Introduction

In December 1992, the FASB issued Statement No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts. Statement 113 is effective for fiscal years beginning after December 15, 1992 and affects many existing reinsurance contracts, as well as all contracts entered into after the Statement's effective date.

In January, the FASB staff met with the AICPA's Insurance Companies Committee to discuss the staff's answers to implementation questions raised by the Committee and to consider other questions that have been asked about Statement 113. The Committee and others have suggested that there is a need for timely implementation guidance, particularly on transition issues, and urged that the staff's views on implementation be disseminated more broadly. This Viewpoints article addresses a number of the questions discussed at that meeting, as well as other frequently asked questions about Statement 113.

Overview

A principal objective of Statement 113 is to account for an agreement with a reinsurer according to its substance. Many of the implementation questions addressed in this article involve potential differences between a contract's form and its substance. Difficulty in evaluating a contract under Statement 113 is an indication that the contract's form and substance may differ. For example, when complicated adjustable features or options are present in a contract, close analysis may be required to determine the effect of those contractual provisions on risk transfer.

Key elements of Statement 113 relevant to a number of the implementation questions include:

- The provisions on risk transfer and recognition of revenues and costs apply to all contracts entered into, renewed, amended, or having an anniversary date in the year of adoption.
- In making the transition to the new standard, restatement of previously reported income statement amounts is prohibited without exception.
- Balance sheet amounts relating to existing contracts subject to Statement 113 that do not meet the new risk transfer provisions must be reclassified as deposits in fiscal 1993 financial statements.
- Accounting for a contract that meets the risk transfer requirements of Statement 113 depends on whether the contract is prospective, retroactive, or a blended contract. Whether a reinsurance contract, or portion of a contract, is prospective or retroactive is determined by whether the contract reinsures past or future events covered by the underlying insurance policies.

Although many implementation questions involve these points, Statement 113 represents a comprehensive revision of previous reinsurance accounting practices. Accordingly, the following
implementation guidance must be read in the context of the entire Statement.

Questions and Answers

Effective Date (♦ paragraph 33)

1. Q—[Question deleted 9/99 because the effective date of FASB Statement No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts, has passed.]

Statement 113 is effective for fiscal 1993 financial statements and applies to certain contracts having an anniversary date in the year of the Statement's adoption. Does Statement 113 first apply to those contracts beginning on their anniversary date?

A—No. The reference to anniversary date identifies which contracts are subject to Statement 113, but does not modify the Statement's effective date. Therefore, for 1993 annual financial statements, those contracts must be accounted for in accordance with Statement 113 as of the beginning of fiscal 1993.

2. Q—[Question deleted 9/99 because the effective date of Statement 113 has passed.]

Statement 113 states that the risk transfer provisions (♦ paragraphs 8-13) and the provisions for recognizing revenues and costs (♦ paragraphs 17-26) need not be applied in interim periods in the year of adoption, as long as those periods are restated when presented with annual financial statements. Does this guidance also apply to other provisions of the Statement, such as the gross reporting provisions in ♦ paragraphs 14-16?

A—No. Provisions that were not explicitly provided a delayed effective date are subject to the Statement's general effective date of January 1, 1993.

Applicability (♦ paragraph 33)

3. Q—Statement 113 applies to companies that are subject to FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises, and specifies the accounting and reporting for reinsurance contracts. What contracts are considered reinsurance contracts for purposes of applying Statement 113?

A—Statement 113 states that any transaction that indemnifies an insurer against loss or liability relating to insurance risk under the conditions set forth in ♦ paragraphs 8-13 must be accounted for as a reinsurance contract. Therefore, all contracts, including contracts that may not be structured or described as reinsurance, must be accounted for as reinsurance when those conditions are met. Furthermore, ♦ EITF Topic No. D-79, "Accounting for Retroactive Insurance Contracts Purchased by Entities Other Than Insurance Enterprises," describes the FASB staff's position that retroactive insurance contracts purchased by entities other than insurance enterprises that indemnify the insured should be accounted for similar to reinsurance contracts under Statement 113. [Revised 9/99.]

4. Q—The provisions of Statement 113 relating to risk transfer and recognition of revenues and costs apply to contracts entered into, renewed, amended, or having an anniversary date in the year of adoption. What contracts would be exempt from Statement 113 under this provision?

