

Participating (With-Profits) Contracts

Basic Issue 9 Are there any Specific Accounting Issues for Participating (With-Profits) Contracts?

433. Basic Issue 9 covers the following Sub-issues:

- (a) should unallocated **divisible surplus** be recognised as a liability or as equity;
- (b) does a mutual insurer have equity;
- (c) should insurance enterprises recognise **allocations** to participating policyholders as an expense or as an appropriation of equity;
- (d) are any specific disclosures needed about participating (with-profits) contracts; and
- (e) are there any other specific issues for mutual insurers?

Background

434. Most insurance enterprises are organised as either stockholder-owned or mutual companies. In a stockholder-owned insurer, the policyholders are the customers and the stockholders are the owners. In a mutual insurer, the policyholders are the customers and, at least notionally, are also the owners. While the mutual form of organisation is not unique to insurance enterprises, mutually-owned entities in many other industries tend to be relatively small and are organised for specific purposes. Agricultural cooperatives, credit unions, and mutual savings institutions are examples. In contrast, some mutual insurers are among the largest in their industry and provide a range of financial services in addition to traditional insurance products.
435. Some, or perhaps all, of a mutual insurer's policyholders provide the enterprise with its capital and are entitled to **allocations** of its profits or of the surplus generated by a specific fund or a specific group of contracts, under what are referred to as **participating contracts** (sometimes called **with-profits policies**). Participating contracts are also issued by some stockholder-owned insurers.
436. In some jurisdictions, participating contracts represent the majority of life insurance contracts in force for both stockholder-owned and mutual life insurers. In others, like the US, the percentage of participating contracts sold by stockholder-owned insurers has historically been small. In recent years, however, many mutual insurers have converted from policyholder to stockholder ownership (a process referred to as demutualising). As a result, some stockholder-owned insurers have a significant number of outstanding participating contracts and continue to market contracts with participating features.
437. Allocations (sometimes called **distributions**, **dividends** or **bonuses**) to participating policyholders may take a number of forms, including cash, additional insurance cover

or units in an invested fund managed by the insurer. Allocations may be made annually or at other periodic intervals throughout the term of the policy. Under some contracts, a terminal allocation is made at the end of the contract term.

438. The determination of **allocations** varies from one jurisdiction to another. At one extreme, the amount of distributions may be governed strictly by a contractual or statutory formula. At the other extreme, the management of an insurer may have almost unlimited discretion – at least in theory - to vary the amount allocated, or even to omit allocations altogether. However, the distributions are usually made annually based on the experience of the business, fund or group of contracts over a number of years. The objective is generally to return most of the surplus generated by a group of similar contracts to policyholders in that group, while leaving a portion of the profit in the insurer to provide a capital base. Another common objective is to pool investment performance over the long term to reduce the volatility of returns to policyholders.
439. Stockholder-owned insurers are often required to divide allocations between stockholders and participating policyholders in fixed proportions, although the insurer controls the amount and timing of the allocation, at least to some extent. For example, in some countries, participating contracts commonly specify that participating policyholders receive 90% of any allocation and stockholders receive the remaining 10%. In some countries, stockholders are entitled to an allocation from participating contracts only if policyholders also receive an allocation.
440. In this Paper, the term “**unallocated divisible surplus**” refers to the cumulative amount that is available for allocation to current or future policyholders (and, where applicable, stockholders) but remains unallocated. The right of any particular policyholder to unallocated divisible surplus is generally not absolute but conditional on future events, such as continuance of the contract, the payment of further premiums and allocation decisions by the insurer. In some cases, a policyholder who terminates a contract may have a right to a share of unallocated divisible surplus.
441. In some cases, an insurer will ultimately be required to allocate to policyholders, but it does not know which policyholders will receive allocation. Indeed, the insurer may not even know how much of the unallocated divisible surplus that exists currently will be allocated to current policyholders and how much will be allocated to future policyholders. In other cases, part of the unallocated divisible surplus may eventually be available for allocation to stockholders. However, the timing of that allocation may not be known – and, in some cases, the insurer may not know how much will be allocated to stockholders and how much to current and future policyholders.

Sub-issue 9A Should Unallocated Divisible Surplus be Recognised as a Liability or as Equity?

442. IASC’s Framework defines a liability as “a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits”. Under the Framework, a liability is recognised in the balance sheet when:

- (a) it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation; and
 - (b) the amount at which the settlement will take place can be measured reliably.
443. Once an insurer allocates amounts to a particular policyholder, it is clear that the insurer has a liability that should be recognised. However, there are different views on whether some or all unallocated divisible surplus represents a liability. These views are:
- (a) all unallocated divisible surplus should be classified as equity;
 - (b) all unallocated divisible surplus should be classified as a liability;
 - (c) part of the unallocated divisible surplus should be as equity and part should be classified as a liability; or
 - (d) unallocated divisible surplus is neither clearly a liability nor clearly equity and should be classified as an intermediate category.
444. Some believe that the classification of unallocated surplus may need to be different for mutual insurers than for stockholder-owner insurers. Sub-issue 8B addresses this view.

