated with contracts it has written by entering into a reinsurance contract with another insurance enterprise (the **reinsurer** [2] or **assuming enterprise**). The insurer (or **ceding enterprise**) 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.

2. FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises* (issued in 1982), specified the accounting by insurance enterprises for reinsurance contracts. Statement 60 is an extraction of requirements of the AICPA Industry Audit Guides, *Audits of Fire and Casualty Insurance Companies* and *Audits of Stock Life Insurance Companies* (1979 editions). It continued the long-established practice that originated in statutory accounting whereby ceding enterprises reported insurance activities net of the effects of reinsurance. If a reinsurance contract indemnified the ceding enterprise against loss or liability, Statement 60 required the ceding enterprise to reduce unpaid claim liabilities by related estimated amounts recoverable from reinsurers (ceded reserves or reinsurance recoverables) and to reduce unearned premiums by related amounts paid to reinsurers (ceded unearned premiums or prepaid reinsurance premiums).

3. APB Opinion No. 10, *Omnibus Opinion—1966,* paragraph 7, states, "It is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of setoff exists." FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts,* specifies criteria for determining whether a right of setoff exists but does not change the offsetting permitted or required by existing accounting pronouncements. Amounts payable to the policyholder and amounts receivable from the reinsurer do not meet the criteria for offsetting in Opinion 10 or Interpretation 39. Those criteria include the requirement that the reporting party have the legal right to set off the amount owed to one party with an amount receivable from that same party.

4. The issues of (a) whether net reporting of the effects of reinsurance is appropriate and (b) what is meant by indemnification against loss or liability under a reinsurance contract (generally referred to as risk transfer) have been studied by the insurance industry and the accounting and actuarial professions for some time. Interest in those issues has grown in recent years as a result

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of widespread public attention focused on failures of insurance enterprises. Risks associated with reinsurance have been cited as a contributing factor in several of those failures. Some commentators have observed that the offsetting of reinsurance-related assets and liabilities and inadequate reinsurance disclosures obscure risks associated with reinsurance. Others have observed that the accounting guidance in Statement 60 allows the use of reinsurance to accelerate the recognition of income relating to the reinsured contracts.

5. The increasing concerns about the effect of reinsurance accounting for contracts that do not indemnify the ceding enterprise against loss or liability, the limited accounting guidance on reinsurance in Statement 60, the lack of disclosure requirements for reinsurance transactions, and the inconsistency between the net accounting for reinsurance-related assets and liabilities and the established criteria for offsetting led the Board to reconsider the accounting and reporting for reinsurance required by Statement 60.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Applicability and Scope

6. This Statement applies to all insurance enterprises to which Statement 60 applies. Insurers may enter into various types of contracts described as reinsurance, including those commonly referred to as **fronting arrangements**. This Statement provides guidance in paragraphs 8-13 on determining whether those contracts indemnify the ceding enterprise against loss or liability and therefore meet the conditions for reinsurance accounting. Contracts that meet those conditions shall be accounted for according to the provisions of paragraphs 14-26 of this Statement; other contracts with reinsurers are accounted for as deposits. The accounting provisions for reinsurance depend on whether the contract is long duration or short duration and, if short duration, on whether the contract is considered **prospective reinsurance** or **retroactive reinsurance**. Regardless of its form, any transaction that indemnifies an insurer against loss or liability relating to **insurance risk** shall be accounted for according to the provisions of this Statement.

7. This Statement does not address or change existing practice in accounting for reinsurance assumed, other than to provide guidance on indemnification against loss or liability relating to insurance risk in paragraphs 8-13 and require certain disclosures in paragraph 27.

Indemnification against Loss or Liability Relating to Insurance Risk

8. Determining 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 enterprise and related reinsurers. A complete

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understanding includes an evaluation of all contractual features that (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) or (b) delay the timely reimbursement of claims by the reinsurer (such as through payment schedules or accumulating retentions from multiple years).

Reinsurance of Short-Duration Contracts

9. Indemnification of the ceding enterprise against loss or liability relating to insurance risk in reinsurance of short-duration contracts requires both of the following, unless the condition in paragraph 11 is met:

a. The reinsurer assumes significant insurance risk under the reinsured portions of the underlying insurance contracts.
b. It is reasonably possible that the reinsurer may realize a significant loss from the transaction.

A reinsurer shall not be considered to have assumed significant insurance risk under the reinsured 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 enterprise would prevent this condition from being met.

10. The ceding enterprise'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 enterprises 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.

11. Significance of loss shall be evaluated by comparing the present value of all cash flows, determined as described in paragraph 10, with the present value of the amounts paid or deemed to have been paid [3] to the reinsurer. If, based on this comparison, the reinsurer is not exposed to the reasonable possibility of significant loss, the ceding enterprise 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.[4]

Reinsurance of Long-Duration Contracts

12. Indemnification of the ceding enterprise 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 as that concept is contemplated in Statement 60 and 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 97 defines long-duration contracts that do not subject the insurer to mortality or morbidity risks as investment contracts. Consistent with that definition, a contract

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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 enterprise against insurance risk.

13. The evaluation of mortality or morbidity risk in contracts that reinsure policies subject to Statement 97 shall be consistent with the criteria in paragraphs 7 and 8 of that Statement. 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.

Reporting Assets and Liabilities Related to Reinsurance Transactions

14. Reinsurance contracts that are legal replacements of one insurer by another (often referred to as assumption and novation) extinguish the ceding enterprise's liability to the policyholder and result in removal of related assets and liabilities from the financial statements of the ceding enterprise. Reinsurance contracts in which a ceding enterprise is not relieved of the legal liability to its policyholder do not result in removal of the related assets and liabilities from the ceding enterprise's financial statements. Ceding enterprises shall report estimated **reinsurance receivables** arising from those contracts separately as assets. Amounts paid to the reinsurer relating to the unexpired portion of reinsured contracts (prepaid reinsurance premiums) also shall be reported separately as assets.

15. Amounts receivable and payable between the ceding enterprise and an individual reinsurer shall be offset only when a right of setoff exists, as defined in Interpretation 39.

16. The amounts of earned premiums ceded and recoveries recognized under reinsurance contracts either shall be reported in the statement of earnings, as separate line items or parenthetically, or those amounts shall be disclosed in the footnotes to the financial statements.

Recognition of Revenues and Costs

17. The financial reporting for a contract with a reinsurer depends on whether the contract is considered to be reinsurance for purposes of applying this Statement. Paragraphs 8-13 identify the conditions necessary for a contract to be accounted for as reinsurance. 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 prospective or retroactive. Paragraphs 18-20 prescribe accounting standards applicable to all reinsurance contracts. Paragraphs 21-25 prescribe accounting standards specifically applicable to reinsurance of short-duration contracts, and paragraph 26 prescribes accounting standards for reinsurance of long-duration contracts.

18. This Statement does not specify the accounting for contracts that do not meet the conditions for reinsurance accounting, other than to incorporate the following provisions from

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paragraphs 39 and 40 of Statement 60, which continue in effect:

a. To the extent that a reinsurance contract does not, despite its form, provide for indemnification of the ceding enterprise by the reinsurer against loss or liability, the premium paid less the premium to be retained by the reinsurer shall be accounted for as a deposit by the ceding enterprise. A net credit resulting from the contract shall be reported as a liability by the ceding enterprise. A net charge resulting from the contract shall be reported as an asset by the reinsurer.
b. 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.[5] If the ceding enterprise has agreed to service all of the related insurance contracts without reasonable compensation, a liability shall be accrued for estimated excess future servicing costs under the reinsurance contract. The net cost to the assuming enterprise shall be accounted for as an acquisition cost.

19. 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 enterprise's liability to the policyholder.

20. Reinsurance receivables shall be recognized in a manner consistent with the liabilities (including estimated amounts for claims incurred but not reported and future policy benefits) relating to the underlying reinsured contracts. Assumptions used in estimating reinsurance receivables shall be consistent with those used in estimating the related liabilities.

Recognition of Revenues and Costs for Reinsurance of Short-Duration Contracts

21. Amounts paid for prospective reinsurance that meets the conditions for reinsurance accounting shall be reported as prepaid reinsurance premiums and 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.

22. Amounts paid for retroactive reinsurance that meets the conditions for reinsurance accounting shall be reported as reinsurance receivables 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 receivables shall be increased to reflect the difference and the resulting gain deferred. The deferred gain 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 (the interest method). Otherwise, the proportion of actual recoveries to total estimated recoveries (the recovery method) shall determine the amount of amortization.

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

24. 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. Reinsurance receivables shall reflect the related change in the amount recoverable from the reinsurer, and a gain to be deferred and amortized, as described in paragraph 22, shall be adjusted or established as a result.[6] 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.

25. When practicable,[7] prospective and retroactive provisions included within a single contract shall be accounted for separately. 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.