A—As described in ♦ paragraph 119, the Board intended all in-force reinsurance contracts having anniversary dates in the year of adoption to be subject to Statement 113. Therefore, the only contracts not subject to Statement 113 are:
• Purely retroactive short-duration contracts that cover only insured events occurring before January 1, 1993, provided those contracts were entered into before that date and are not subsequently amended.
• Contracts that expired before January 1, 1993 and are not amended after that date.
• In-force contracts that will expire without amendment after January 1, 1993 so that they are no longer in force on their 1993 anniversary dates.

5. Q—What is the anniversary date of a multiple-year reinsurance contract?
A—The anniversary date is the annual recurrence of the date on which coverage begins under the contract. Thus, a five-year contract with a June 30, 1992 effective date has an anniversary date on June 30, 1993 and is subject to Statement 113.

6. Q—Footnote 9 to ¶ Paragraph 33 defines an amendment as any change or adjustment of contractual terms. What if the change in terms is not significant, or the terms changed have no financial effect on the contract? [Revised 12/98.]
A—In general, the term amendment should be viewed broadly to include all but the most trivial changes in order to comply with footnote 9's definition of and amendment as "any change or adjustment of contractual terms" (emphasis added.) Examples of amendments include, but are not limited to, replacing one assuming company with another (including an affiliated company) or modifying the contract's limit, coverage, premium, commissions, or experience-related adjustable features. The wording in paragraph 33 and footnote 9 does not distinguish between financial and nonfinancial terms. [Revised 12/98.]

7. Q—Must Statement 113 be applied to an otherwise exempt contract if the ceding company pays additional premiums under the contract after December 31, 1992?
A—The answer depends on why the additional premiums are paid. If the additional premiums are the result of a renegotiation, adjustment, or extension of terms, the contract is subject to Statement 113. However, additional premiums paid without renegotiation, adjustment, or extension of terms would not make an otherwise exempt contract subject to Statement 113.

8. Q—¶ Paragraph 25 allows prospective and retroactive portions of a short-duration reinsurance contract to be accounted for separately, if practicable. Can the retroactive portion of an existing contract be segregated and "grandfathered" under the transition provisions of ¶ paragraph 33?
A—No. The transition provisions apply to an entire contract, which is either subject to or exempt from Statement 113. Paragraph 25 permits a ceding company to bifurcate a short-duration contract already subject to Statement 113 and then account for both the prospective and retroactive portions in accordance with the new accounting standards.

Risk Transfer (¶ paragraphs 8-13)

9. Q—Do the new risk transfer provisions apply to existing contracts that are subject to Statement 113?
A—Yes. Statement 113 applies in its entirety to all contracts subject to its provisions, including existing contracts. Therefore, those contracts must be evaluated to determine whether they qualify for reinsurance accounting.

10. Q—How does the Statement's effective date affect the assessment of whether a significant loss to the reinsurer was reasonably possible in reinsurance of short-duration contracts?
A—Under Statement 113 the risk transfer assessment is made at contract inception, based on facts and circumstances known at the time. Because that point in time has passed for existing contracts, some have suggested that the risk transfer provisions be applied as of the Statement's effective date. However, that approach to the risk transfer assessment would violate the requirement in paragraph 10 to consider all cash flows from the contract. Therefore, the test must be applied from contract inception, considering the effect of any subsequent contract amendments. Careful evaluation and considered judgment will be required to determine whether a significant loss to the reinsurer was reasonably possible at inception.

11. Q—Should risk transfer be reassessed if contractual terms are subsequently amended?

A—Yes. Consistent with paragraph 33, when contractual terms are amended, risk transfer should be reassessed. For example, a contract that, upon inception, met the conditions for reinsurance accounting under Statement 113 could later be amended so that it no longer meets those conditions. The contract should be reclassified and accounted for as a deposit in accordance with the AICPA Statement of Position 98-7, Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Risk. [Revised 9/99.]

12. Q—How should the risk transfer assessment be made when a contract has been amended?

A—Statement 113 does not prescribe a particular method for assessing risk transfer in the event of a contract amendment. Whether an amended contract in substance transfers risk must be determined considering all of the facts and circumstances in light of the Statement's risk transfer requirements. Judgment also will be required to determine whether an amendment in effect creates a new contract.

