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Draft of Educational Note

Accounting for Reinsurance Contracts under International Financial Reporting Standards

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Draft of Educational Note

Accounting for Reinsurance Contracts under International Financial Reporting Standards

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Members should be familiar with educational notes. Educational notes describe but do not recommend practice in illustrative situations. They do not constitute Standards of Practice and are, therefore, not binding. They are, however, intended to illustrate the application (but not necessarily the only application) of the Standards of Practice, so there should be no conflict between them. They are intended to assist actuaries in applying Standards of Practice in respect of specific matters. Responsibility for the manner of application of Standards of Practice in specific circumstances remains that of the members in the Life and Property and Casualty Insurance practice areas.

Memorandum

To: Members in the Life Insurance and Property and Casualty Insurance Practice Areas

From: Jacques Tremblay, Chairperson
CIA Practice Council

Date: June 25, 2009

Subject: **Draft Educational Note: Accounting for Reinsurance Contracts under International Financial Reporting Standards**

Document 209062

International Financial Reporting Standards (IFRS) will be effective in Canada for interim and financial statements relating to fiscal years starting on or after January 1, 2011.

In preparation for this conversion, the Practice Council has examined the International Actuarial Standards of Practice (IASPs) that have been issued by the International Actuarial Association (IAA), and has decided to release selected IASPs, as either Educational Notes or Research Papers, to assist CIA members in the application of IFRS. Since the IASPs were originally published by the IAA, they are presented in a different format and may use somewhat different terminology than that used in the Standards of Practice and Educational Notes developed by the CIA. Nevertheless, the Practice Council has decided to release the documents without modification.

This Draft Educational Note addresses professional services related to the classification, recognition and measurement of reinsurance contracts for purposes of preparation or review of financial statements in accordance with IFRS. It was originally published by the IAA as IASP 9.

In accordance with the CIA Policy on Due Process for the Approval of Guidance Material Other than Standards of Practice, this Draft Educational Note has received final approval for distribution by the Practice Council on June 4, 2009.

As outlined in subsection 1220 of the Standards of Practice, “*The actuary should be familiar with relevant Educational Notes and other designated educational material.*” That subsection explains further that a “practice which the Educational Notes describe for a situation is not necessarily the only accepted practice for that situation and is not necessarily accepted actuarial practice for a different situation.” As well, “Educational Notes are intended to illustrate the application (but not necessarily the only application) of the standards, so there should be no conflict between them.”

If you have any questions or comments regarding this Draft Educational Note, please contact Jacques Tremblay, Practice Council Chair, at his CIA Online Directory address, jacques.tremblay@oliverwyman.com.

JT

This Practice Guideline applies to an actuary only under one or more of the following circumstances:

- If the Practice Guideline has been endorsed by one or more IAA Full Member associations of which the actuary is a member for use in connection with relevant International Financial Reporting Standards (IFRSs);
- If the Practice Guideline has been formally adopted by one or more IAA Full Member associations of which the actuary is a member for use in connection with local accounting standards or other financial reporting requirements;
- If the actuary is required by statute, regulation, or other binding legal authority to consider the Practice Guideline for use in connection with IFRS or other relevant financial reporting requirements;
- If the actuary represents to a principal or other interested party that the actuary will consider the Practice Guideline for use in connection with IFRS or other relevant financial reporting requirements; or
- If the actuary's principal or other relevant party requires the actuary to consider the Practice Guideline for use in connection with IFRS or other relevant financial reporting requirements.

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1. Scope

The purpose of this PRACTICE GUIDELINE (PG) is to give advisory, non-binding guidance to ACTUARIES or other PRACTITIONERS that they may wish to take into account when providing PROFESSIONAL SERVICES in accordance with INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRSs) concerning specific classification, recognition, and measurement issues arising for REINSURANCE CONTRACTS. It is a class 4 INTERNATIONAL ACTUARIAL STANDARD OF PRACTICE (IASP).

Reliance on information in this PG is not a substitute for meeting the requirements of the relevant IFRSs. Practitioners are therefore directed to the relevant IFRSs (see Appendix C) for authoritative requirements. The PG refers to IFRSs that are effective for annual periods beginning on or after 1 January 2007. If IFRSs are amended after that date, actuaries should refer to the most recent version of the IFRS.

2. Publication Date

This PG was published on 26 January 2007, the date approved by the Council of the INTERNATIONAL ACTUARIAL ASSOCIATION (IAA).

3. Background

This PG relates to both the treatment of reinsurance from the perspective of the ceding company and the assuming company, which is directly applicable to REINSURANCE CONTRACTS that are the focus of IFRS 4. Appendix A contains references from IFRS 4 related to reinsurance.