Recognition of Revenues and Costs for Reinsurance of Long-Duration Contracts

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

Disclosure

27. All insurance enterprises shall disclose the following in their financial statements:

a. The nature, purpose, and effect of ceded reinsurance transactions on the insurance enterprise's operations (Ceding enterprises also shall disclose the fact that the insurer is not relieved of its primary obligation to the policyholder in a reinsurance transaction.[8])
b. For short-duration contracts, premiums from direct business, reinsurance assumed, and

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reinsurance ceded, on both a written and an earned basis; for long-duration contracts, premiums and amounts assessed against policyholders from direct business, reinsurance assumed and ceded, and premiums and amounts earned

c. Methods used for income recognition on reinsurance contracts.

28. A ceding enterprise shall disclose concentrations of credit risk associated with reinsurance receivables and prepaid reinsurance premiums under the provisions of FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk.*

Amendments to Other Pronouncements

29. This Statement supersedes paragraphs 38-40 and 60(f) of Statement 60, which address reinsurance, and incorporates the provisions of paragraphs 39 and 40 of Statement 60 in paragraph 18 of this Statement.

30. This Statement amends FASB Statement No. 5, *Accounting for Contingencies,* to include the following footnote at the end of paragraph 44:

> *Paragraphs 8-13 of FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts,* identify conditions that are required for a reinsurance contract to indemnify the ceding enterprise against loss or liability and to be accounted for as reinsurance. Any transaction between enterprises to which FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises,* applies must meet those conditions to be accounted for as reinsurance.

31. Paragraph 27 of Statement 97, which refers to the reinsurance guidance in Statement 60, is amended to read as follows:

> The provisions of Statement 60 addressing loss recognition (premium deficiency) and financial statement disclosure, and the provisions of FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts,* addressing reinsurance shall apply to limited-payment and universal life-type contracts addressed by this Statement.

32. Interpretation 39 does not modify the accounting prescribed by authoritative pronouncements in specific circumstances that result in offsetting or in a presentation that is similar to the effect of offsetting. Paragraph 7 of Interpretation 39 includes examples of that accounting and is amended to delete the reference to reinsurance in Statement 60.

Effective Date and Transition

33. This Statement is effective for financial statements for fiscal years beginning after

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December 15, 1992, with earlier application encouraged. The provisions of paragraphs 8-13 that establish the conditions for reinsurance accounting and paragraphs 17-26 that address recognition of revenues and costs of reinsurance need not be applied in financial statements for interim periods in the year of initial application, but amounts reported for those interim periods shall be restated if they are reported with annual financial statements for that fiscal year. Restatement of financial statements for earlier years to apply the provisions of paragraphs 8-13 and 17-26 is prohibited. Restatement of financial statements for earlier years to apply paragraphs 14-16 relating to gross reporting is encouraged but not required. The provisions of this Statement that establish the conditions for reinsurance accounting and address recognition of revenues and costs apply to reinsurance contracts entered into, renewed, amended,[9] or having an anniversary date in the year of adoption.

The provisions of this Statement need not be applied to immaterial items.

This Statement was adopted by the unanimous vote of the seven members of the Financial Accounting Standards Board:

Dennis R. Beresford, *Chairman*
Joseph V. Anania
Victor H. Brown
James J. Leisenring
Robert H. Northcutt
A. Clarence Sampson
Robert J. Swieringa

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Appendix A

BASIS FOR CONCLUSIONS

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Appendix A: BASIS FOR CONCLUSIONS

Introduction

34. This appendix summarizes considerations deemed significant by Board members in reaching the conclusions in this Statement. It includes reasons for accepting certain approaches and rejecting others. Individual Board members gave greater weight to some factors than to others.

35. An FASB Exposure Draft, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts,* was issued for public comment in March 1992 and distributed to members of various industry organizations, in addition to the standard distribution, to encourage comment by those most affected by the proposal. Fifty-three comment letters were received in response to the Exposure Draft. The Board concluded that it could reach an informed decision without holding a public hearing. However, those who responded to the Exposure Draft were invited to participate in a public Board meeting, which took place in September 1992.

Background Information

36. For reinsurance contracts that indemnified the ceding enterprise against risk of loss or liability, Statement 60 continued the long-established practice that originated in statutory accounting whereby ceding enterprises reported insurance activities net of the effects of reinsurance. Unearned premiums and unpaid claim liabilities represent an insurance enterprise's obligation to policyholders at different times during the period of an insurance contract. Similarly, prepaid reinsurance premiums and reinsurance receivables represent probable future economic benefits to be received from a reinsurer. Statement 60 required insurance liabilities to be reported net of the related reinsurance amounts and also allowed reporting of earned premiums and claims costs net of reinsurance amounts in the statement of earnings.

37. Whether this offsetting of reinsurance amounts in financial statements of insurance enterprises should continue has been a recurring issue. Opinion 10 states, "It is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of setoff exists." In issuing Interpretation 39, the FASB did not modify accounting treatments specified in existing FASB and AICPA accounting pronouncements that result in offsetting, including the accounting for reinsurance under Statement 60.

38. How to determine whether a reinsurance contract indemnifies the ceding enterprise against loss or liability has been another recurring issue. Statement 5 requires deposit accounting for insurance and reinsurance contracts that do not indemnify the insured or ceding

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enterprise against loss or liability. Statement 60 incorporates that guidance for reinsurance contracts without specifying further the conditions under which loss or liability is indemnified. At the time Statement 60 was issued, the insurance industry and the accounting and actuarial professions were studying what circumstances constitute indemnification against loss or liability in a reinsurance transaction.

39. Many have expressed concern about the appropriateness of reporting the effects of reinsurance on a net basis, the effect of reinsurance accounting for contracts written as reinsurance that do not indemnify the ceding enterprise against loss or liability, the adequacy of reinsurance disclosures, and the limited accounting guidance for reinsurance contracts in Statement 60. In response to those concerns, the Board decided to reconsider the reinsurance provisions of Statement 60.

40. The Board had two objectives in adding this project to its agenda. The first objective was to consider the inconsistency between accounting for reinsurance and the established criteria for offsetting and to address the perceived deficiencies in the reporting of reinsurance transactions. Amounts recoverable from reinsurers are a very significant asset for some insurance enterprises. However, the netting provisions of Statement 60 and the exclusion of insurance contracts from Statement 105 have resulted in limited reporting about the amounts receivable from reinsurers, the effects of reinsurance on the reporting enterprise's operations, and the resulting exposure to credit risk. The second objective was to address the recognition of revenues and costs resulting from reinsurance transactions. The Board concluded that it was necessary to consider the lack of guidance in Statement 60 on recognition issues relating to reinsurance because of the increasing diversity and complexity of reinsurance arrangements and the proliferation of nontraditional reinsurance contracts. There also was an apparent inconsistency between the practice of immediately recognizing gains and losses on reinsurance contracts and the premise that reinsurance does not result in extinguishment of the related liabilities.

Benefits and Costs

41. The FASB's mission statement calls for the Board to determine whether a proposed standard will fill a significant need and whether the costs it imposes, compared with the possible alternatives, will be justified in relation to the overall benefits. The costs to implement an accounting standard and the benefits of reporting consistent, comparable, and reliable information in financial statements ordinarily must be assessed in general terms and cannot be quantified. There also is no common measure for objectively comparing those costs and benefits. Moreover, implementation costs are borne primarily by the preparers of financial statements rather than the broader constituency that also benefits from improved reporting. In establishing standards that are cost-effective, the Board must balance the diverse and often conflicting needs of a variety of constituents.

42. In addressing this project, the Board determined that the information provided to users about the effects of reinsurance transactions could be improved by (a) eliminating the industry

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practice of offsetting reinsurance assets and liabilities, (b) requiring disclosures about the credit risk associated with reinsurance receivables, and (c) limiting diversity among ceding enterprises in recognizing revenues and costs from reinsurance contracts.

43. The Board concluded that not all accounting issues relating to reinsurance contracts could be effectively addressed in this Statement. However, information provided to users about the effects of reinsurance could be improved and inconsistencies could be reduced by providing guidance for both short-duration and long-duration contracts. The Exposure Draft provided only general implementation guidance and did not attempt to identify and address all issues that could arise. Some respondents recommended that the Statement provide far more extensive implementation guidance and additional examples, particularly on applying the conditions for reinsurance accounting. Those requests were evaluated individually and, in certain instances, the Board concluded that additional guidance was warranted. However, because the Board believes that the cost of implementing very detailed standards for reinsurance accounting would outweigh the benefits, the overall approach of providing general rather than detailed guidance was retained. The Board believes the increased usefulness of the information provided on the effects of reinsurance transactions will exceed the costs of complying with this Statement.