13. Q—For purposes of evaluating whether a contract with a reinsurer transfers risk, what constitutes a contract?

A—Statement 113 does not define what constitutes a "contract," which is essentially a question of substance. It may be difficult in some circumstances to determine the boundaries of a contract. For example, the profit-sharing provisions of one contract may refer to experience on other contracts and, therefore, raise the question of whether, in substance, one contract rather than several contracts exist.

Statement 113 limits the inconsistency that could result from varying interpretations of the term contract by requiring that features of the contract or other contracts or agreements that directly or indirectly compensate the reinsurer or related reinsurers for losses be considered in evaluating whether a particular contract transfers risk. Therefore, if agreements with the reinsurer or related reinsurers, in the aggregate, do not transfer risk, the individual contracts that make up those agreements also would not be considered to transfer risk, regardless of how they are structured.

Certain guidance relevant to determining the boundaries of a contract is provided in the accounting literature. As described in paragraph 8 of Statement 113, provisions of other related contracts may be considered part of the subject contract under certain circumstances. Likewise, paragraphs 59 and 60 of Statement 113 indicate that the Board did not intend for different kinds of exposures combined in a program of reinsurance to be evaluated for risk transfer and accounted for together, because that would allow contracts that do not meet the conditions for reinsurance accounting to be accounted for as reinsurance by being designated as part of a program. In addition, Question 12 above refers to the fact that an amendment of a contract may create a new contract. [Revised 12/98.]

The legal form and substance of a reinsurance contract generally will be the same, so that the risks
reinsured under a single legal document would constitute a single contract for accounting purposes. However, that may not always be the case. Accordingly, careful judgment may be required to determine the boundaries of a contract for accounting purposes. [Revised 12/98.]

If an agreement with a reinsurer consists of both risk transfer and nonrisk transfer coverages that have been combined into a single legal document, those coverages must be considered separately for accounting purposes. [Revised 12/98.]

14. Q—If the assessment of risk transfer changes after the initial assessment at contract inception, how should the ceding company account for the change?

A—The status of a contract should be determinable at inception and, absent amendment, subsequent changes should be very rare. If the risk of significant loss was not deemed reasonably possible at inception, and a significant loss subsequently occurred, the initial assessment was not necessarily wrong, because remote events do occur. Likewise, once a reasonable possibility of significant loss has been established, such loss need not occur in order to maintain the contract's status as reinsurance.

Nevertheless, Statement 113 does not preclude reclassification if the initial assessment is later deemed incorrect. However, careful consideration would need to be given to whether the reclassification represents the correction of an error.

15. Q—In reinsurance of short-duration insurance policies, Statement 113 requires that reasonably possible outcomes be evaluated to determine the reinsurer's exposure to significant loss. What factors should be considered in determining whether a scenario being evaluated is reasonably possible?

A—The term reasonably possible is used in the context of FASB Statement No. 5, Accounting for Contingencies, to mean that the scenario's probability is more than remote. The test is applied to a particular scenario, not to the individual assumptions used in the scenario. Therefore, a scenario is not reasonably possible unless the likelihood of the entire set of assumptions used in the scenario occurring together is reasonably possible.

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

A—No. Paragraph 10 states that the evaluation is based on the present value of all cash flows between the ceding and assuming enterprises under reasonably possible outcomes and therefore precludes considering other expenses of the reinsurer in the calculation.

17. Q—In evaluating the significance of a reasonably possible loss under paragraph 11, should the reasonably possible loss be compared to gross or net premiums?

A—Gross premiums should be used. Statement 113 does not provide for expenses to be deducted from premiums in evaluating the significance of a reasonably possible loss.

18. Q—How does a commutation clause affect the period of time over which cash flows are evaluated for reasonable possibility of significant loss to the reinsurer?

A—Paragraph 10 requires all cash flows to be assessed under reasonably possible outcomes. The present value of cash flows should be determined over the period in which cash flows are reasonably expected to occur. Therefore, unless commutation is expected in the scenario being evaluated, it should not be assumed in the calculation. Further, the assumptions used in a scenario
must be internally consistent and economically rational in order for that scenario's outcome to be considered reasonably possible.