All Unallocated Divisible Surplus as Equity

445. Some argue that all unallocated divisible surplus should be classified as equity. This treatment is often supported on the basis that policyholders have a dual role – one as a customer and another as an equity participant – and allocations to participating policyholders are equity distributions. The allocations of divisible surplus are seen as being discretionary in the same way that dividends to stockholders are discretionary. It could be argued, for example, that the divisible surplus may be eliminated by a dramatic fall in asset prices and the insurer would exercise its discretion not to pay. Indeed, there would be no surplus to allocate in such an example. A counter-argument to this is that a dramatic fall in asset prices should be accounted for when it occurs and should not affect the recognition of a liability under current conditions.
446. Others oppose this approach because the insurer may have a legal or **constructive obligation** to allocate part of the unallocated divisible surplus to policyholders if any allocation is made to stockholders. Some regulators refer to constructive obligations of this kind by such terms as “policyholders’ reasonable expectations”. Also, opponents of this treatment (classifying all unallocated divisible surplus as equity) argue that it presents unallocated divisible surplus as fully available to the stockholders (in a stockholder-owned insurer) or for indefinite retention (in a mutual insurer); in their view, this would be misleading.
447. Proponents of classifying all unallocated divisible surplus as equity often argue that liabilities should be recognised only when it is known which policyholders will receive the surplus. However, others note that paragraph 20 of IAS 37 states:

An obligation always involves another party to whom the obligation is owed. It is not necessary, however, to know the identity of the party to whom the obligation is owed – indeed the obligation may be to the public at large.

448. Some argue that a policyholder’s “right” to receive future allocations of existing or future divisible surplus is only notional because it depends on the continuation of the policy and discretionary decisions by the insurer. However, others note that in some countries (such as Australia, New Zealand and the UK), life insurance contracts can be sold to a third party. Some of the value of the policy in an exchange may be due to that “right”, in which case it can be argued that the policyholder has more than a notional right to benefit from divisible surplus.

All Unallocated Divisible Surplus as a Liability

449. Some argue that all unallocated divisible surplus should be classified as a liability, particularly in a stockholder-owned company. The basis for this view is that the stockholders have no access to divisible surplus until some of it is allocated to them. Others who support this view argue that it is the most prudent approach.
450. Others oppose this approach because it treats the entire unallocated divisible surplus as a liability, even though it is expected that part of it will never be allocated to policyholders. They argue that this is misleading – and contrary to the Framework.

Unallocated Divisible Surplus as Part Liability and Part Equity

451. Some argue that:
- (a) the portion of the unallocated divisible surplus that is expected to be allocated eventually to policyholders should be classified as a liability; and
 - (b) the remainder should be classified as equity. In a stockholder-owned insurer, this portion represents the portion that is expected to be allocated eventually to stockholders. In a mutual, this portion represents the portion that is expected to be retained in the insurer indefinitely.
452. Supporters of this view argue that, where there is a legal obligation to allocate the divisible surplus to participating policyholders, a liability should be recognised. The legal obligation may be to allocate all the divisible surplus to participating policyholders or a certain percentage to participating policyholders, with the remainder being allocated to stockholders.
453. Some supporters of this view would go further. They believe that in some cases an insurer has created “reasonable expectations” on the part of participating policyholders that they will receive a share of the profits relating to the business in which they participate. Such expectations may arise from, for example, a stable pattern of past allocations or information given to prospective participating policyholders about future allocations. Proponents of this view argue that the expectations of policyholders form the basis of a constructive obligation, which gives

rise to a liability. IAS 37, Provisions, Contingent Liabilities and Contingent Assets, states that a constructive obligation arises when:

- (a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the enterprise has indicated to other parties that it will accept certain responsibilities; and
- (b) as a result, it has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

454. Some argue that an insurer may have a legal or constructive obligation towards current policyholders, but that no present obligation can exist towards future policyholders. Opponents of this view argue that an obligation may exist towards the class of all current and future policyholders.
455. Some believe that it is not always possible to estimate reliably how much of the unallocated divisible surplus will ultimately be allocated to policyholders and how much will be allocated to stockholders (or, in a mutual, retained indefinitely). To minimise the need for subjective judgments and to promote comparability, they oppose the splitting of unallocated divisible surplus into a liability component and an equity component. Alternatively, they suggest that unallocated divisible surplus should be classified by default as a liability except to the extent that it is clearly shown to have an equity component. (Some would propose equity as the default classification.)
456. In some cases, the legal position may not provide a clear basis for classifying divisible surplus. For example, where the divisible surplus has built up over a long period, some regulators may allow the stockholders to take more than their normal statutory percentage where it can be established that the divisible surplus is well in excess of the reasonable expectations of remaining participating policyholders. This situation has arisen in the UK, where the term **orphan estate** is used to refer to divisible surplus of uncertain ownership. Current practice in the UK is to treat these amounts as a separate component of equity when the regulator has agreed the basis for the allocation.
457. Some argue that information about the basis for future allocations is sensitive and that insurers should not be required to reveal this basis.
458. If part of the unallocated divisible surplus is classified as equity and part is classified as a liability, there is no need to specify when an enterprise should recognise allocations that are described as relating to the current period but are not declared formally until the following period. For example, an insurer will probably not determine the amount of allocations for 20X1 until early in 20X2 when the results for 20X1 are known. However, if all unallocated divisible surplus is classified as equity or all is classified as a liability, it will be necessary to consider when the allocations are recognised:
- (a) in the current period, on the grounds that they relate to the current period;