44. The information required by this Statement should be readily available to the reporting enterprise because of similar regulatory reporting guidelines. Modification of existing systems may be required to facilitate reporting concentrations of credit risk and to comply with the provisions for recognizing revenues and costs required by this Statement. The Exposure Draft would have required prospective and retroactive elements of all reinsurance contracts to be accounted for separately. Respondents indicated that the cost of allocating amounts related to these provisions could be significant and that allocation might not always be practicable. To address these concerns, the Board concluded that contracts containing both prospective and retroactive elements should be accounted for as retroactive contracts when allocation is impracticable.

Scope

45. After reviewing current practice and the nature of reinsurance contracts, the Board concluded that an extensive reconsideration of the accounting for reinsurance is not necessary at this time; concerns could be addressed by modifying the standards of financial accounting and reporting for reinsurance in Statement 60 and by providing limited additional guidance. The guidance in paragraphs 39 and 40 of Statement 60 was not reconsidered and continues in effect. The provisions of those paragraphs have been incorporated in this Statement for convenience.

46. This Statement applies to any transaction that indemnifies an insurer against loss or liability relating to insurance risk. All transactions must meet the conditions in paragraphs 8-13 of this Statement to be accounted for as reinsurance. The Exposure Draft would have amended paragraph 44 of Statement 5 to indicate that similar conditions are required for an insurance policy to indemnify the insured against loss or liability. While that amendment was not expected

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to have a significant effect in practice, some respondents indicated its effect would be greater than anticipated. The Board decided not to extend the provisions in paragraphs 8-13 to primary insurance transactions. This potential inconsistency was accepted, even though paragraph 44 of Statement 5 suggests it is appropriate to apply a uniform concept of indemnification to both insurance and reinsurance, because the Board's intention was to not significantly change the accounting for primary insurance transactions in this narrow-scope project.

47. Likewise, the Board concluded that it was not necessary to address the accounting for reinsurance by the assuming enterprise. An assuming enterprise generally accounts for a reinsurance contract in the same manner as an insurance contract sold to an individual or non-insurance enterprise, as prescribed in Statements 60 and 97. Some constituents recommended that the Board specify the accounting by assuming enterprises and require symmetrical accounting by both parties to a reinsurance transaction. Those recommendations were not adopted because addressing the accounting for assuming enterprises would inevitably require a reconsideration of the accounting for primary insurance, which was beyond this project's scope. However, the conditions for reinsurance accounting in paragraphs 8-13 and certain disclosure requirements apply to both ceding and assuming enterprises.

48. Some respondents to the Exposure Draft asked that certain types of entities or transactions be excluded from the scope. The Board was urged to limit the scope to loss portfolio transfers or other transactions that some consider prone to abusive accounting under current standards. The Board considered and rejected that approach because it perceived the need for improved accounting and reporting guidance for reinsurance in general. The transactions in question also could not be distinguished conceptually from other reinsurance transactions. Insurers may enter into various transactions with reinsurers that serve legitimate business purposes but do not meet the conditions for reinsurance accounting in this Statement. The Board's objective was only to specify the accounting standards for reinsurance, as distinct from other transactions.

49. For similar reasons, fronting arrangements are included within the scope of this Statement. Some insurance enterprises currently do not report fronting arrangements as reinsurance contracts. However, the ceding enterprise in a fronting arrangement retains the same risks associated with any other type of reinsurance contract and is not relieved of its obligation to the policyholders.

50. Several respondents questioned whether servicing carriers for involuntary risk pools should be included in the Statement's scope. Servicing carriers generally retain the primary obligation to the policyholder and have no right to offset claim liabilities against amounts due from other pool participants. Although the credit risk associated with involuntary pools may be reduced because of the pool membership's joint and several liability, the servicing carrier is still dependent on the ability of other pool members to pay their proportionate share of claims. State authorities oversee such pools and may act to support the solvency of a pool, but that action generally is voluntary. The Board concluded that it was unable to effectively distinguish servicing carrier business from other types of reinsurance for accounting purposes. Separate

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presentation or disclosure of servicing carrier activity is not precluded by this Statement.

51. Some respondents asked the Board to limit the Statement's scope to short-duration contracts, citing a perceived lack of accounting abuse related to long-duration contracts and the differences between the long-duration and short-duration insurance models. However, reinsurance of long-duration contracts sometimes is used to accelerate income recognition by effectively unlocking the assumptions used in estimating benefit reserves. In addition, reinsurance of long-duration contracts is not unique and the specific questions raised by respondents about how the standard would be applied to long-duration contracts were not so complex or difficult as to justify a separate project to develop additional detailed guidance for reinsurance of long-duration contracts.

52. Reinsurance contracts sometimes are used to "sell" a line of business by coinsuring all or substantially all of the risks related to the line. Some respondents asked that those contracts be exempt from the requirements of this Statement. The Board concluded that unless the ceding enterprise is legally relieved of its liability to the policyholder, as described in paragraph 19, such reinsurance does not constitute a sale and immediate recognition of a gain should be precluded.

53. Some respondents asked whether structured settlement transactions are included within the scope of this Statement. Structured settlements may, in some circumstances, legally replace one insurer by another and thereby extinguish the primary insurer's liability to the policyholder. This Statement requires that an immediate gain or loss be recognized when such an extinguishment occurs. A structured settlement transaction that does not constitute an extinguishment is accounted for as reinsurance if the annuity funding the settlement meets the conditions for reinsurance accounting. Otherwise, the transaction is accounted for in accordance with paragraph 18 of this Statement. Whether a ceding enterprise has been legally relieved of its entire obligation to the policyholder under a structured settlement is a factual question that depends on the settlement's terms.

54. This Statement applies only to enterprises to which Statement 60 applies and, thus, continues the exemption in Statement 60 for mutual life insurance enterprises. The Board specifically considered whether that exemption is appropriate in accounting and reporting for reinsurance. Mutual life insurance enterprises are included within the scope of Interpretation 39 and Opinion 10, suggesting that they also should be required to separately report assets and liabilities arising from reinsurance. However, the Board observed that this Statement's provisions on reporting revenues and costs are closely linked to the accounting model for long-duration contracts found in Statement 60. Determining how those provisions would apply to enterprises that do not follow the Statement 60 model might be time-consuming and could involve considering the appropriate accounting for insurance contracts by mutual life insurance enterprises.

55. The Board also noted that it has asked the AICPA to expeditiously complete its project on

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the accounting for insurance activities, including reinsurance, by mutual life insurance enterprises. Accordingly, the Board did not expand this Statement's scope to encompass those topics, and concluded that this Statement should apply only to enterprises to which Statement 60 applies.

Indemnification against Loss or Liability Relating to Insurance Risk

56. This Statement incorporates the provisions of paragraph 40 of Statement 60 that require deposit accounting for reinsurance contracts that do not indemnify the ceding enterprise against loss or liability. Those provisions incorporate without change the guidance in paragraph 44 of Statement 5. Determining whether a reinsurance contract indemnifies the ceding enterprise against loss or liability has been controversial and problematic in practice. The Board concluded that this Statement should provide general guidance on the circumstances under which reinsurance contracts provide indemnification against loss or liability and therefore meet the conditions for reinsurance accounting.

57. Transactions other than reinsurance may provide indemnification against various types of loss or liability. Under this Statement, the distinguishing characteristic of reinsurance is indemnification against loss or liability related to insurance risk. As contemplated in Statements 60 and 97, insurance risk is the risk associated with the occurrence of insured events under an insurance contract. Those risks include the uncertainties relating to both the ultimate amount of payments and the timing of those payments. Risks other than those associated with the occurrence of insured events under an insurance contract, such as the risk that investment income will vary from expectations, are not elements of insurance risk. Although insurers may face significant exposure to risks other than insurance risk, indemnification against loss or liability in a reinsurance transaction is a function of the insurance risk assumed by the reinsurer.

58. Determining whether a reinsurance contract indemnifies the ceding enterprise against loss or liability relating to insurance risk requires a complete understanding of all contracts or agreements with related reinsurers. Although an individual contract may appear to indemnify the ceding enterprise, the risk assumed by the reinsurer through one reinsurance contract may have been offset by other contracts or agreements. A contract does not meet the conditions for reinsurance accounting if features of the reinsurance contract or other contracts or agreements directly or indirectly compensate the reinsurer or related reinsurers for losses. That compensation may take many forms, and an understanding of the substance of the contracts or agreements is required to determine whether the ceding enterprise has been indemnified against loss or liability relating to insurance risk. For example, contractual features may limit the reinsurer's exposure to insurance risk or delay the reimbursement of claims so that investment income mitigates exposure to insurance risk. Examples of those contractual features, which are not intended to be all-inclusive, are included in paragraph 8 of this Statement.

59. Reinsurance programs often entail the reinsurance of various layers of exposure through multiple reinsurance contracts. The Board concluded that indemnification against loss or

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liability relating to insurance risk should be determined in relation to the provisions of the individual reinsurance contract being evaluated. That is, to meet the conditions for reinsurance accounting, the terms of the individual reinsurance contract must indemnify the ceding enterprise against loss or liability relating to insurance risk.