19.  **Q**—What interest rate should be used in each evaluated scenario to make the present value calculation?

   **A**—◊ Paragraph 66 refers to a reasonable and appropriate interest rate. The Board explicitly chose not to give further detailed guidance on the choice of rates. However, a reasonable and appropriate rate generally would reflect the expected timing of payments to the reinsurer and the duration over which those cash flows are expected to be invested by the reinsurer.

20.  **Q**—◊ Paragraph 8 refers to payment schedules and accumulating retentions from multiple years as features that delay timely reimbursement of claims. Does the presence of those features generally prevent a contract from meeting the conditions for reinsurance accounting?

   **A**—Yes. The examples referred to in paragraph 8 are contractual features inherently designed to delay the timing of reimbursement to the ceding company. Regardless of what a particular feature might be called, ◊ paragraph 9 states that any feature that can delay timely reimbursement violates the conditions for reinsurance accounting. As indicated in ◊ paragraph 62, transfer of insurance risk requires that the reinsurer's payments to the ceding company depend on and directly vary with the amount and timing of claims settled under the reinsured contracts. Contractual features that can delay timely reimbursement prevent this condition from being met. Therefore, any feature that may affect the timing of the reinsurer's reimbursement to the ceding company should be closely scrutinized.

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

   **A**—◊ Paragraph 9 requires both of the following as conditions for reinsurance accounting:

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

   b.  Reasonable possibility of significant loss to the reinsurer.

   As stated in paragraph 9 and discussed in ◊ Question 20, features that can delay timely reimbursement violate condition (a). Because both condition (a) and condition (b) must be met, failure to transfer significant timing and underwriting risk is not overcome by the possibility of significant loss to the reinsurer.

22.  **Q**—Does Statement 113 permit evaluating timely reimbursement on a present value basis?

   **A**—No. Statement 113 uses the word *timely* in the ordinary temporal sense to refer to the length of time between payment of the underlying reinsured claims and reimbursement by the reinsurer.

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

23.  **Q**—Are there any circumstances under which the conditions in ◊ paragraph 9 for risk transfer of short-duration contracts need not be met?
A—Yes. The Board provided an extremely narrow and limited exemption for contracts that reinsure either an individual risk or an underlying book of business that is inherently profitable. Paragraph 11 specifies that when substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts has been assumed by the reinsurer, the contract meets the conditions for reinsurance accounting. To qualify under this exception, no more than trivial insurance risk on the reinsured portions of the underlying insurance contracts may be retained by the ceding company. The reinsurer's economic position must be virtually equivalent to having written the relevant portions of the reinsured contracts directly.

24. Q—in determining whether a reinsurance contract qualifies under the exception in paragraph 11, how should the economic position of the reinsurer be assessed in relation to that of the ceding company?

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

In other types of reinsurance, determining the reinsurer's net cash flows relative to the insurer is likely to be substantially more difficult. For example, it generally would be difficult to demonstrate that the ceding company's premiums and losses for a particular layer of insurance are the same as the reinsurer's premiums and losses related to that layer. If the economic position of the reinsurer relative to the insurer cannot be determined, the contract would not qualify under the exception in paragraph 11.

Accounting Provisions (paragraphs 24-26)

25. Q—how should adverse development occurring after the effective date be accounted for in retroactive reinsurance of short-duration insurance policies not subject to Statement 113?

A—Statement 60 accounting continues to apply to these contracts. Therefore, increases in amounts recoverable from the reinsurer are recognized immediately in the statement of earnings.

26. Q—an existing contract that was accounted for as reinsurance under Statement 60 no longer qualifies for reinsurance accounting under Statement 113. How should the ceding and assuming companies account for the contract under Statement 113?

A—Because the income statement cannot be restated under paragraph 33, previously recognized gains and losses are not revised. However, any existing balances related to the contract would be reclassified as deposits and accounted for in accordance with SOP 98-7. [Revised 9/99.]

Premium payments to a reinsurer would be recorded as deposits. Likewise, losses recoverable from a reinsurer would not be recognized as receivables. Rather, any reimbursement for losses would be accounted for upon receipt as a refund of deposit. Investment income and expense should be accrued on balances accounted for as deposits.