- (b) in the following period, on the grounds that IAS 10, Events After the Balance Sheet Date, prohibits the recognition of non-adjusting events after the balance sheet date (defined by IAS 10 as events that are indicative of conditions that arose after the balance sheet date).

Unallocated Divisible Surplus as Neither Liability nor Equity

- 459. Some take the view that unallocated divisible surplus is neither clearly a liability nor clearly equity and should be classified as an intermediate category. An example of this approach is found in the European Union's Insurance Accounts Directive. Under the Directive, member states may permit insurers to set up a **Fund for Future Appropriations** to include "funds the allocation of which either to policyholders or to shareholders has not been determined by the close of the financial year."
- 460. Others oppose this view because, under the Framework, all balance sheet items are shown as part of equity if they do not meet the Framework's definition of, and recognition criteria for, assets or liabilities.

Tentative Steering Committee View

461. *In the Steering Committee's view:*

- (a) *unallocated surplus should be classified as a liability, except to the extent that the insurer:*
 - (i) *has no legal or constructive obligation at the balance sheet date to allocate part of the surplus to current or future policyholders; or*
 - (ii) *has such a legal or constructive obligation, but cannot measure that obligation reliably; and*
 - (b) *the rest of the unallocated surplus should be classified as equity. Where there is any doubt as to whether, or what amount of, that equity will flow to the insurer's owners, the insurer should disclose the fact that the owners have restricted access to that equity.*
- 462. *Allocations made after the balance sheet date should influence the classification of unallocated divisible surplus only to the extent that they give evidence of whether a legal or constructive obligation existed at the balance sheet date. This is consistent with the Framework's definition of a liability and with IAS 10, Events After the Balance Sheet Date.*
 - 463. *For the purpose of determining whether an insurer can measure an obligation reliably, the Steering Committee refers to the following guidance in paragraphs 25 and 26 of IAS 37, Provisions, Contingent Liabilities and Contingent Assets.*

25. The use of estimates is an essential part of the preparation of financial statements and does not undermine their reliability. This is especially true in the case of provisions, which by their nature are more uncertain than most

other balance sheet items. Except in extremely rare cases, an enterprise will be able to determine a range of possible outcomes and can therefore make an estimate of the obligation that is sufficiently reliable to use in recognising a provision.

26. In the extremely rare case where no reliable estimate can be made, a liability exists that cannot be recognised. That liability is disclosed as a contingent liability (see paragraph 86).

464. *Under some participating contracts, policyholder benefits are linked to the historical cost of designated assets. To the extent that the designated assets are measured at fair value in the financial statements, the measurement of the related liabilities should reflect the fair value of the assets.*

Sub-issue 9B Does a Mutual Insurer have Equity?

465. Sub-issue 9A considered the classification of unallocated divisible surplus in the context of both a stockholder-owned insurer and a mutual insurer. Sub-issue 9B addresses a related question specific to mutual insurers. Some argue that a mutual insurer can never have any equity, on the grounds that:

- (a) the insurer has an obligation to allocate all of its surplus to its current and future owners, who are current and future policyholders. Therefore, the Steering Committee's conclusion on Sub-issue 8A leads to the result that all unallocated divisible surplus of a mutual should be classified as a liability;
- (b) in many countries, there is a trend of demutualisation – mutual insurers converting into stockholder-owned insurers. Demutualisations sometimes involve an allocation to existing policyholders of all of the previously unallocated surplus. This may be seen as an indication that the unallocated divisible surplus was already a liability; and
- (c) in the absence of stockholders, there can be no equity. The existence of equity presupposes a profit motive that does not exist in the case of a mutual.