60. Several respondents to the Exposure Draft observed that this requirement could result in different accounting for similar transactions depending on the contractual structure of the transactions. Those respondents recommended that the conditions for reinsurance accounting be evaluated based on whether a reinsurance program, taken as a whole, indemnifies the insurer against loss or liability related to insurance risk. That approach was rejected because it would not have been practicable to define what constitutes a reinsurance program. Further, contracts that are not, in substance, reinsurance could meet the conditions for reinsurance accounting by being designated as part of a program that, as a whole, met those conditions.

Reinsurance of Short-Duration Contracts

61. A short-duration insurance contract requires that an insurer make payments to the policyholder because insured events occurred during the contract period. However, an insurer's exposure to risk does not end with the close of the contract period. Exposure to risk extends beyond that date to the date when the last claim is settled and paid. During that period, many factors may affect the ultimate claims paid. Policyholders may discover and assert more claims than expected or may assert them more quickly than expected. The costs of individual claims may exceed the insurer's expectations. Courts and legislative bodies may extend the insurer's exposure beyond that originally contemplated. A reinsurance contract may limit the insurer's exposure to some or all of those circumstances. The extent of protection provided may range from very little to a considerable amount.

62. The Board concluded that two conditions must be met for reinsurance of a short-duration contract to indemnify the ceding enterprise against loss or liability relating to insurance risk. First, the reinsurer must assume significant insurance risk under the reinsured portions [10] of the underlying 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. Contractual features that delay timely reimbursement to the ceding enterprise prevent the reinsurer's payments from directly varying with the claims settled under the reinsured contracts.

63. Second, even if the first condition is met, the contract does not indemnify the ceding enterprise against loss or liability relating to insurance risk unless either (a) it is reasonably possible that the assuming enterprise may realize a significant loss [11] from the transaction or (b) the contract fulfills the condition described in paragraph 11.

64. The Exposure Draft did not specify how to determine exposure to significant loss, and a number of respondents asked for additional guidance in this area. Paragraph 10 requires that

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significance be determined based on the present value of all cash flows between the ceding and assuming enterprise under reasonably possible outcomes. All cash flows are included 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. Consistent with Statement 5, an outcome is reasonably possible if its probability is more than remote.

65. Respondents asked for more guidance about the benchmark for measuring significance. The Board clarified this provision to indicate that significance of loss is evaluated in relation to the present value of the amounts paid to the reinsurer.

66. The cash flows between the ceding and assuming enterprise and the amounts paid to the reinsurer are compared at their present values to achieve a consistent temporal frame of reference. A constant interest rate is used in determining those present values because the possibility of investment income varying from expectations is not an element of insurance risk. The Board concluded that it was not necessary to specify in detail the interest rate used in the calculation; judgment is required to identify a reasonable and appropriate rate.

67. Under very limited circumstances, the reinsurer need not be exposed to the reasonable possibility of significant loss for a contract to meet the conditions for reinsurance accounting. For example, applying the "reasonable possibility of significant loss" condition is problematic when the underlying insurance contracts themselves do not result in the reasonable possibility of significant loss to the ceding enterprise.[12] The Board concluded that, when the reinsurer has assumed substantially all of the insurance risk in the reinsured portions of the underlying policies,[13] even if that risk does not result in the reasonable possibility of significant loss, the transaction meets the conditions for reinsurance accounting. In this narrow circumstance, the reinsurer's economic position is virtually equivalent to having written the insurance contract directly. The risks retained by the ceding enterprise are insignificant, so that the reinsurer's exposure to loss is essentially the same as the insurer's.

Reinsurance of Long-Duration Contracts

68. The Board considered the concept of insurance risk as it relates to certain long-duration contracts when it deliberated Statement 97 and concluded that, to be considered insurance, those contracts must subject the insurance enterprise to mortality or morbidity risk. Indemnification of a ceding enterprise against loss or liability relating to insurance risk under a related reinsurance contract requires that the reinsurer be subject to those same risks. Even though other risks, such as investment yield risk, are significant business elements of a long-duration insurance contract, those risks are not unique to insurance or reinsurance. Consistent with Statement 97, reinsurance of long-duration contracts that does not subject the reinsurer to mortality or morbidity risks associated with the underlying reinsured contracts is, in substance, an investment contract. The Board also concluded that for a long-duration contract to meet the conditions for reinsurance

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accounting, the contract must subject the reinsurer to the reasonable possibility of significant loss from the insurance risk assumed.

69. Statement 97 focuses on certain life insurance-type contracts and excludes various other types of long-duration contracts, such as health and disability insurance contracts. The Board concluded that the conditions for reinsurance accounting for other types of long-duration contracts should be consistent with those described in paragraph 68 of this Statement. To be accounted for as reinsurance, the contract must subject the reinsurer to the risks insured by the underlying reinsured contracts.

Reporting Assets and Liabilities Related to Reinsurance Transactions

70. The Actuarial Standards Board's Actuarial Standard of Practice No. 11, *The Treatment of Reinsurance Transactions in Life and Health Insurance Company Financial Statements,* acknowledges the need to evaluate the gross liability to policyholders in establishing an appropriate net liability under a reinsurance contract. Auditing guidance issued by the AICPA identifies reinsurance as an area with potential for increased audit risk and emphasizes the exposure associated with the gross insurance liability. However, some observers have expressed concern that actuarial and audit practices sometimes focus on net exposures and may fail to adequately assess and analyze gross exposures.

71. The Board determined that the net reporting of assets and liabilities related to reinsurance is inconsistent with the established conditions for offsetting and does not result in a meaningful presentation in financial statements of insurance enterprises. Some respondents to the Exposure Draft objected to gross reporting on the basis that disclosure is adequate to ensure a meaningful presentation. However, disclosure of offsetting amounts is not equivalent to the recognition of assets and liabilities in the statement of financial position. In addition, some reinsurance disclosures are not easily understood or comparable with disclosures of other insurance enterprises.

72. The net accounting for reinsurance prescribed in Statement 60 also may obscure the required accounting for the underlying reinsured contracts. A number of constituents indicated that the current practice of reporting insurance net of reinsurance activity is consistent with the way insurers view and manage their businesses. These constituents maintained that reporting the net exposure from the reinsured contracts appropriately reflects the role of reinsurance in mitigating risk. However, the existence of a reinsurance contract does not alter the measurement of the liabilities that should be recognized on the underlying reinsured contracts. The Board concluded that separate reporting of reinsurance receivables and the related liabilities will provide a more relevant and representationally faithful presentation of the effects of reinsurance. The additional disclosures required for reinsurance transactions in paragraph 27 should provide users of financial statements with information about the purpose of reinsurance and its role in mitigating risk.

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73. The Board also concluded that reinsurance receivables should be recognized consistent with recognition of the liabilities related to the underlying reinsured contracts. Because the valuation of reinsurance receivables depends on the terms of the reinsurance contract and on estimates used in measuring the liabilities relating to the reinsured contracts, the Board chose not to stipulate a specific valuation method. However, the ceding enterprise must assess the collectibility of those receivables in accordance with Statement 5.

74. Some respondents to the Exposure Draft disputed the Board's characterization of reinsurance receivables on unpaid claims as assets. In their view, the reporting of a claim is the event triggering asset recognition; otherwise, the reinsurer has no contractual obligation to the ceding enterprise. However, reinsurance receivables on unpaid claims represent probable future economic benefits controlled by the ceding enterprise as a result of the payment of a reinsurance premium and the occurrence of an insured event. The entity that controls the economic benefit need not have the ability to convert it to cash or another asset immediately, through sale or assertion of a contractual right, to meet the established criteria for recognition. Reporting and settlement of claims relate to measurement of the asset rather than the criteria for recognition. Those events represent the conditions [14] necessary to establish the ultimate amount of the asset and the timing of its collection.

75. Some respondents suggested that reinsurance recoverables be reported as valuation accounts associated with the claim liability. FASB Concepts Statement No. 6, *Elements of Financial Statements,* paragraph 43, describes a liability valuation account:

> A separate item that reduces or increases the carrying amount of a liability is sometimes found in financial statements. For example, a bond premium or discount increases or decreases the face value of a bond payable to its proceeds or present value. Those "valuation accounts" are part of the related liability and are neither liabilities in their own right nor assets.

Reinsurance receivables are an asset, not a liability valuation account. Valuation accounts exist only as part of a measurement of a liability, not as a complete measurement of a liability.

76. Amounts recoverable from reinsurers on unasserted claims may be included with other reinsurance receivables in the statement of financial position. Some respondents objected to the combined presentation because users of financial statements might find that presentation confusing. However, similar concerns could be expressed about other balances typically reported in an insurer's financial statements. For example, claim liabilities generally include amounts relating to both reported and unreported claims. Although this Statement requires amounts recoverable on unasserted claims to be reported as reinsurance receivables, it does not preclude separate presentation or disclosure of various types of receivables.