IFRS 4 and INTERNATIONAL ACCOUNTING STANDARD (IAS) 39 provide guidance for the recognition and measurement of insurance and INVESTMENT CONTRACTS, while IFRS 7 provides guidance for the disclosure of these contracts. IAS 1 provides overall guidance regarding the presentation of general purpose FINANCIAL STATEMENTS for these instruments.

4. Practice Guideline

4.1 Definition of a reinsurance contract

The IFRS 4 definition of a reinsurance contract is “An insurance contract issued by one INSURER (the REINSURER) to compensate another insurer (the CEDANT) for losses on one or more CONTRACTS issued by the cedant.”

This definition describes the contract issued by an insurer to compensate another insurer. IFRS 4 defines an insurer in terms of a party to an insurance contract as “The party that has an obligation under an insurance contract to compensate a POLICYHOLDER if an INSURED EVENT occurs.”

The IFRS 4 definition of a reinsurer is very similar: “The party that has an obligation under a reinsurance contract to compensate a cedant if an insured event occurs.”

IFRS 4 defines a reinsurance contract as a type of insurance contract between two insurers. Common usage generally applies the term reinsurance contract to a contract for which the purchaser of reinsurance is a company that issues insurance contracts and the provider is a company that issues reinsurance contracts, insurance contracts, or both. The purchaser of reinsurance is also referred to as the reinsured, cedant, or ceding company. The provider of reinsurance is also referred to as the reinsurer or assuming company. Assumed reinsurance contracts are also known as inward

reinsurance. Ceded reinsurance contracts are also known as purchased reinsurance or outward reinsurance.

When a reinsurer issues reinsurance contracts related to the reinsurance business of another company, such contracts are also referred to as retrocessions; the issuing company is also referred to as the retrocessionaire; and the reinsured company is also referred to as the retrocedant.

The legal form of a reinsurance contract can be a contract between two parties, the reinsurer and the reinsured, or a multi-party contract between several reinsurers and one or more reinsureds.

In general, the treatment of insurance contracts and assumed reinsurance contracts is the same for FINANCIAL REPORTING under IFRS 4. However, the financial reporting of ceded reinsurance contracts differs from insurance contracts and assumed reinsurance contracts in several respects. This PG discusses the provisions of IFRS 4 affecting the financial reporting of ceded reinsurance contracts.

4.1.1 Classification of reinsurance contracts

The definition of insurance according to IFRS 4 will apply to the classification of assumed reinsurance contracts. The same definition also applies to the classification of ceded reinsurance contracts. In order to determine the financial reporting for reinsurance for an entity, each of the entity's reinsurance contracts has to be properly classified in one of the following categories: (a) insurance contracts, (b) FINANCIAL INSTRUMENTS (which are sometimes referred to as investment contracts), or (c) SERVICE CONTRACTS according to the IFRSs. IFRS 4 applies only to those reinsurance contracts that are classified as insurance. The guidance provided in IASP 3, *Classification of Contracts under IFRS*, applies to both assumed and ceded reinsurance contracts.

Because reinsurance has a wide variety of contract terms, features, and practices, the appropriate classification of ceded reinsurance contracts may involve detailed procedures to establish which contracts meet the IFRS 4 definition of insurance, particularly the IFRS 4 requirement to have significant INSURANCE RISK in the contract.

Reinsurance contracts can be complex and may contain features that could affect the classification of the contract under the IFRSs. IASP 3 provides guidance regarding whether a single insurance contract might be separated into COMPONENT parts for accounting purposes, and whether several insurance contracts might be combined into one insurance contract for accounting purposes. IFRSs require the consideration of substance over form, and therefore in the classification of reinsurance transactions, all agreements between the reinsurer and reinsured, whether formal written contracts or not, should be considered, even if they are not part of the main contract between the parties. Reinsurance contracts may also be subject to such separation or combination in determining whether such a contract, or components of a contract, meets the IFRS 4 definition of insurance, which also applies to reinsurance contracts. There may be some situations where two companies have two or more reinsurance contracts where one company is the reinsurer on one reinsurance contract with the second company but is the reinsured under another reinsurance contract with the same second company. If these contracts affect the economic relationship between the two companies, then the IFRS 4 definition of insurance would need to be applied to the combination of the reinsurance contracts taken as one economic contract for accounting purposes rather than two or more separate contracts. IFRS 4, B25, refers to contracts that are entered into simultaneously with a single counterparty as forming a single contract for purposes of assessing the significance of insurance risk for an individual contract.

