FA Module 20: Insurance contracts: GAAP readings from SFAS 113

(The attached PDF file has better formatting.)

Note: The final exam does *not* test reinsurance contracts, whether for GAAP or for IFRS. The accounting rules are included on the discussion forum for those students working with reinsurance contracts.

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

! Reading: SFAS 113: Summary; 1, 3, 6, 8-11, 14-16

This posting has the sections of SFAS (Statement of Financial Accounting Standard) 113 on the VEE financial accounting syllabus, along with explanations of the text. The SFAS 113 text is in italics; the explanations follow the text.

SFAS 113 Summary

… 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. … 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.

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 … 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 ceding insurer (or primary insurer) cedes (transfers) the insurance liabilities to the assuming reinsurer. The risk transfer tests of SFAS 113 determine whether the cession qualifies as reinsurance for GAAP.

§5 *The increasing concerns about the effect of reinsurance accounting for contracts that do not indemnify the ceding enterprise against loss or liability… led the Board to reconsider the accounting and reporting for reinsurance.*

GAAP for insurance contracts reports unpaid claims at nominal value, not present value. When interest rates are high, contracts with long lags from premium collection to claim payment may show losses on the income statement, even if the contracts are profitable. Some reinsurers sell contracts (financial reinsurance) that do not transfer risk but charge premiums equal to the present value of unpaid claims, removing these losses from the ceding insurer's income statement. The reinsurance premium adjusts as the estimated claim payments change, leaving all risk with the ceding company.

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 …*

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.

SFAS 113 has two risk transfer tests: 9(a) and 9(b).

9A. *The reinsurer assumes significant insurance risk:* Variation in the claim amounts (general insurance) or the timing of claim payments (life insurance) is insurance risk and qualifies a contract as reinsurance. Variation in market interest rates is not insurance risk and does not qualify a contract as reinsurance.

9B. *It is reasonably possible that the reinsurer may realize a significant loss:* SFAS 113 sets the principle; auditors must judge whether a reinsurance contract meets the principle. Whether a loss is significant is often judged by its relation to the reinsurance premium: a loss equal to 20% of the premium is significant but a loss equal to 2% of the premium is not significant. The reasonable possibility is harder to judge, since highly risk catastrophe reinsurance contracts often cover extreme events (earthquakes, hurricanes) with low probabilities.

§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.*

GAAP reports claims for short duration insurance contracts at nominal values, not present values, so even if a reinsurance contract is profitable, the income statement may show an accounting loss. Paragraph 10 clarifies that the risk transfer test in Paragraph 9B uses present values, not nominal values. A contract must have a reasonable possibility of being unprofitable (on a present value basis) to quality as reinsurance.

§11 *Significance of loss shall be evaluated by comparing the present value of all cash flows … with the present value of the amounts paid … 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.*

One exception to the risk transfer test in paragraph 9B exists. An insurer might transfer a portfolio of business to a reinsurer (such as when it is leaving a line of business or a geographical region). Even if the portfolio of business has low risk and does not meet the risk transfer test in paragraph 9B, the transfer is reinsurance, since all the insurance risk is transferred.