77. Statement 60 requires that unearned premiums received by an insurance enterprise relating to the unexpired portion of short-duration contracts be reported separately from other liabilities.

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The Board concluded that a ceding enterprise should likewise report amounts paid to reinsurers relating to the unexpired portion of short-duration contracts (referred to in Statement 60 as ceded unearned premiums) separately from reinsurance receivables. Those amounts represent prepaid premiums on prospective reinsurance contracts.

78. Several balances may arise between the ceding and assuming enterprise in a reinsurance contract, including funds withheld on ceded premiums, commissions, unsettled claims, and funds advanced by the assuming enterprise. Those items may qualify for offsetting under the conditions established by Interpretation 39, and this Statement does not preclude offsetting when appropriate. However, an insurance enterprise must evaluate each situation in light of the conditions required for offsetting in determining the appropriate financial statement presentation.

79. Some respondents suggested that gross reporting of amounts related to reinsurance would result in less useful financial statements. Those respondents generally maintained that users of financial statements are more interested in the net exposure, consistent with the way management views its business. Some were concerned that enterprises engaging heavily in reinsurance transactions will be perceived as being financially stronger because of the correspondingly larger assets and liabilities that will be reported. Others stated that financial ratios and trend data used by analysts will be adversely affected by the change. Respondents also suggested that commingling assets and liabilities related to servicing carrier business with other types of reinsurance will diminish the usefulness of financial statements. However, a number of respondents indicated that gross information would be more useful than net information.

80. The comments on usefulness often referred to the perceived relevance and representational faithfulness of net reporting. The Board carefully considered those comments and concluded that financial statements from which significant amounts of assets and liabilities are omitted generally lack relevance and are not representationally faithful. Offsetting reinsurance assets against the related liabilities implies a relationship between those assets and liabilities that does not exist unless the established criteria for offsetting are met. Further, offsetting reinsurance receivables against the related liabilities obscures the credit risk associated with reinsurance.

81. Examples of other accounting literature in which net reporting is permitted, such as pension accounting and leveraged leases, were cited by some respondents as a basis for continuing the practice of net reporting of reinsurance transactions. Interpretation 39 did not modify the accounting treatment of those transactions. The Board decided to include the exemptions in Interpretation 39 as a practical matter to avoid disturbing certain longstanding accounting practices without full exploration of the issues involved. Having addressed those issues for reinsurance, the Board concluded that the benefits of reporting reinsurance assets and liabilities separately are sufficient to justify the change.

82. A number of respondents asked the Board to consider allowing reinsurance recoverables

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on unpaid claims to be reported as a contraliability against claim reserves, rather than as an asset. Many of the same arguments made against gross reporting were provided as reasons for a contraliability presentation.

83. Advocates of a contraliability presentation also observed that the amount recoverable from the reinsurer and the related claim liabilities are difficult to measure. In their view, the volatile nature of the reinsured risks renders the gross amounts unreliable, but the presence of reinsurance permits measurement of a net exposure with more reliability. Contraliability presentation would minimize the effect of that volatility by presenting the reinsurance recoverable and the related liabilities together.

84. Advocates of a contraliability presentation also cited the linkage between the reinsured liabilities and the amounts recoverable from the reinsurer. In reinsurance, the asset arises from and is dependent on the same transaction as the liability for both the amount and timing of its realization. These respondents believe that relationship is more faithfully represented by displaying those amounts together rather than as a separate asset and liability.

85. The Board acknowledged the potential volatility of the estimates and the close linkage between the asset and liability but rejected the contraliability approach. Reinsurance recoverables on unpaid claims meet the qualifications for recognition as an asset and should be reported as such. Contraliabilities are not considered a financial statement element under the Board's conceptual framework. The Board also was not persuaded that the characteristics of a reinsurance transaction are sufficiently different from other transactions to justify a presentation other than that prescribed in Interpretation 39. The additional disclosure requirements this Statement prescribes, including the requirement to disclose the nature, purpose, and effect of reinsurance on the enterprise's operations, should provide users of financial statements with additional information to assess the effect of volatility and the ability of reinsurance to mitigate it.

86. Paragraph 38 of Statement 60 allowed, but did not require, amounts paid to reinsurers and reinsurance recoveries to be netted against related earned premiums and incurred claim costs in the statement of earnings. Most enterprises report those amounts on a net basis consistent with the presentation in the statement of financial position. The Board determined that reporting gross amounts in the statement of earnings would be preferable. However, the Board acknowledged that the reasons for gross reporting in the statement of earnings are less compelling. Opinion 10 and Interpretation 39 address only the offsetting of assets and liabilities. Further, unlike the statement of financial position, the statement of earnings does not convey information about credit risk.

87. As proposed in the Exposure Draft, enterprises could have reported the effects of reinsurance on earned premiums and claim costs (that is, the amount by which earned premiums are reduced by amounts paid or payable to reinsurers, and the amount by which claim costs are reduced by amounts received or receivable from reinsurers) either as separate line items or

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parenthetically within the statement of earnings. Appendix B illustrates those presentations. Respondents recommended that the Board also allow those amounts to be reported net, with appropriate footnote rather than parenthetical disclosure. The Board agreed that earned premiums ceded and reinsurance recoveries may be disclosed rather than reported separately in the statement of earnings.

Recognition of Revenues and Costs

88. Accounting for the effects of reinsurance contracts on the revenues and costs of the ceding enterprise is complicated because reinsurance contracts serve various objectives. An insurance enterprise 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 enterprise. The insurance enterprise 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. It is not practicable to identify and separately account for each individual element of a reinsurance contract, and the guidance in Statement 60 is inadequate to result in consistent accounting for the payments and proceeds resulting from reinsurance contracts. The Board determined that this Statement should prescribe in more detail the accounting for revenues and costs of reinsurance contracts.

89. Although a contract may meet the conditions for reinsurance accounting, the difference between the amount paid to the reinsurer and the liabilities related to the reinsured contracts may result from underwriting, investment, service, sales, or financing activities. Varying applications of the provisions of Statement 60 have sometimes resulted in immediate recognition of a gain or loss equal to that difference. The Exposure Draft concluded that immediate recognition of gains or losses from reinsurance contracts generally is inappropriate and inconsistent with the premise that the insurance enterprise has not been relieved of its obligations to the holders of the reinsured contracts.[15]

90. Some constituents stated that it would be appropriate to recognize the effects of reinsurance in income immediately, referring to reinsurance as a sale or a form of extinguishment of debt. Others stated that, when the ceding enterprise has been indemnified against loss or liability relating to insurance risk, sufficient risk has been transferred to the reinsurer to result in immediate recognition. However, in the Board's view, immediate recognition is not appropriate unless an extinguishment has taken place. The conditions necessary for indemnification against insurance risk are considerably less stringent than those required for extinguishment, which occurs only when the ceding enterprise has been entirely relieved of its obligations to the policyholder.

91. A few respondents stated that the reinsurance transaction is a significant event that should result in remeasurement of the related liabilities and recognition of the effects of remeasurement in income. The Board concluded that reinsurance does not alter the nature or amount of the obligations owed to the policyholder. Rather, the ceding enterprise has acquired a separate

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asset—the right to recoveries from the reinsurer.

92. Some respondents said that the significant gains sometimes recognized by ceding enterprises under the current standards result from an accounting anomaly, and the Board's proposed accounting would not resolve that anomaly. The amounts paid to the reinsurer may reflect the time value of money as an element of pricing. The ceding enterprise's gains occur at least partly because the related liabilities are not stated at present value under current accounting standards. Several constituents recommended that the Board defer reaching a conclusion about reinsurance until the fundamental question of the role of discounting in measuring assets and liabilities is resolved. Those constituents correctly described the nature of the issue, but the Board decided that delaying resolution of the inconsistencies in reinsurance accounting would not be appropriate.

93. The Board concluded that estimated reinsurance receivables should be recognized in a manner consistent with the related liability. The accounting for amounts that represent recovery of acquisition costs is addressed in paragraph 39 of Statement 60 and incorporated in paragraph 18 of this Statement. Other amounts paid or received, other than advances or forms of collateral, are presumed to be part of the net cost of reinsurance discussed in paragraphs 94-109.

Recognition of Revenues and Costs for Reinsurance of Short-Duration Contracts

94. Contracts that meet the conditions for reinsurance accounting also may include elements of a financing arrangement. Existing accounting pronouncements do not provide guidance that would allow an insurer to identify the separate elements and costs of reinsurance. If a reinsurance contract is prospective, reinsurance activities affect the results of the ceding enterprise while the reinsured contracts are in force (the contract period) and during the subsequent period over which claims are settled. If a reinsurance contract is retroactive, the coverage period is closed and the reinsurance contract can affect only the remaining settlement period.