An insurer, or a reinsurer, can issue both insurance and non-insurance contracts, which is consistent with the various discussions within IFRS 4. The IFRS 4 criteria for whether there is significant insurance risk under a ceded reinsurance contract are broad enough to permit the insurance definition to be applied to the entire ceded reinsurance contract, even if some of the cedant's underlying¹ contracts, which do not meet the IFRS 4 definition of an insurance contract, are also covered under the ceded reinsurance contract. A specific ceded reinsurance contract may not meet the IFRS 4 definition of insurance and therefore may be considered a financial instrument or a service contract, even if every underlying contract meets the definition of an insurance contract. For example, a specific ceded reinsurance contract that transfers only FINANCIAL RISK associated with a block of underlying insurance contracts, e.g., guarantees an investment return on assets transferred linked to an index, would not normally meet the IFRS 4 definition, even though the underlying contracts are insurance contracts. If, however, the specific ceded reinsurance contract transfers both financial risk and significant insurance risk, then the specific ceded reinsurance contract would be expected to meet the IFRS definition of insurance.

It may not be necessary for the cedant to evaluate all of its underlying contracts to determine whether a specific ceded reinsurance contract meets the IFRS 4 insurance definition. At least one of the cedant's underlying contracts² is required to meet the IFRS 4 insurance definition. (See IFRS 4, IG Example 1, paragraph 1.29.) The REPORTING ENTITY is responsible for determining its evaluation of the reinsurance contract. For example, the cedant is responsible for the evaluation regarding the classification of its underlying contracts and its ceded reinsurance contracts, i.e., the reinsurer is not bound by the classification decision of the cedant. In other words, the reinsurer is responsible for the classification of the reinsurance contract sold to the cedant. Neither the cedant nor the reinsurer is bound by the classification of the counterparty; rather, the classification of the reinsurance contract is determined according to the specific ACCOUNTING POLICY of the responsible reporting entity. Note that where the cedant and reinsurer are related parties that qualify for consolidated reporting, they may wish to maintain consistency.

4.1.2 Determining whether reinsurance contracts have significant insurance risk

IASP 3 provides some guidance regarding determining whether an insurance contract meets the IFRS 4 requirement that a contract accept significant insurance risk in order to be treated as an insurance contract for financial reporting purposes. For a reinsurance contract to meet the significant insurance risk criteria, the contract would need to be evaluated with respect to whether the contract involved payments to the cedant for insurance risk, financial risk, or both, according the IFRS 4 definitions of insurance risk and financial risk. In addition, the payments related to insurance risk under a reinsurance contract will need to be evaluated as to whether such payments for insurance risk are significant.

¹ Use of the term “underlying,” when used in the context of reinsurance, refers to the insurance policy, reinsurance contracts, or non-insurance contracts issued by the cedant, which are the subject of the reinsurance contract between the cedant and the reinsurer. The use of “underlying contract,” as used in this PG, is common business usage of the term among the parties to a reinsurance contract. This usage differs in the case of financial instruments, known as derivatives, where the term “underlying” has a specific meaning in the structure of a derivative contract.

² If none of the cedant's underlying contracts meets the IFRS insurance definition, but the ceded “reinsurance” contract does meet that definition, then this “ceded” contract would be classified as insurance purchased rather than reinsurance purchased. IFRS 4 does not address the financial reporting of insurance purchased.

According to IFRS 4, B23:

Insurance risk is significant if, and only if, an insured event could cause an insurer to pay significant additional BENEFITS in any scenario, excluding scenarios that lack commercial substance (i.e., have no discernible effect on the economics of the transaction). If significant additional benefits would be payable in scenarios that have commercial substance, the condition in the previous sentence may be met even if the insured event is extremely unlikely or even if the expected (i.e., probability-weighted) present value of contingent cash flows is a small proportion of the expected present value of all the remaining contractual cash flows.

The additional benefits referred to in IFRS 4 are further described in IFRS 4, B24, as amounts in excess of the amounts payable when no insured event occurred. Consequently, the significant insurance risk requirement under IFRS 4 can be easily met in many typical reinsurance contracts where payments for an insured event are possible, even though they are extremely unlikely. Generally it can be assumed that an ultimate cession of insurance risk that would qualify a direct insurance contract under the accounting policies of the reporting entity as an insurance contract would qualify the cession as a reinsurance contract as well, unless additional special agreements reduce the ceded insurance risk below a significant level.

A reinsurance contract may not satisfy the classification criteria for insurance contracts of the accounting policy in use before the first-time adoption of IFRS 4 to be continued under IFRS 4, but it may satisfy the IFRS 4 requirements for treatment as an insurance contract. In this situation, IFRS 4 allows reporting for such a reinsurance contract under the accounting policy previously used, but that accounting policy could prohibit accounting for the contract as an insurance contract as defined in that prior accounting policy. In that case, an entity whose contracts meet the IFRS 4 criteria would not change how it reports such contracts. IFRS 4 does not refer to a continuation of prior accounting policy for insurance contracts in general or to the application of such prior accounting policy to any contract subject to IFRS 4. Rather, IFRS 4 permits the continuation of the prior accounting policy for such contracts. However, if a reinsurance contract does not meet the IFRS 4 criteria for significant insurance risk, then the financial reporting for such a contract follows the applicable IFRSs for a financial instrument or a service contract, i.e., IAS 39 or IAS 18, respectively. IFRS 4 does provide under certain conditions for the reporting entity to change its accounting policies.