466. Others argue that a mutual insurer should report a separate category of equity, on the grounds that:

- (a) users of an insurer's financial statements need, among other things, to assess the insurer's financial strength, its ability to withstand shocks and the extent to which bonus allocations are made out of current performance rather than out of capital. Such assessments will be difficult to make if the insurer always reports equal amounts of liabilities and assets;
- (b) although part of a mutual's unallocated divisible surplus may be returned to current or future policyholders (and so may be considered temporary), no mutual would ever distribute the entire amount. Any mutual will inevitably retain some permanent capital to meet regulatory capital requirements, to provide working capital, to provide a safety margin against external shocks

and to finance expansion. It would be misleading to classify this as a liability; and

- (c) the owners of a mutual own its equity in the same way that the owners of a stockholder-owned insurer own its equity – and are exposed to the same equity-type risks. They face these risks in their capacity as owners, rather than as creditors. Furthermore, any payment to them on a demutualisation is in exchange for them giving up their equity interest in the mutual, rather than the settlement of an existing obligation.

Tentative Steering Committee View

467. *The Steering Committee notes that the question of whether a mutual has equity is not unique to the insurance industry. In the Steering Committee's view:*

- (a) *a mutual insurer should classify unallocated surplus as a liability, except to the extent that the mutual insurer;*
 - (i) *has no legal or constructive obligation at the balance sheet date to allocate part of the surplus to current or future policyholders; or*
 - (ii) *has such a legal or constructive obligation, but cannot measure that obligation reliably; and*
- (b) *a mutual insurer should classify the rest of the unallocated surplus as equity.*

Sub-issue 9C Should Insurers Recognise Allocations to Participating Policyholders as an Expense or as an Appropriation of Equity?

468. There is widespread debate about whether allocations to participating policyholders are distributions of equity or expenses of the enterprise. An associated issue is whether the classification of allocations should depend on whether the insurer is a mutual or stockholder-owned.

Views Favouring Classification as Expenses

469. Some favour classification of participating policyholder allocations as expenses. They do so on the basis of one or more of the following arguments:
- (a) the allocations are, in substance, adjustments in the price charged for an insurance contract. Insurers often include schedules of expected premiums in sales illustrations and emphasise the net cost in marketing to potential policyholders. From this perspective, participating policyholder allocations are like rebates or refunds of premiums paid;
 - (b) insurers that issue participating contracts have an unfair competitive advantage if policyholder allocations are not treated as expenses, as this practice makes such insurers appear more profitable;

- (c) the accumulated allocations made in previous periods are generally regarded as liabilities. Under IASC's Framework for the Preparation and Presentation of Financial Statements, an addition to a liability is an expense;
- (d) profit sharing by employees can be viewed as similar to participating policyholders sharing in divisible surplus. IAS 19, Employee Benefits, states "An obligation under profit sharing and bonus plans results from employee service and not from a transaction with the enterprise's owners. Therefore, an enterprise recognises the cost of profit sharing and bonus plans not as distribution of net profit but as an expense"; and
- (e) although some argue that treating allocations as distributions of equity would preserve the relationship between pre-tax accounting profit and income tax expense, this can also be achieved by explanations in the notes to the financial statements or by grossing up the allocation expense for income tax expense, as is the practice in some jurisdictions.

Views Favouring Classification as Distributions of Equity

470. Some favour classifying participating policyholder allocations as equity distributions. They do so on the basis of one or more of the following arguments:
- (a) the Framework defines equity as "the residual interest in the assets of an enterprise after deducting all its liabilities". Some argue that holders of participating contracts have such a residual interest in some or all of the insurer's assets. They also point to paragraph 30 of IAS 32, which requires that "[d]istributions to holders of a financial instrument classified as an equity instrument should be debited by the issuer directly to equity";
 - (b) in most jurisdictions, policyholders of a mutual insurer have many of the rights usually held by stockholders. Policyholders vote on the appointment of management and auditors. While policyholders cannot usually transfer their interests, their approval is often required for the demutualisation of the insurer;
 - (c) allocations can only be made to the extent that there is an actuarially determined divisible surplus for a class of contracts. One class of policyholders has no right to share in the profits of another class of policyholders or to share in the residual equity of the insurer. This makes the participating policyholder allocations more like a sharing of profits than an adjustable contract feature; and
 - (d) allocations to participating policyholders are sometimes determined after taking into account income tax and are sometimes not tax deductible. If net of tax allocations are treated as expenses, the relationship between pre-tax accounting profit and income tax expense will be distorted.
471. In some jurisdictions, stockholders in an insurance enterprise are unable to access the profits from participating contracts without also allocating profits to participating policyholders. In Australia, for example, there is a statutory minimum split between

stockholders and participating policyholders of 20% to 80%. That is, for every 100 allocated, at least 80 must go to participating policyholders. Some people argue that this type of restriction helps to characterise allocations to participating policyholders as distributions of equity because they are associated with distributions of equity to stockholders. Others argue that statutory rules about the relative split of profits among policyholders and stockholders are merely devices used by regulators to help protect the interests of policyholders and are not relevant to determining the classification of allocations.