95. 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 prior to entering into the reinsurance contract is a retroactive contract.

96. Some constituents stated that, in their view, the distinction between prospective and retroactive contracts is unnecessary because all reinsurance transactions that indemnify the ceding enterprise against loss or liability relating to insurance risk should be treated alike. However, the Board was not prepared to impose settlement period accounting on all reinsurance transactions without a more complete exploration of the insurance accounting model.

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97. Some would prefer that the distinction between prospective and retroactive contracts be based on the event covered by the reinsurance contract rather than the insured event under the insurance contract. Others recommended using management's intentions to determine whether the contract is prospective or retroactive. The Board concluded that the significant distinction in reinsurance is whether an insured event has occurred under the underlying insurance contracts. The nature of the risks assumed by the reinsurer is fundamentally different when an insured event has already occurred. The Board also believes that management's intentions do not determine whether a contract is retroactive or prospective.

98. 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.[16]

99. A troublesome issue for the Board was deciding whether and how to separate the various elements of such mixed contracts. The Exposure Draft proposed separate accounting for the prospective and retroactive elements of all contracts having elements of both. Respondents observed that the cost to separate these elements could be significant and separation would not be practicable in all circumstances. They generally would have resolved this problem by making the classification based on the contract's predominant characteristics. The Board rejected that approach because the criterion for making the determination was vague and could require extremely detailed implementation guidance. When practicable, separate accounting is required for the prospective and retroactive provisions of the contract. Otherwise, the contract is classified as retroactive.

100. The Board concluded that amounts paid for prospective reinsurance should be amortized over the contract period in proportion to the amount of insurance protection provided. This approach ignores the protection provided by reinsurance over the remaining settlement period but is consistent with the basic insurance accounting model in Statement 60 for short-duration contracts, which recognizes estimated revenues and costs over the contract period. Subsequent changes in estimates are recognized in income of the period in which the estimates are changed.

101. The amounts paid for retroactive reinsurance are made up of various elements of the reinsurance contract. The primary elements are the implicit discounting of the related liabilities and a premium for indemnification against loss from adverse development on the reinsured contracts. It generally is not practicable to identify the effect of each element, and the Board has not required these elements to be accounted for separately. However, the amount paid to the reinsurer for retroactive reinsurance may exceed the recorded liabilities relating to the reinsured contracts. In the Exposure Draft, the Board concluded that amounts paid for a reinsurance

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contract in excess of the related liabilities either may result from significant risk of future adverse development under the reinsured contracts or may indicate that the liabilities are understated. The Exposure Draft would have permitted amounts in excess of the recorded liabilities to be recognized as an asset to the extent they represented protection against future adverse development.

102. Respondents who addressed this issue generally disagreed with the Board's conclusion. Some pointed out that, when such differences arise from retroactive transactions, the reinsured events have already occurred. The uncertainty that is being reinsured is the estimation of the liabilities relating to those past events, and the amount paid to the reinsurer in excess of the recorded liabilities may be viewed as representing at least the minimum liability that should be accrued. Otherwise, the amount does not reflect anticipated future recoveries from the reinsurer and should not be recorded as an asset. The Board concluded that amounts paid for retroactive reinsurance in excess of recorded liabilities should be charged to expense at the inception of the reinsurance contract. The offsetting adjustment may increase the liability, reduce the amount recoverable from the reinsurer, or both, depending on the facts and circumstances. Recognizing an appropriate liability for the claims relating to the underlying reinsured contracts may require a charge to expense greater than the amount paid in excess of the recorded liabilities, but the charge to expense will not be less than that amount.

103. The Board concluded that costs and revenues of retroactive reinsurance other than amounts in excess of the recorded liabilities should be accounted for over the settlement period of the underlying insurance contracts. Unlike prospective reinsurance, a retroactive reinsurance contract cannot provide protection over the coverage period. That period is past, and any protection provided by retroactive reinsurance must relate to the remaining settlement period.

104. Some respondents objected to the inconsistency between settlement period accounting for retroactive contracts and the contract period accounting required by the insurance accounting model. However, the Board observed that resolving that inconsistency would entail a comprehensive review of insurance accounting, including reconsideration of revenue and expense recognition, measurement (discounting), and financial statement presentation. One solution to the inconsistency that likely would be considered if such a comprehensive review were undertaken is accounting for all insurance and reinsurance contracts over the settlement period. Although the Board has not deliberated this issue, some believe that the settlement period best represents the period over which services are provided by insurers and reinsurers and, therefore, is the appropriate period over which all revenues and costs should be recognized. The Board concluded that the concerns raised in this project are not sufficient to expand the scope to a general reconsideration of insurance accounting and that users would be better served by a more timely resolution of concerns specific to reinsurance reporting.

105. The Board faced similar issues in defining the amortization method for gains deferred for retroactive reinsurance contracts. To the extent the deferred gain arises from the implicit discounting of liabilities, amortization using the interest method would appear appropriate.

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However, the difference being amortized is the net accounting effect of all elements of the reinsurance contract, including the effects of discounting and of the premium paid for indemnification against loss or liability relating to insurance risk. Separate identification and accounting for each element is not considered feasible and would have greatly increased the complexity of this Statement. The interest method also requires estimates of the amount and timing of payments, which may not be practicable in some circumstances. Consequently, the Exposure Draft would have permitted ratable recognition as amounts are recovered under the reinsurance contract (the recovery method) or on a straight-line basis.

106. The Board's decision to eliminate the deferral of amounts in excess of recorded liabilities (as described in paragraph 23) made the straight-line method unnecessary. Many respondents to the Exposure Draft found that method objectionable on conceptual grounds. A number of respondents also recommended that the interest method be required when practicable. Upon reconsideration, the Board agreed to require the interest method when the amount and timing of the recoveries can be reasonably estimated and require the recovery method in other circumstances.

107. Amortization of deferred amounts arising from retroactive reinsurance under both the interest method and the recovery method is based on the ceding enterprise's estimates of the expected timing and total amount of cash flows. The Board concluded that the timing of changes in those estimates should not alter the recognition of the revenues and costs of reinsurance. Therefore, this Statement requires changes in estimates of the amount recoverable from the reinsurer to be accounted for consistently both at the inception of and after the reinsurance transaction.

108. Establishing an amount recoverable from a reinsurer may result in a deferred gain, reflecting the amount by which the recorded liabilities exceed the amounts paid to the reinsurer. Likewise, a change in the estimate of the amount recoverable from a reinsurer after the inception of the reinsurance transaction results in or adjusts the amount of a deferral. Previously deferred amounts are reduced when the estimate is decreased. However, if the revised estimate of the related liabilities is less than the amounts paid to the reinsurer, a loss is not deferred. The resulting difference is charged to expense, as described in paragraph 23.

109. Changes in the estimated amount recoverable from a reinsurer or the timing of receipts related to those amounts affect amortization through a catch-up adjustment. When the change in estimate is recognized, the deferral is adjusted to the balance that would have existed had the revised estimate been available at the inception of the reinsurance transaction, with an offsetting charge or credit to income.

Recognition of Revenues and Costs for Reinsurance of Long-Duration Contracts

110. When a long-duration contract is reinsured, there may be a difference between the amounts paid for the reinsurance contract and the amount of liabilities related to the underlying reinsured contracts. That difference results from differences between the assumptions used by

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the ceding enterprise and those used by the reinsurer in estimating the future performance of the reinsured contracts.

111. The Board concluded that the difference between the amounts paid for a reinsurance contract and the amount of liabilities related to the underlying long-duration contracts should be considered part of the net cost of the reinsurance at the time it is acquired. The cost of reinsurance should be recognized over the remaining life of the underlying reinsured contracts unless the reinsurance contract is short duration in nature, when the cost should be recognized over the period of the reinsurance contract. Determining whether reinsurance of a long-duration contract is short duration in nature is a matter of judgment. 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. Paragraphs 7 and 8 of Statement 60 provide guidance on distinguishing between short-duration and long-duration contracts.

Disclosure

112. Statement 60 required disclosure of the nature and significance of reinsurance transactions to the enterprise's operations, including total reinsurance premiums assumed and ceded, and estimated amounts recoverable from reinsurers, which are offset against claim liabilities. Current reinsurance disclosures are not comparable, are often difficult to understand, and are not as useful as they could be in assessing the effect of reinsurance on the operating results of an insurance enterprise. Moreover, disclosures about the credit risk associated with reinsurance receivables currently are not provided.