4.2 Separate reporting of ceded reinsurance

Specific financial reporting requirements exist for ceded reinsurance contracts according to the provisions of IFRS 4 dealing with reinsurance purchased. IFRS 4.14(d) specifies that INSURANCE LIABILITIES and income statement items resulting from insurance contracts will be reported without any reduction for reinsurance purchased (also referred to as reporting on a “gross” basis). If one applies IFRS 4, a cedant’s contractual rights are reported as reinsurance assets.³ Also, income and expense from ceded reinsurance transactions are to be reported separately without the offsetting of accounting entries before ceded reinsurance contracts. Hence, accounting policies will not be acceptable under IFRS 4 if such accounting policies provide for the recognition of premiums, losses, expenses, assets and liabilities only after deduction for ceded reinsurance have been made (also referred to as reporting on a “net” basis). Rather, the premiums, losses, expenses, assets, and

³ The term “reinsurance assets,” as used here, refers to ceded reinsurance assets that are by definition only those assets of the cedant associated with ceded reinsurance contracts. A reinsurer’s assets for reinsurance premiums receivables or funds withheld by the cedant are not reinsurance assets as defined in IFRS 4.

liabilities are to be reported on a gross basis. In addition, the effect of ceded reinsurance on premiums, losses, expenses, assets, and liabilities is also to be reported by providing either the “net” amounts or the ceded amounts.

This principle may affect various transactions and accounting entries for ceded reinsurance and also can affect other financial reporting items that need to be reported before any reinsurance recoveries or reinsurance recoverables. The principle underlying IFRS 4 is that ceded reinsurance entries, e.g., premium ceded, ceding commissions, losses ceded, reinsurance recoveries on paid losses, reinsurance recoverable on unpaid losses, ceded incurred but not reported (IBNR) liabilities, ceded loss adjustment expenses, ceded unearned premium, ceded liabilities, etc., are to be accounted for as separate ceded transaction entries and presented separately in the financial statements. Thus, IFRS 4 effectively requires a reporting entity’s accounting policy to support financial reporting on both a gross and net basis with respect to the ceded reinsurance contracts purchased by the reporting entity.

This principle would also apply to the cedant’s financial reporting for ceding commissions. It would not be acceptable under IFRS 4 to avoid the separate reporting of ceding commissions by simply reducing the cedant’s expenses. Also, since ceding commissions do not usually provide compensation for the cedant’s losses, they are not considered a benefit received, or the indemnification of loss, under the ceded reinsurance contract for financial reporting purposes. Depending on the jurisdiction, allowable reporting of ceding commissions⁴ may include (1) reporting such commissions as recoveries for expenses associated with business ceded, (2) reporting commissions as a profit “on buying reinsurance,” or (3) deducting the ceding commissions from the ceded premiums. Where ceding commissions are subject to adjustment or determination after inception of the reinsurance contract, such as when ceding commissions are adjusted or determined based on ceded losses, there may be additional considerations on how such adjustable ceding commissions are recognised in the financial statements⁵.

For companies that have not previously reported reinsurance as an asset, the separate reporting of insurance liabilities and reinsurance assets may involve considering or disclosing that the reported insurance liabilities on a gross basis may be subject to significantly increased uncertainty. Also, IFRS 4 does not prescribe how to value the amount to be reported for the reinsurance asset, except that the value of the reinsurance asset needs to be reduced if the reinsurance asset is impaired.

4.2.1 Prudence in ceded reinsurance

One area of potential importance for some companies is where accounting policy allows or requires the inclusion of prudence in the measurement of insurance and reinsurance contracts. In some jurisdictions, it is usual for measurement of insurance liabilities to include a measure of prudence. (An example might be the reporting of certain insurance liabilities on a non-discounted basis.) Prudence is also sometimes referred to as a margin for adverse deviation, provision for adverse deviation, risk margin, or prudential PROVISION. When used, prudence is typically applicable to insurance liabilities, where reported liabilities are higher than they would be without the inclusion of

⁴ Ceding commissions may be adjustable based on ceded losses or other reinsurance contract amounts. Where the cedant’s reinsurance contracts include such adjustable ceding commission terms, the treatment of estimates and adjustments of such ceding commissions would be addressed in the reporting entity’s accounting policy.