Tentative Steering Committee View

472. *The Steering Committee supports the view that allocations to participating policyholders are expenses, regardless of whether the allocations have been made to individual policyholders or to a class of policyholders and regardless of whether the insurer is mutual or stockholder-owned. This is on the basis that the allocations give rise to increases in liabilities and are therefore expenses. Similarly, increases (decreases) in the liability portion of unallocated divisible surplus are an expense (income).*

Sub-issue 9D Are any Specific Disclosures needed about Participating (With-Profits) Contracts?

Tentative Steering Committee View

473. *The Steering Committee believes that there may be a need for disclosures about an insurer's policy in making allocations for participating (with-profits) contracts and about the related assumptions that are reflected in the financial statements. The Steering Committee invites commentators to indicate any specific disclosures that may be needed for such contracts.*

Sub-issue 9E Are there any other Specific Issues for Mutual Insurers?

474. *The Steering Committee invites commentators to indicate whether there are any specific issues for mutual insurers that this Issues Paper does not address. The Steering Committee is not aware of any such issues.*

Reinsurance

Basic Issue 10 Are there any Specific Accounting Issues for Reinsurance Contracts?

475. Basic Issue 9 covers the following Sub-issues:

- (a) is the distinction between direct insurance and reinsurance important enough to warrant different accounting treatments;
- (b) should a ceding insurer recognise gains or losses when it enters into a reinsurance transaction;
- (c) should a ceding insurer recognise separate assets and liabilities arising from reinsurance arrangements, or should amounts be offset against related ceded liabilities;
- (d) how should a ceding insurer report revenue and expenses that result from reinsurance arrangements;
- (e) when, if ever, should a reinsurance arrangement be treated as an extinguishment of liabilities; and
- (f) are there any special considerations in measuring assets and liabilities under reinsurance contracts?

476. The following issues are often important for reinsurance contracts, but also arise in direct insurance contracts and so are covered in other sections of this paper:

- (a) how much uncertainty is required for a contract to qualify as an insurance contract (see Sub-issue 1C); and
- (b) should an enterprise account separately for the components of insurance contracts that bundle together an insurance element and other elements, such as an investment (or financing) element or an embedded derivative (see Sub-issue 1E)?

Sub-issue 10A Is the Distinction between Direct Insurance and Reinsurance Important Enough to Warrant Different Accounting Treatments?

477. Direct insurers (both general and life) and reinsurers often purchase reinsurance contracts with other insurers to limit their exposure to risks arising under their own contracts. In some jurisdictions, regulatory requirements for reinsurers differ from those for direct insurers. Often, these differences reflect the fact that purchasers of direct insurance may be consumers, whereas purchasers of reinsurance are market professionals.

478. Reinsurance is sometimes described as “insurance purchased by insurance companies.” That description probably oversimplifies an often complex relationship, but it captures the essential nature of the relationships embodied in a reinsurance contract. Paragraph 1 of FASB Statement No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts, describes reinsurance in the following terms:

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 associated with contracts it has written by entering into a reinsurance contract with another insurance enterprise (the reinsurer 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. [Footnote references omitted.]

479. Reinsurance contracts are often complex agreements tailored to particular needs and situations. For example, the reinsurer may agree to receive a portion of all premiums and assume a portion of all claims from a particular class of policies (referred to as **quota share** reinsurance). Alternatively, the reinsurer may agree to pay the portion of claims that exceed a certain amount (referred to as **excess of loss** reinsurance). When purchasing reinsurance for life insurance policies, an insurer often reinsures only the portion related to mortality (referred to as **yearly term** reinsurance). Reinsurance contracts may be **prospective**, covering claims related to events that have yet to occur, or **retroactive**, covering the development of claims related to events that have occurred but have not yet settled.
480. In recent years, reinsurance contracts have developed with explicit provisions to take account of the time value of money in the settling of claims (sometimes referred to as **financial** reinsurance). A primary motive for financial reinsurance contracts is sometimes to overcome or exploit the effect of measuring insurance liabilities on an undiscounted basis.
481. Sometimes, accounting requirements for reinsurers differ from the accounting requirements for direct insurers. One motivation for such differences may be the time lags that occur in transmitting information to reinsurers about premiums and claims. An example of such differences is the form of **deferred annual accounting** permitted under the European Union’s Insurance Accounting Directive and sometimes used in, for example, Germany. Deferred annual accounting is used where only limited information about premiums receivable or claims payable for the underwriting year is available when the financial statements are prepared.
482. Under the deferred annual method, the premium and claim information in the financial statements relates to a twelve month period that wholly or partly precedes

the reporting enterprise's own financial year. For example, the income statement for the year ended 31 December 20X1 may include information about premiums and claims for the twelve months to 30 September 20X1.