113. This Statement supersedes the disclosure requirements in paragraph 60(f) of Statement 60. Because of the complexities of reinsurance, the Board concluded that the gross amounts reported in the financial statements should be supplemented by disclosure about the nature, purpose, and effect of reinsurance transactions on the ceding enterprise. However, because the uses of reinsurance are varied, the Board did not specify what information is useful in assessing the effect of reinsurance, other than to require an indication by ceding enterprises that reinsurance does not relieve the insurer of its obligation to the policyholder. Appendix B provides some illustrations of disclosures required by this Statement. The Board determined that information about the significance of reinsurance, as reflected in the total amount of reinsurance premiums ceded and assumed, should be provided, including information about both written and earned premiums relating to short-duration contracts (if the difference is significant).

114. In reviewing current disclosure practices, the Board observed that credit risk associated with amounts due from reinsurers, although significant to some insurance enterprises, is not disclosed. Insurance contracts were among the financial instruments excluded from the scope of Statement 105, because the significant business risks involved generally are other than credit and market risk, namely, uncertainty about the ultimate timing and amount of claims. Because receivables and payables that result from insurance contracts are not subject to the same insurance risks that persuaded the Board to exclude insurance contracts from Statement 105, the

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Board concluded that Statement 105 disclosures are required for concentrations of credit risk for reinsurance receivables and prepaid reinsurance premiums.

115. The Board considered whether disclosures about the extent to which reinsurance contracts indemnify the ceding enterprise against loss or liability relating to insurance risk would be useful in assessing the viability of an insurance enterprise and the objectives of reinsurance. The Board decided that a specific disclosure requirement should not be imposed in this Statement. The extent to which risk is transferred between enterprises has broader implications than reinsurance. For example, those disclosures would be relevant for insurance purchased by any enterprise and for transactions that purport to hedge financial positions. Developing verifiable and reliable disclosures may be difficult, but the Board encourages appropriate disclosure of indemnification policies as part of this Statement's required disclosure about the nature and effect of reinsurance transactions.

116. Some respondents asked the Board to consider requiring numerous additional disclosures other than those included in the Exposure Draft. Several of these would have imposed more stringent requirements on insurers than are imposed on other enterprises in the same circumstances. For example, a number of respondents suggested additional disclosures about credit risk that would have effectively amended Statement 105 to result in stricter requirements for insurers. The Board rejected these suggestions because it believes disclosures applicable to all enterprises should be applied consistently across industries. In considering requests for additional disclosures, the Board also balanced concerns about "disclosure overload" with requests from some respondents for additional disclosures that financial statement users might find useful. The Board concluded that the disclosures required in this Statement achieve an appropriate balance between those concerns.

Effective Date and Transition

117. The Board concluded that this Statement should be applied in a manner that will minimize the accounting changes that must be made for existing reinsurance contracts. The Board discussed effective dates intended to allow insurance enterprises sufficient time to gather the required information for restatement of assets and liabilities of prior periods, if desired. Because information similar to that required by this Statement must be reported under current regulatory requirements and should be available to the reporting enterprise and because constituents indicated that improved reporting in this area is needed as soon as is practicable, the Board concluded that this Statement should be effective for fiscal years beginning after December 15, 1992. However, to allow more time for adoption, the provisions of this Statement relating to indemnification against loss or liability relating to insurance risk and recognition of revenues and costs need not be applied in financial statements for interim periods in the year of adoption. If those interim amounts are reported with annual financial statements for that fiscal year, restatement is required.

118. The Exposure Draft would have allowed restatement of previously reported revenues and

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costs if the financial statements also were restated to report gross amounts. Upon reconsideration, the Board concluded that restatement was not appropriate because of the significance of management's intentions in determining whether and when to enter into a reinsurance transaction. Prohibiting restatement of revenues and costs also will result in more consistent reporting during the transition period and will lessen implementation costs for some enterprises.

119. The Exposure Draft would have applied to transactions entered into or renewed in the year of adoption. Respondents asked how this provision should be applied to continuous and multiple-year contracts and to contract amendments. The Board concluded that this Statement should apply to transactions having an anniversary date in the year of adoption, effectively subjecting all in-force reinsurance contracts to its provisions. The Board also concluded that this Statement should apply to all contract amendments, including amendments of contracts that were otherwise excluded from this Statement under the transition provisions. However, because financial statements will not be restated to reflect the provisions on recognition of revenues and costs, previously recognized amounts relating to existing contracts are not affected by this Statement.

Appendix B: ILLUSTRATIONS

Introduction

120. This appendix contrasts reporting of gross amounts for reinsurance contracts, as required by this Statement, and reporting of net amounts for those contracts, as previously required by Statement 60. The requirements of this Statement are applied to a property-casualty insurance enterprise that issues short-duration contracts in Illustration 1 and to a life insurance enterprise that issues long-duration contracts in Illustration 2. The illustrations include examples of reinsurance disclosures that would be appropriate under the provisions of this Statement. Significant judgment is required in assessing the adequacy of disclosures. These examples are not intended to incorporate all possible types of disclosure that may be relevant.

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Illustration 1

The Property-Casualty Insurance Company
Statement of Financial Position
(in millions)

	Gross	Net [a]
Assets:		
Investments	$ 8,500	$ 8,500
Cash	20	20
Receivables:		
Reinsurance [b]	1,400	100
Other	1,900	1,900
Deferred policy acquisition costs	300	300
Prepaid reinsurance premiums [c]	250	—
Other assets	1,400	1,400
Total assets	$13,770	$12,220
Liabilities and equity:		
Liabilities for claims and claim settlement 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

The Property-Casualty Insurance Company
Statement of Earnings
(in millions)

	Gross	Net [a]
Revenues:		
Premiums earned	$3,350	$2,900
Premiums ceded [d]	(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:		
Claims and claim settlement expenses	2,200	1,900
Reinsurance recoveries [d]	(300)	—
Net claims and claim settlement expenses	1,900	1,900

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The Property-Casualty Insurance Company
Statement of Earnings
(in millions)

	Gross	Net [a]
Revenues:		
Premiums earned	$3,350	$2,900
Premiums ceded [d]	(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:		
Claims and claim settlement expenses	2,200	1,900
Reinsurance recoveries [d]	(300)	—
Net claims and claim settlement expenses	1,900	1,900
Policy acquisition costs	1,450	1,450
Other expenses	1,150	1,150
Total expenses	4,500	4,500
Earnings before tax	$ 500	$ 500

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The Property-Casualty Insurance Company
Notes to Financial Statements

Summary of Significant Accounting Policies

In the normal course of business, the Company seeks to reduce the loss that may arise from catastrophes or other events that cause unfavorable underwriting results by reinsuring certain levels of risk in various areas of exposure with other insurance enterprises or reinsurers.

Amounts recoverable from reinsurers are estimated in a manner consistent with the claim liability associated with the reinsured policy. The amount by which the liabilities associated with the reinsured policies exceed the amounts paid for retroactive reinsurance contracts is amortized in income over the estimated remaining settlement period using the interest method. The effects of subsequent changes in estimated or actual cash flows are accounted for by adjusting the previously deferred amount to the balance that would have existed had the revised estimate been available at the inception of the reinsurance transactions, with a corresponding charge or credit to income.

Reinsurance

Reinsurance contracts do not relieve the Company from its obligations to policyholders. Failure of reinsurers to honor their obligations could result in losses to the Company; consequently, allowances are established for amounts deemed uncollectible. The Company evaluates the financial condition of its reinsurers and monitors concentrations of credit risk arising from similar geographic regions, activities, or economic characteristics of the reinsurers to minimize its exposure to significant losses from reinsurer insolvencies. At December 31, 19X3, reinsurance receivables with a carrying value of $260 million and prepaid reinsurance premiums of $45 million were associated with a single reinsurer. The Company holds collateral under related reinsurance agreements in the form of letters of credit totaling $150 million that can be drawn on for amounts that remain unpaid for more than 120 days.

The effect of reinsurance on premiums written and earned is as follows (in millions):

	Written	**Earned**
Direct	$2,880	$2,730
Assumed	630	620
Ceded	(470)	(450)
Net premiums	$3,040	$2,900

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Illustration 2

The Life Insurance Company
Statement of Financial Position
(in millions)

	Gross	Net[a]
Assets:		
Investments	$13,100	$13,100
Cash	20	20
Receivables:		
Reinsurance [b]	1,400	100
Other	1,900	1,900
Deferred policy acquisition costs	300	300
Other assets	1,400	1,400
Total assets	$18,120	$16,820
Liabilities and equity:		
Liability for policy benefits	$ 7,200	$ 6,300
Policyholders' contract deposits	5,000	4,600
Other liabilities	3,750	3,750
Equity	2,170	2,170
Total liabilities and equity	$18,120	$16,820

The Life Insurance Company
Statement of Earnings
(in millions)

	Gross	Net[a]
Revenues:		
Premiums and policyholder fees earned	$3,350	$2,900
Premiums ceded [c]	(450)	—
Net premiums and policyholder fees earned	2,900	2,900
Net investment income	1,700	1,700
Other revenues	400	400
Total revenues	5,000	5,000
Expenses:		
Policyholder benefits	2,200	1,900
Reinsurance recoveries [c]	(300)	—
Net policyholder benefits	1,900	1,900

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Amortization of deferred policy acquisition costs	950	950
Other expenses	1,650	1,650
Total expenses	4,500	4,500
Earnings before tax	$ 500	$ 500

The Life Insurance Company
Notes to Financial Statements

Summary of Significant Accounting Policies

In the normal course of business, the Company seeks to limit its exposure to loss on any single insured and to recover a portion of benefits paid by ceding reinsurance to other insurance enterprises or reinsurers under excess coverage and coinsurance contracts. The Company retains a maximum of $500,000 of coverage per individual life.