⁵ Adjustable ceding commissions may include sliding scale commissions, profit commissions, contingent commissions, profit sharing agreements, etc. These might be recognised as assets for the cedant since they represent a right to receive compensation related to the ceded reinsurance contract. Also, these adjustable commissions might include deposit components that are evaluated to determine if unbundling is required.

prudence. However, IFRS 4 does not address the treatment of “prudence” in the reinsurance assets. Since IFRS 4 does require the separate reporting of ceded reinsurance as an asset, the inclusion of prudence in insurance liabilities, or in ceded reinsurance assets, needs to be clearly understood by the reporting entity and incorporated into the entity’s accounting policy.

IFRS 4 does not prohibit the inclusion of prudence in the measurement of ceded reinsurance assets. Generally an increase in the reported value of a reinsurance asset is not considered to be consistent with the general concept of prudence in financial reporting, i.e., prudence in the measurement of assets would indicate a lower value rather than a higher value. In contrast, IFRS 4 relies on the principle that existing accounting policies are generally considered to be reasonable. Note that IFRS 4 does not require an adequacy test of assets; hence, IFRS 4 would allow an entity’s prior accounting policy to be continued where such policy permits, or requires, the reporting of higher ceded reinsurance asset values consistent with the prudence in the corresponding insurance liabilities. It is not unusual for existing accounting policies to require that ceded reinsurance assets be measured using the same assumptions as the ceded INSURANCE LIABILITY. Consequently, the recognition of a reinsurance asset under such an accounting policy can be greater than the expected value of future net cash flows from the reinsurance contract.

IFRS 4 does not require or prohibit the inclusion of a prudence provision in the measurement of insurance or reinsurance contracts. However, IFRS 4.26 states:

An insurer need not change its accounting policies for insurance contracts to eliminate excessive prudence. However, if an insurer already measures its insurance contracts with sufficient prudence, it shall not introduce additional prudence.

If an entity’s current accounting policy includes prudence in the measurement of insurance liabilities, in many cases, that prudence has been set on a basis net of reinsurance. Hence, it may not be consistent to include prudence in reported insurance liabilities based on the gross liabilities (i.e., insurance liabilities without reduction for ceded reinsurance) if the entity does not use consistent prudence assumptions in calculating the value of the reinsurance asset (i.e., increase the value of the reinsurance asset higher than the value calculated without such prudence). Otherwise, the entity will have introduced “additional prudence” into its accounting policy, which appears to be contrary to the intent of IFRS 4.

In summary, if an entity which had previously included prudence in its reported insurance liabilities on a net basis, then under IFRS 4 such an entity will need to consider how to treat prudence in its accounting policy. While it is important to reflect consistency in the reporting of assets and liabilities, there are other considerations to take into account. The following two possible approaches illustrate this issue (see examples in Appendix B):

- (a) ceded reinsurance assets reported without “prudence” and gross insurance liabilities reported including only prudence that is reflective of the net insurance liabilities; and
- (b) insurance liabilities reported including prudence that is reflective of the gross insurance liabilities, and ceded reinsurance assets reported using the same assumptions to determine both the gross insurance liability and the ceded reinsurance asset.

Under (a), the cedant’s accounting policy includes prudence in the liabilities for contracts without reinsurance differently than in the liabilities for contracts with reinsurance. Such an accounting

policy may be considered to conflict with IFRS 4, since accounting policies measuring net liabilities are not relevant under IFRS 4. The accounting policy for contracts without reinsurance applies to all contracts, including those where reinsurance applies.

Under (b), the cedant's accounting policy includes prudence in the measurement of insurance liabilities which is consistent whether reinsurance has been purchased or not. However, as discussed above, if the measurement of ceded reinsurance asset values is consistent with the corresponding insurance liability measurement, then the asset value will result in a higher value reflective of the prudence included in the liabilities and the effect of the ceded reinsurance. IFRS 4 does not specifically address this issue. Such an accounting policy might be considered to be inconsistent with the general concept of prudence in financial reporting, but this approach does not appear to create a conflict with the requirement of IFRS 4 (not to introduce additional prudence into the measurement of its insurance contracts).

This IASP considers alternative treatments that could be addressed in the reporting entity's accounting policy. The expectation regarding such alternatives is, subject to being consistent with the accounting policy selected, that the transactions of the reinsurance contract are consistent with the economic substance of the gross transactions, adjusted by any transformation of risk arising from differences between the direct and reinsurance contracts.

IFRS 4 allows for the consolidated financial statements for entities with certain differences in the prior accounting policies in the various jurisdictions where it operates through subsidiaries, branches, or other arrangements. Consequently, if an entity includes prudence in the measurement of insurance contracts and ceded reinsurance assets in some jurisdictions, but not in others, IFRS 4 does not require a change. However, IFRS 4 does not resolve the possible impact of inconsistencies in measurement, e.g., with regard to prudence, that may result from the consolidation of items under different prior accounting policies for insurance liabilities or ceded reinsurance assets, except for the separation of ceded reinsurance assets from insurance liabilities gross of ceded reinsurance. Inter-company transactions and their effects would need to be eliminated from the consolidated statement, even if different measurement results in eliminations that do not off-set entirely, i.e. inter-company profit or loss resulting from differing measurement of inter-company transactions within the consolidated group needs to be eliminated.