Tentative Steering Committee View

483. *The Steering Committee has not identified any reason to set different accounting requirements for reinsurers. Among other things, the Steering Committee believes that improvements in communications mean that the deferred annual method is no longer needed. The Steering Committee would welcome comments on any aspects of reinsurance that warrant separate consideration.*
484. *The principles discussed in the Steering Committee's view on Sub-issue 6A may sometimes lead to a unit of account in reinsurance that differs from the unit of account in direct insurance.*

Sub-issue 10B Should a Ceding Insurer Recognise Gains or Losses when it Enters into a Reinsurance Transaction?

485. The amount paid to a reinsurer often differs from the carrying amount of related insurance liabilities. For example, a direct insurer might collect premiums of 1,000 and cede half of the insurance coverage for a reinsurance premium of 425. Assume that the half that is ceded has the same risk profile and other characteristics as the half that is retained. (In this example, the reinsurance premium is less than 50% of the premium on the direct insurance contract. There may be a number of reasons for this. For example, the direct insurer may need to cover the costs of an extensive sales network and the reinsurer does not.) Over the life of the policies, the insurer incurs and pays claims of 950.
486. Illustration A70 in Appendix A of the accompanying booklet shows the simple prospective reinsurance arrangement just described. The first two columns depict financial statements in which the ceding company recognises a gain for the difference between the reinsurance premium (425) and the related deferred premium (500). The final two columns depict financial statements in which the ceding company does not recognise a gain on inception. The illustration is not intended to indicate a preference for a particular method of presentation. Also, it does not address accounting for acquisition costs.
487. In Illustration A70, the ceding company purchased reinsurance at about the same time that it collected premiums from policyholders - a prospective reinsurance arrangement. However, many reinsurance arrangements are retroactive. The ceding company purchases reinsurance after insured events have occurred but before claims have settled, perhaps even before policyholders have presented claims. In Illustration A71, the ceding company purchases reinsurance at the end of the term of direct insurance policies. As before, the first two columns show the ceding company

recognising a gain when it pays the reinsurance premium.¹⁷ The last two columns show the ceding company deferring that gain and recognising it over the period in which claims are paid.

488. The two illustrations portray reinsurance of general insurance policies. Reinsurance of life insurance policies is often more complex, owing to the long-term nature of life insurance. However, the underlying principles and issues are similar. The two illustrations also portray situations in which the ceding company expects the reinsured claims to equal or exceed the reinsurance premium. Most in the insurance industry agree that in the opposite case, in which the reinsurance premium exceeds the expected amount of reinsured claims, deferral is not appropriate. In that situation, the ceding company should re-evaluate its estimate of claims and recognise additional claim expense or a loss on the reinsurance contract.

Views on Gain Recognition

489. Some maintain that the gains recognised in Illustrations A70 and A71 are appropriate. In their view, a reinsurance arrangement allows the ceding company to fix the amount of its obligation (subject to credit risk). The ceding company collected premiums of 500 (½ of the 1,000 total premiums) and fixed its obligation with regard to claims on the reinsured premiums at 425. Also, they note that the Framework does not accept the deferral of gains in the balance sheet as if they were a liability. From this perspective, the ceding company should recognise a gain at the inception of both prospective and retroactive reinsurance arrangements.
490. Others maintain that the gain recognised in Illustration A71 (the retroactive arrangement) is appropriate, but that the gain recognised in Illustration A70 is not. In their view, reinsurance represents a sharing (ceding) of premium between a primary insurer and a reinsurer. From this perspective, the ceding company should recognise reinsurance premiums in the income statement in a manner that matches the cost of reinsurance with revenue from the related policies. In Illustration A71, all premiums have been recognised as revenue before the reinsurance transaction occurred, so there is no need for matching and hence gain recognition is appropriate.
491. Still others maintain that gain recognition is not appropriate in either illustration. In their view, reinsurance is a financial instrument that entitles the ceding companies to cash inflows over a period of time. From this perspective, the gain that may exist should be recognised over the period of those cash flows (the settlement period of the related primary insurance contracts). Those who hold this view often observe that the reinsurance contract in no way “fixes” the amount that must be paid to policyholders. It simply provides a related promise from the reinsurer. If the reinsurer defaults or refuses to pay, the primary company must still make payments to policyholders for valid claims.

¹⁷ If insurance contracts are recognised initially at cost, it might be argued that the gain is recognised not on initial recognition but on the first subsequent remeasurement of the contract. The practical effect on the financial statements will be the same.