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

A—As described in paragraph 95 and Appendix C, the distinction between prospective and retroactive reinsurance is based on whether a contract reinsures future or past insured events covered by the underlying insurance contracts. In the example above, the insured event is the occurrence of loss within the coverage of the underlying insurance contracts, not the finding of a court. Therefore, the fact that the asbestos exposure or pollution is covered under insurance policies effective during prior periods makes the reinsurance coverage in this example retroactive.

28. Q—Would the answer to Question 27 change if the reinsurance were written on a claims-made basis?

A—No. The form of the reinsurance—whether claims-made or occurrence-based—does not determine whether the reinsurance is prospective or retroactive. Paragraph 95 states, "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."

29. Q—What is the effect of adjustments to future premiums or coverage in determining whether reinsurance of short-duration insurance policies is prospective or retroactive?

A—Adjustments to future premiums or coverage may affect the accounting for a reinsurance contract. As defined in Appendix C, whenever an adjustment results in a reinsurer providing new or additional coverage for past insurable events, that coverage is retroactive. For example, if subsequent years' premiums under a multi-accident year contract create additional coverage for previous accident years, the additional coverage is retroactive, even if the original coverage provided in the contract for those accident years was prospective. Likewise, if current losses under a multi-year contract eliminate coverage in future periods, some or all of the premiums to be paid in those future periods should be charged to the current period. For issues relating to multiple-year retrospectively rated contracts by ceding and assuming enterprises, refer to EITF Issue No. 93-6, "Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises," and Topic No. D-35, "FASB Staff Views on Issue No. 93-6, 'Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises'," in Appendix D of EITF Abstracts. [Revised 12/98.]

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

A—The portion of the contract related to the period of time between the effective date of the contract and the date the contract was entered into is retroactive because it covers insured events that occurred prior to entering into the reinsurance contract.

31. Q—How is the date the reinsurance contract was entered into determined?

A—Footnote 16 to paragraph 98 states, "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." For example, a contract may be considered to have been substantively entered into even though regulatory approval of that contract has not taken place.

The absence of agreement on significant terms, or the intention to establish or amend those terms at a later date based on experience or other factors, generally indicates that the parties to the
contract have not entered into a reinsurance contract, but rather have agreed to enter into a reinsurance contract at a future date. If contractual provisions under a contract substantively entered into at a future date cover insurable events prior to that date, that coverage is retroactive.

32. Q—Are contracts to reinsure calendar-year incurred losses on short-duration insurance policies considered "blended" contracts that have both prospective and retroactive elements?

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

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

A—Statement 113 does not require any specific method for allocating reinsurance premiums to the prospective and retroactive portions of a contract. However, separate accounting for the prospective and retroactive portions of a contract may take place only when an allocation is practicable.

Practicability requires a reasonable basis for allocating the reinsurance premiums to the risks covered by the prospective and retroactive portions of the contract, considering all amounts paid or deemed to have been paid regardless of the timing of payment. If a reasonable basis for allocating the premiums between the prospective and retroactive coverage does not exist, the entire contract must be accounted for as a retroactive contract.

34. Q—Paragraphs 22 and 23 require gains arising from retroactive reinsurance to be deferred and losses to be charged to expense immediately. How is this requirement affected by paragraph 24, which provides for a catch-up adjustment to reflect changes in estimates of amounts recoverable from reinsurers?

For example, assume Company A pays $100 of premium in 1993 for $150 limit of retroactive reinsurance and has recorded related liabilities of $110. Assuming a 5-year settlement period, how would adverse development of $30, or favorable development of $15, be accounted for in the subsequent year?

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

If adverse development of $30 occurred in the first year, paragraph 24 requires an adjustment to bring the balance of the deferred gain to the balance that would have existed had the revised estimate been available at inception, less cumulative amortization. The balance that would have existed at inception is $40 ($140 reserves less $100 premium) and cumulative amortization to date is $8 ($40/5 years). Therefore, a net $32 deferred gain balance is required. Company A would defer $30 of additional gain ($40 less the $10 already recorded) and credit income for $8 amortization. (Note: Straight-line amortization is used for simplicity of illustration rather than the interest or recovery methods required in paragraph 22.)