An example is provided in Appendix B.

4.3 Measuring the impairment of ceded reinsurance assets

IFRS 4 requires reinsurance assets to be reduced to the extent of the impairment of such reinsurance assets. This requirement for the measurement of reinsurance assets would not replace, but would supplement those aspects of the prior accounting policy that are continued under IFRS 4. IFRS 4 specifies the conditions for impairment in terms of objective evidence, the result of an event, and reliably measurable impact on the amounts that the cedant may not receive from the reinsurer.

IFRS 4.20 states:

If a cedant's reinsurance asset is impaired, the cedant shall reduce its carrying amount accordingly and recognise that impairment loss in profit or loss. A reinsurance asset is impaired if, and only if:

- (a) there is objective evidence, as a result of an event that occurred after initial recognition of the reinsurance asset, that the cedant may not receive all amounts due to it under the terms of the contract; and

- (b) that event has a reliably measurable impact on the amounts that the cedant will receive from the reinsurer.

These criteria for impairment are further clarified in IFRS 4, BC108, *Impairment of Reinsurance Assets*, which states that:

The Board concluded that an impairment test for phase I:

- (a) should focus on credit risk (arising from the risk of default by the reinsurer and also from disputes over coverage) and
- (b) should not address matters arising from the measurement of the underlying direct insurance liability.

The Board decided that the most appropriate way to achieve this was an incurred loss model based on that in IAS 39 (see IFRS 39.20).

IAS 39.59, *Impairment and Uncollectibility of Financial Assets*, provides additional context on impairment considerations as follows:

A FINANCIAL ASSET or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the assets (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated. It may not be possible to identify a single, discrete event that caused the impairment. Rather the combined effect of several events may have caused the impairment. Losses expected as a result of future events, no matter how likely, are not recognised. Objective evidence that a financial asset or group of assets is impaired includes observable data that comes to the attention of the holder of the asset about the following loss events:

- (a) significant financial difficulty of the ISSUER or obligor;
- (b) a breach of contract, such as a default or delinquency in interest or principal payments;
- (c) the lender, for economic or legal reasons relating to the borrower's financial difficulty, granting to the borrower a concession that the lender would not otherwise consider;
- (d) it becoming probable that the borrower will enter bankruptcy or other financial reorganization;
- (e) the disappearance of an active market for that financial asset because of financial difficulties; or
- (f) observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets.

With regard to the reference to an event (e) above from IAS 39, and the specific issue of a drop in ratings, IAS 39.60 provides additional guidance:

The disappearance of an active market because an entity's financial instruments are no longer publicly traded is not evidence of impairment. A downgrade of an entity's credit rating is not, of itself, evidence of impairment, although it may be evidence of impairment when considered with other available information.

While there may be merit in adjusting reported ceded reinsurance asset values to reflect a reinsurer's ratings based on the probability of collecting the full amount of reinsurance recoverables when due,

IFRS 4 addresses only the impairment of ceded reinsurance asset values when the impact of the event can be measured reliably. Additionally, IAS 36, *Impairment of Assets*, provides guidance regarding how the reporting entity recognizes and measures impairment based on management's best estimate of "VALUE IN USE," using reasonable and supportable assumptions for cash flow projections.

Under IFRS 4, reinsurance asset reduction due to impairment clearly applies when:

1. The reinsurer is insolvent and the cedant does not expect payment of any of the amounts due under the reinsurance contract;
2. There is some settlement or adjudication of the reinsurance contract, or liquidation of the reinsurer's assets, such that only a portion of amounts due will be paid or payments of the amounts due are limited to fixed amounts or some other formula; or
3. The cedant can reliably measure the amount of reinsurance recovery that it will not receive as a result of the event.

In addition, objective evidence that may indicate consideration of ceded reinsurance asset impairment could include the following situations:

1. Contractual payments or other terms have not been met (breach of contract);
2. The reinsurer will likely enter bankruptcy or other financial reorganization and this event will cause a loss of contractual cash flows;
3. The reinsurer has been downgraded by a major rating agency⁶;
4. The reinsurer is closed to new business⁶;
5. Financial results have deteriorated; and
6. National or local economic conditions correlate with reinsurer defaults.

If one or more of the above occur, these negative attributes are assessed to determine if they are temporary or will not have an impact on future cash flows. This assessment also considers any collateral or credit enhancements that apply. If the determination is that the negative attributes are temporary or will not have an impact on future cash flows, the reinsurance asset is not impaired. If this is not the case, the reinsurance asset is considered to be impaired and an impairment loss is determined and recognized in the income statement.