492. Finally, some argue that the apparent anomalies in the two illustrations result from a failure to measure the liability properly. In their view, the difference between the recorded claim liability in Illustration A71 (475, $\frac{1}{2}$ of 950, net of reinsurance receivables) and the reinsurance premium paid (425) probably includes time value of money between the date of the reinsurance arrangement and the date on which claims will be paid. Those who hold this view observe that the claim liability is usually an undiscounted amount, but that reinsurers routinely reflect present value in determining the amount of premium charged. From this perspective, most of the apparent anomaly would be eliminated by using present value techniques to measure the liability (either deferred premium or claim liabilities). In Sub-issue 7I, the Steering Committee concluded that insurance liabilities should be discounted. Under this proposal, a ceding insurer's gains on entering into a reinsurance contract would be less than under the common practice of measuring general insurance liabilities on an undiscounted basis.
493. Some believe that for a non-proportional reinsurance transaction, such as an excess of loss reinsurance transaction, it would be difficult to determine which part of the direct insurance premium is ceded and which part is retained. In their view, it would be necessary to assume that the ceded premium is equal to the premium for the reinsurance transaction – which effectively gives the same result as the deferral model.
494. The question of whether the ceding insurer should recognise a gain on reinsurance reflects a number of related issues:
- (a) should an insurer recognise an immediate gain on the sale of an insurance contract (see Sub-issue 7C);
 - (b) when, if ever, should a reinsurance arrangement be treated as an extinguishment of liabilities (see Sub-issue 10E); and
 - (c) when an insurer reinsures an insurance liability, should the measurement of the original insurance liability be affected by the existence of the reinsurance?

Sub-issue 10B focuses mainly on the last of these questions.

495. Some argue that entering into a reinsurance transaction should not directly affect the measurement of the original liability, on the grounds that the original liability and recoveries under the reinsurance contract are separate items and should be measured separately. Some who take this view might accept that a reinsurance contract could affect the measurement of the original contract indirectly, by giving the original insurer more information to help predict the timing and amount of claims. Others argue that prices in the reinsurance market are often influenced by other factors, such as the business cycle or a desire to buy market share. Also, some would argue that reinsurers may be able to price more competitively than a direct insurer for the same risk because they may have a more diversified portfolio of contracts or because their distribution costs are lower.
496. Some argue that at least some reinsurance effectively settles part or all of the insurer's original liability by reimbursing part or all of the claims. Accordingly, they suggest

that the ceding insurer should not measure the original liability at a higher amount than its rights to recovery under the reinsurance contract.

497. There is little support for deferring any loss that arises on a reinsurance transaction, as any such loss is likely to reflect a loss that would have required recognition anyway in the absence of the reinsurance transaction.

Tentative Steering Committee View

498. *The Steering Committee prefers an asset and liability approach to this Sub-issue. Deferred gains of the kind discussed above do not meet the Framework's definition of a liability. Therefore, such gains should be recognised immediately.*

Sub-issue 10C Should a Ceding Insurer Recognise Separate Assets and Liabilities arising from Reinsurance Arrangements, or should Amounts be Offset against Related Ceded Liabilities?

499. In some jurisdictions, amounts ceded to reinsurers are offset against deferred premium revenue and amounts due from reinsurers are offset against claims payable. In others, the amounts are presented in the balance sheet as separate assets and liabilities. Those who support a net presentation argue that this represents the insurer's overall net exposure. Those who support a gross presentation argue that this enables users to make better predictions of future cash flows.
500. IAS 1, Presentation of Financial Statements, prohibits offsetting of assets and liabilities unless this is explicitly permitted or required by another International Accounting Standard. Paragraph 35 of IAS 32, Financial Instruments: Disclosure and Presentation, contains the following requirements on offsetting financial assets and liabilities:

A financial asset and a financial liability should be offset and the net amount reported in the balance sheet when an enterprise:

- (a) has a legally enforceable right to set off the recognised amounts; and
- (b) intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

501. Most reinsurance arrangements do not meet the criteria in IAS 32. The ceding company typically does not have the right to offset an amount due from one party, a reinsurer, against amounts due to another party, a policyholder.
502. Under paragraph 52 of IAS 37, Provisions, Contingent Liabilities and Contingent Assets, where some or all of the expenditure required to settle a provision is expected to be reimbursed by an insurer, the policyholder should recognise the reimbursement when and only when it is virtually certain that reimbursement will be received. The reimbursement should be treated as a separate asset. Some argue that a ceding insurer should use the same treatment for expected reimbursements by a reinsurer.

Tentative Steering Committee View

503. *In view of the requirements in IAS 32 and IAS 37, the Steering Committee knows of no basis for offsetting amounts due from reinsurers against related insurance liabilities.*

Sub-issue 10D How Should a Ceding Insurer Report Revenue and Expenses from Reinsurance Arrangements?