Amounts paid or deemed to have been paid for reinsurance contracts are recorded as reinsurance receivables. The cost of reinsurance related to long-duration contracts is accounted for over the life of the underlying reinsured policies using assumptions consistent with those used to account for the underlying policies.

Reinsurance

Reinsurance contracts do not relieve the Company from its obligations to policyholders. Failure of reinsurers to honor their obligations could result in losses to the Company; consequently, allowances are established for amounts deemed uncollectible. The Company evaluates the financial condition of its reinsurers and monitors concentrations of credit risk arising from similar geographic regions, activities, or economic characteristics of the reinsurers to minimize its exposure to significant losses from reinsurer insolvencies. At December 31, 19X3, reinsurance receivables with a carrying value of $260 million were associated with a single reinsurer. The Company holds collateral under related reinsurance agreements in the form of letters of credit totaling $150 million that can be drawn on for amounts that remain unpaid for more than 120 days.

The effect of reinsurance on premiums and amounts earned is as follows (in millions):

Direct premiums and amounts assessed against policyholders	$2,730
Reinsurance assumed	620
Reinsurance ceded	(450)
Net premiums and amounts earned	$2,900

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Appendix C: GLOSSARY

121. This appendix defines certain terms as they are used in this Statement. Various other terms common to the insurance industry are defined in Appendix A of Statement 60.

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

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

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

Fronting arrangements
Reinsurance arrangements in which the ceding enterprise issues a policy and reinsures all or substantially all of the insurance risk with the assuming enterprise.

Insurance risk
The risk arising from uncertainties about both (a) the ultimate amount of net cash flows from premiums, commissions, claims, and claim settlement expenses paid under a contract (often referred to as underwriting risk) and (b) the timing of the receipt and payment of those cash flows (often referred to as 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.

Prospective reinsurance
Reinsurance in which an assuming enterprise agrees to reimburse a ceding enterprise 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.

Reinsurance receivables
All amounts recoverable from reinsurers for paid and unpaid claims and claim settlement expenses, including estimated amounts receivable for unsettled claims, claims incurred

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but not reported, or policy benefits.

Reinsurer

Refer to **Assuming enterprise.**

Retroactive reinsurance

Reinsurance in which an assuming enterprise agrees to reimburse a ceding enterprise 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 enterprise expects to recover substantially all amounts due from the reinsurer under the terms of the reinsurance contract.

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Footnotes

FAS113, Footnote 1--The term *claim* is used in this Statement in the sense used in FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises,* to describe a demand for payment of a policy benefit because of the occurrence of an event insured by a long-duration or short-duration insurance contract.

FAS113, Footnote 2--Words that appear in the glossary are set in **boldface type** the first time they appear.

FAS113, Footnote 3--Payments and receipts under a reinsurance contract may be settled net. The ceding enterprise may withhold funds as collateral or may be entitled to compensation other than recovery of claims. Determining the amounts paid or deemed to have been paid (hereafter referred to as "amounts paid") for reinsurance requires an understanding of all contract provisions.

FAS113, Footnote 4--This condition is met only if insignificant insurance risk is retained by the ceding enterprise on the reinsured portions of the underlying insurance contracts. The term *insignificant* is defined in paragraph 8 of 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,* to mean "having little or no importance; trivial" and is used in the same sense in this Statement.

FAS113, Footnote 5--Paragraph 29 of Statement 60 addresses recognition of acquisition costs.

FAS113, Footnote 6--Decreases in the estimated amount of the liabilities shall reduce the related amount recoverable from the reinsurer and accordingly reduce previously deferred gains. 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 23.

FAS113, Footnote 7--This term is used in the sense used in paragraph 15 of FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments,* to mean that the prospective and retroactive provisions can be accounted for separately without incurring excessive costs.

FAS113, Footnote 8--As indicated in paragraph 16, the amount of recoveries recognized under reinsurance contracts also must be disclosed by the ceding enterprise if not reported separately in the statement of earnings.

FAS113, Footnote 9--Any change or adjustment of contractual terms is considered an amendment for purposes of applying this Statement.

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FAS113, Appendix A, Footnote 10--A ceding enterprise 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.

FAS113, Appendix A, Footnote 11--The Exposure Draft would have required the possibility of significant gain or loss. Based on comments received, the Board concluded that possibility of loss is the essential condition for indemnification and deleted the reference to gain from this Statement.

FAS113, Appendix A, Footnote 12--Most commonly, this arises when an individual risk or insurance contract, rather than a group of risks or contracts, is reinsured. The probability of loss from any individual short-duration insurance contract generally is considered to be remote. Therefore, outcomes that would expose the assuming enterprise to risk of significant loss ordinarily could not be characterized as reasonably possible.

FAS113, Appendix A, Footnote 13--It is presumed that those policies qualify as insurance for accounting purposes.

FAS113, Appendix A, Footnote 14--Among the transactions specifically addressed by Interpretation 39 is the offsetting of amounts related to conditional contracts, whose obligations or rights depend on the occurrence of some specified future event that is not certain to occur.

FAS113, Appendix A, Footnote 15--The Board decided, as a number of respondents to the Exposure Draft recommended, that losses relating to retroactive contracts should be distinguished from other gains and losses arising from reinsurance transactions. The accounting for retroactive contracts is described in paragraphs 22-24.

FAS113, Appendix A, Footnote 16--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 must be determined based on the facts and circumstances.

FAS113, Appendix B, Footnote a--Net numbers are presented for illustrative comparison and are not required by this Statement.

FAS113, Appendix B, Footnote b--Under Statement 60 requirements, typically only the amount receivable for paid claims and claim settlement expenses would be reported as a reinsurance receivable. This Statement requires that estimated amounts receivable from reinsurers include amounts related to paid and unpaid claims and claims incurred but not reported. Details of the

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amounts comprising reinsurance receivables may be presented separately.

FAS113, Appendix B, Footnote c--Prepaid reinsurance premiums include amounts paid to reinsurers relating to the unexpired portion of reinsured policies, often referred to as ceded unearned premiums.

FAS113, Appendix B, Footnote a--Net numbers are presented for illustrative comparison and are not required by this Statement.

FAS113, Appendix B, Footnote d--Alternatively, the effect of reinsurance on premiums earned and claim costs may be shown parenthetically or may be disclosed. For example, following is an illustration of a parenthetical presentation:

Premiums earned (net of premiums ceded totaling $450)	$2,900
	=====
Claims and claim settlement expenses	
(net of reinsurance recoveries totaling $300)	$1,900
	=====

FAS113, Appendix B, Footnote d--Alternatively, the effect of reinsurance on premiums earned and claim costs may be shown parenthetically or may be disclosed. For example, following is an illustration of a parenthetical presentation:

Premiums earned (net of premiums ceded totaling $450)	$2,900
	=====
Claims and claim settlement expenses	
(net of reinsurance recoveries totaling $300)	$1,900
	=====

FAS113, Appendix B, Footnote a--Net numbers are presented for illustrative comparison and are not required by this Statement.

FAS113, Appendix B, Footnote b--Under Statement requirements, typically only the amount receivable for benefits and expenses paid would be reported as a reinsurance receivable. This Statement requires that estimated amounts receivable from reinsurers include amounts related to paid and unpaid benefits, including amounts related to liabilities recognized for future policy benefits. Details of the amounts comprising reinsurance receivables may be presented separately.

FAS113, Appendix B, Footnote a--Net numbers are presented for illustrative comparison and are not required by this Statement.

FAS113, Appendix B, Footnote c--Alternatively, the effect of reinsurance on premiums earned

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and benefit costs may be shown parenthetically or may be disclosed. For example, following is an illustration of a parenthetical presentation:

Premiums and policyholder fees earned (net of premiums ceded totaling $450)	$2,900
	=====
Benefits (net of reinsurance recoveries totaling $300)	$1,900
	=====

FAS113, Appendix B, Footnote c--Alternatively, the effect of reinsurance on premiums earned and benefit costs may be shown parenthetically or may be disclosed. For example, following is an illustration of a parenthetical presentation:

Premiums and policyholder fees earned (net of premiums ceded totaling $450)	$2,900
	=====
Benefits (net of reinsurance recoveries totaling $300)	$1,900
	=====

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