If favorable development of $15 occurred in the first year, the amount of ceded premiums ($100) would exceed the related revised liabilities ($95). Paragraph 24 states that decreases in the estimated amount of the liabilities reduce the related amount recoverable and reduce previously deferred gains. Further, if the revised estimate of the liabilities is less than the amounts paid to the reinsurer, the difference must be charged to earnings. Company A would therefore reduce the reinsurance recoverable by $15, reduce the $10 deferred gain to zero, and charge $5 to earnings.
35. **Q**—A reinsurance contract contains a "cut-through" provision that provides the ceding company's policyholders and claimants with the right to recover their claims directly from the reinsurer. May the ceding company net the recoverable due from the reinsurer against the gross loss obligations on the underlying insurance contracts?

**A**—No. As stated in ♦ paragraphs 14 and 15, reinsurance contracts in which a ceding company is not relieved of its legal liability to its policyholder do not result in removal of the related assets and liabilities from the ceding company's financial statements. Amounts receivable and payable between the ceding company and a reinsurer may be offset only when a right of setoff exists, as defined in FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*.

36. **Q**—If the example in ♦ Question 35 involved retroactive reinsurance of short-duration insurance policies that resulted in a gain to the ceding company, could that gain be recognized in income immediately?

**A**—No. ♦ Paragraph 19 states that reinsurance contracts do not result in immediate recognition of gains unless the reinsurance contract is a legal replacement of one insurer by another and thereby extinguishes the ceding company's liability to the policyholder.

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

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

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

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

**A**—No. As described in ♦ Question 36, the proposed accounting treatment is prohibited by ♦ paragraph 19. Unless the reinsurance contract results in legal replacement of one reinsurer by another, a gain may not be recognized at the inception of the contract. In the example given, the reinsurer is substantively acting as disbursing agent for the ceding company. Therefore, the ceding company cannot be said to have recovered amounts due from the reinsurer before payment is made to the claimant.

39. **Q**—Does Statement 113 provide any guidance to determine when an insurer's liability to the policyholder has been entirely extinguished?

**A**—No. Whether the liability to the policyholder has been entirely extinguished essentially is a legal question, depending on all of the facts and circumstances. ♦ Paragraph 16 of FASB
Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, provides guidance for determining when a liability has been extinguished. [Revised 9/99; 9/01.]

40. Q—Paragraph 15 states that amounts receivable and payable between a ceding company and reinsurer shall be offset only when a right of setoff exists. Is that true even when the ceding company and reinsurer are affiliated companies?

A—Yes. Unless the legal right of setoff exists as defined in Interpretation 39, these amounts may not be offset. However, the amounts would be eliminated in consolidation when the affiliated companies are included in consolidated financial statements.

Disclosures (♦ paragraphs 27 and 28)

41. Q—If a ceding company does not have a significant concentration of credit risk with a single reinsurer, are concentration of credit risk disclosures required?

A—FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, requires disclosure of concentrations arising from both individual and group counterparties. Group concentrations may exist if several counterparties are engaged in similar activities and have similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions. FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, supersedes Statement 105. However, ♦ paragraph 531(d) of Statement 133 amends FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, to incorporate the disclosures of concentrations of credit risk from Statement 105. [Revised 12/98; 9/01.]

42. Q—If the ceding company is aware that a reinsured risk or risks have been retroceded to a diverse group of retrocessionaires, must disclosures about concentrations of credit risk still be made under ♦ paragraph 28? [Revised 12/98.]

A—Yes. The assuming company's rights under the retrocessions generally are not available to the ceding company to mitigate its credit risk. Therefore, the ceding company's concentration of credit risk from the assuming company is unchanged.
Endnotes

1 (Popup - Footnote *)
Q&A 113 Footnote *—At the time of issuance of this implementation guide, Alice D. Schroeder was a project manager at the FASB. The positions and opinions expressed in the implementation guide were hers. Revisions to this implementation guide have been made by current members of the FASB staff. Official positions of the FASB are determined only after extensive due process and deliberation.

2 (Popup - Footnote 1)
Q&A 113 Footnote 1—[Footnote deleted 9/99 because the corresponding text was revised or deleted.]