The likelihood that the cedant will not receive all amounts due it under the terms of the reinsurance contract is also a consideration. Normally, a reinsurer is expected to pay all of the amounts due under the contract, and the cedant can recognize those amounts as assets. IFRS 4 does not require a reduction for the impairment of a reinsurance asset without such objective evidence and the ability of the entity to reliably estimate the amount of the reduction. However, IFRS 4 does not prohibit a cedant from reporting a reinsurance asset at a reduced value based on the cedant's assessment of the credit risk or if following the entity's prior accounting policy.

There may be a dispute with a reinsurer regarding the amounts due under a reinsurance contract. IFRS 4 does not require an adjustment for impairment unless there is objective evidence that shows that the cedant will not receive all payments due it under the reinsurance contract and unless the

⁶ Analogous to IAS 39.60, note that a reinsurer's closure to new business is not evidence of impairment. Similarly, a credit rating downgrade is not, of itself, evidence of impairment. However, it may be evidence of impairment when considered with other available information.

amount of reduction can be reliably estimated. The existence of a reinsurance dispute is normally easy to identify, but the amounts recoverable from the dispute may be difficult to estimate reliably. However, IFRS 4 does not prohibit a cedant from reporting a reinsurance asset at a reduced value on the basis of the cedant's expectation of the amount it will receive in the resolution of the dispute.

If the ceded reinsurance asset is determined to be impaired, a calculation of a reliable measure of the impact of the impairment on the ceded reinsurance asset is made. In determining the impairment loss, the recoverable value for the reinsurance asset and any related items is based on the estimate of future reinsurance cash flows, taking into consideration the reinsurer's current and expected future financial condition. Depending on the application, these estimated cash flows are usually incorporated into the original valuation model to calculate the recoverable value; for example, for life insurance, the cash flows are discounted at the then current discount rate.

Note that incorporating revised cash flows in the original valuation model is analogous to the IAS 39 impairment of assets held at AMORTISED COST where revised cash flows are discounted at the original discount rate.

If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognized (similar to an improvement in the debtor's credit rating), the previously recognized impairment loss can be reversed.

A new recoverable value for the ceded reinsurance asset and any related items is calculated with revised estimated cash flows. The reversal shall not result in a carrying amount of the reinsurance asset (and related items) that exceeds what the carrying amount would have been had the impairment not been recognized at the date the impairment is reversed.

It should be noted that some argue that IFRS 4 prohibits a cedant from reporting a reinsurance asset at a reduced value based on the cedant's assessment of the credit risk of the reinsurer. This interpretation is based on IFRS 4.20 allowing for an impairment "if, and only if ..." there is objective evidence, consistent with IAS 39.59. There are also alternative interpretations that take a less proscriptive view.

4.4 Performing LIABILITY ADEQUACY TESTING with ceded reinsurance

IFRS 4 requires that liability adequacy testing for a cedant be conducted on a gross basis, i.e., without regard to ceded reinsurance. This implies that the test would be performed gross of any ceding commission or other reimbursement for deferred ACQUISITION COSTS. IASP 6, *Liability Adequacy Testing, Testing for Recoverability of Deferred Transaction Costs, and Testing for Onerous Service Contracts under IFRS*, provides further discussion of the IFRS with respect to liability adequacy testing and ceded reinsurance (IASP 6 paragraphs 4.1.9 and 4.1.10).

4.5 Identifying embedded derivatives in reinsurance contracts

IFRS 4 does not specifically address the treatment of a reinsurance contract that provides payments to the cedant associated with EMBEDDED DERIVATIVES in contracts issued by the cedant.

Embedded derivatives in a ceded reinsurance contract may affect the financial reporting under IFRS 4 in three situations:

1. When embedded derivatives in the underlying insurance contracts are ceded to the reinsurance contract;

2. When embedded derivatives in the underlying insurance contracts are excluded from the risk transferred to the ceded reinsurance contract; and
3. When embedded derivatives are in the ceded reinsurance contract even though there are no embedded derivatives in the underlying insurance contracts.

A separate PG provides guidance for embedded derivatives. The three situations mentioned above can be considered in conjunction with reference to IFRS 4 and the PG on embedded derivatives. For ceded reinsurance, the IFRS 4 principle that applies first is to determine whether the ceded reinsurance contract contains one or more embedded derivatives, regardless of whether the underlying insurance contracts contain embedded derivatives.

4.6 Identifying when unbundling applies to reinsurance

IFRS 4 has requirements regarding the reporting of contracts that contain both an insurance component and a DEPOSIT COMPONENT. Unbundling refers to the separate measurement of the deposit component and the insurance component. Some reinsurance contracts, whether ceded or assumed, may contain these two components. Two important criteria in IFRS 4 indicate whether:

1. Unbundling is required;
2. Unbundling is permitted but not required; or
3. Unbundling is prohibited.

These criteria are as follows:

1. Whether the insurer can separately measure the deposit component, i.e., without considering the insurance component; and
2. Whether the insurer's accounting policies require it to recognize all obligations and rights arising from the deposit component.