504. Illustrations A70 and A71 showed amounts paid to reinsurers as reductions of premium revenue and amounts received from reinsurers as reductions of claim expense. That presentation is consistent with the traditional characterisation of **premiums ceded** and **claim recoveries**. However, some contend that amounts paid to reinsurers are expenses. They maintain that recording the premiums as reductions of revenue misstates the amount of activity conducted by an insurer and may mislead readers about the amount of its exposure. They favour reporting reinsurance premiums as expenses.
505. Paragraph 34 of IAS 1, Presentation of Financial Statements requires that items of income and expense should not be offset unless required by an International Accounting Standard or where gains and losses arising from the same or similar transactions and events are not material. This suggests that premiums ceded and claims recoveries should be disclosed separately, not offset against the related premiums income and claims payable respectively.
506. Under paragraph 54 of IAS 37, Provisions, Contingent Liabilities and Contingent Assets, the expense relating to a provision may be presented in the income statement net of the amount recognised for a reimbursement. Those who favour a net presentation argue that it keeps the income statement uncluttered and makes it more readable.
507. However, others argue that IAS 37's option of a net presentation in the income statement is not appropriate where reimbursements are a recurring feature of an enterprise's daily operations – as in the case of reinsurance transactions of a direct insurer. They argue that separate disclosure on the face of the income statement is necessary because a reinsurance programme and the underlying direct insurance activity may be driven by different factors.

Tentative Steering Committee View

508. *To enhance the comparability of insurance financial statements, the Steering Committee recommends that activity with reinsurers be reported gross in the income statement, rather than offset against related accounts. However, the Steering Committee does not find a strong conceptual basis for favouring either a net presentation or a gross presentation on the face of the income statement. If a net presentation is permitted, the Steering Committee believes that the gross amounts should be disclosed in the notes to the financial statements.*

Sub-issue 10E When, if Ever, should a Reinsurance Arrangement be Treated as an Extinguishment of Liabilities?

509. Reinsurance contracts are sometimes used to transfer entire classes of policies from one insurer to another in a manner that legally relieves the original insurer of liability under the policies. Such contracts are sometimes described as **novation** or **assumption reinsurance**. In other cases (sometimes known as **indemnity reinsurance**), reinsurance is used in transactions that the direct insurer and reinsurer consider economically the same as a sale, but that do not relieve the original insurer of liability to policyholders. In indemnity reinsurance, the policyholder is not a party to the reinsurance arrangement and is usually unaware of its existence. Those transactions raise a question of whether it is appropriate for the primary company to **derecognise** its liability. The question is different from the question of offsetting described earlier, in that derecognition involves the complete removal of an item from the financial statements.

Views on Derecognition

510. Some contend that an insurer should follow the same standards for derecognising insurance liabilities as those that are being developed for financial instruments generally. IAS 39, Financial Instruments: Recognition and Measurement, states that an enterprise should remove a liability from its balance sheet “when, and only when, it is extinguished – that is, when the obligation specified in the contract is discharged or cancelled or expires.” IASC’s March 1997 Discussion Paper, Accounting for Financial Assets and Financial Liabilities, proposes an identical requirement. On this view, an insurer should derecognise its liability when it either pays the amount due or is legally relieved of that liability. Any transaction that does not meet those criteria does not, from this perspective, justify derecognition.
511. Others maintain that transactions can be structured to provide the primary insurer with the same (or very similar) transfer of risks and rewards that would exist in a sale transaction. Reinsurance is a convenient means of accomplishing this objective without lengthy and costly approvals from policyholders and regulators. From this perspective, a direct insurer should treat the reinsurance transaction as a sale and derecognise its liability in such situations.

Tentative Steering Committee View

512. *The Steering Committee observes that this issue is under consideration by the Joint Working Group on financial instruments. The conclusion reached in that context will be very important in determining conditions (if any) under which reinsurance contracts can serve as a basis for derecognition either of an entire liability or of certain components of a liability. At this stage, the Steering Committee believes that derecognition is appropriate only when the obligation specified in the contract is discharged or cancelled, or expires. In other words, derecognition is appropriate only for a novation or for assumption reinsurance, but not for indemnity reinsurance.*

Sub-issue 10F Are there any Special Considerations in Measuring Assets and Liabilities under Reinsurance Contracts?

513. Reinsurance contracts may pose additional measurement difficulties because there are sometimes long delays before the reinsurer receives information about claims and certain adjustments to premiums. Therefore, some believe that additional measurement guidance may be needed for reinsurance contracts.
514. For example, some ask for additional guidance in a reinsurance context on profit commission and additional or reinstatement premiums. Although such items also arise in direct insurance contracts, they are both more common in a reinsurance context and also more difficult to estimate because of delays in receiving information. **Profit commission** is generally paid by the reinsurer when its experience of that contract is positive. A contract that pays profit commission may be regarded as a form of participating contract. **Reinstatement premiums** are extra premiums that the ceding insurer pays under certain contracts after a claim has occurred, so that the policy will continue to cover claims for the rest of the original contract term.
515. In some cases, such payments may eliminate insurance risk for the reinsurer or may create a non-insurance element that may need to be accounted for separately. Sub-issues IC and IE deal with such questions.

Tentative Steering Committee View

516. At this stage, the Steering Committee does not intend to give additional guidance on measurement of reinsurance assets and liabilities. In the Steering Committee's view, all important aspects of the measurement of reinsurance assets and liabilities are covered by the discussion in other parts of this Issues Paper.