The following table shows the results of the IFRS 4 guidance for contracts that have a deposit component:

Insurer can separately measure deposit component	Insurer's accounting policies require recognition of all obligations and rights from deposit component	Unbundling Treatment
True	True	Unbundling permitted but not required
True	False	Unbundling required
False	Either True or False	Unbundling prohibited

Unbundling requires the application of IAS 39 to the deposit component and IFRS 4 to the insurance component as if each component were separate contracts. The determination of whether a contract has a deposit component and whether an insurer can separately measure the deposit component would need to be evaluated for individual contracts or contracts that are similar in terms of the insurer's ability to separately identify and measure the deposit component.

The unbundling of ceded reinsurance means that the insurance component would be reported as ceded reinsurance assets, while the deposit component of the ceded reinsurance contract would not be reported as reinsurance assets but would be reported separately as FINANCIAL ASSETS.

The ability to measure the deposit component separately does not depend on whether the reinsurance contract contains features that provide for a deposit, an experience account, a notional account, or similar provision. The determination of a deposit component is a function of how the economics of the contract are structured. The Implementation Guidance of IFRS 4 provides an example, IG Example 3, which is discussed in paragraph IG5. The existence of additional premiums, payback features, agreements to “make the reinsurer whole,” etc., are suggestive of situations where a deposit component may exist. However, IFRS 4 does not require unbundling if the insurer recognizes all obligations and rights arising from the deposit component.

IFRS 4 does require the determination of whether an insurer’s accounting policy recognizes all obligations and rights arising from the deposit component. It may be difficult to determine if an insurer’s accounting policy meets this requirement. Examples of practices that may suggest that all rights and obligations are not recognized might include off-balance sheet accounts, funds held by a counterparty or a third party that are not included in reported assets or liabilities, and agreements to offset rights and obligations between counterparties. In the possible unbundling of a reinsurance transaction, all agreements between the reinsurer and reinsured are considered, whether formal written contracts or not, even if they are not part of the main contract between the parties.

4.7 Evaluating retroactive reinsurance

IFRS 4 addresses the definition of an insurance contract to include uncertain future events, such as the discovery of a loss that occurred before the inception of the contract or the discovery of the ultimate COST of unpaid claims after the inception of the contract. These types of events have generally been referred to as retroactive insurance or reinsurance, because the insurance or reinsurance relates to losses that have occurred before the inception of the contract. Such retroactive features do not affect whether the risk is insurance risk under IFRS 4, as long as at least one of the following is uncertain or unknown at the inception of the contract:

1. Whether an insured event will occur;
2. When it will occur;
3. How much the insurer will need to pay if it occurs.

In some jurisdictions, supervisory regulations, local accounting standards, or both can be restrictive as regards retroactive insurance, retroactive reinsurance, or both. Consequently, an insurance or reinsurance contract with retroactive features may not satisfy the local regulations or accounting standards, but it may satisfy the IFRS 4 requirements for treatment as an insurance contract. In this situation, IFRS 4 would allow reporting for such a contract under local accounting, but such local accounting could prohibit accounting for the contract as an insurance contract. In this case, an entity whose accounting policy is to use its prior accounting policy for contracts meeting the IFRS 4 criteria would not change how it reports such contracts. However, if a contract does not meet the IFRS 4 criteria for an insurance contract, then the financial reporting for such a contract would need to use the applicable IAS for a financial instrument or a service contract.

4.8 Disclosure associated with buying reinsurance

IFRS 4 requires disclosure of reported gains and losses recognized in profit or loss on buying reinsurance. Also, if the cedant defers and amortises⁷ gains or losses on buying reinsurance, then the disclosures would include the amount of gain or loss amortised in the applicable reporting period and the amounts unamortised at the beginning and end of the period.

The phrase “on buying reinsurance” refers to the recognition of profit or loss from a specific ceded reinsurance transaction at the inception of the contract, also referred to as profit, or loss, “at issue.” Consequently, a cedant will need to decide for each ceded reinsurance contract whether or not to recognize a profit or a loss or to amortise a profit or a loss at the inception of a ceded reinsurance contract. If the reporting of a reinsurance transaction on the financial statements does not result in equal debits and credits, then IFRS would require disclosure, regardless of whether the recognition of profit or loss is recognized immediately or such recognition is deferred.

The main purpose of this requirement is to disclose the net effect of buying reinsurance in the financial statements, i.e., IFRS 4 requires the effect of recognizing the reinsurance contract to be disclosed. The reference to deferral of profits or losses in IFRS 4 37(b)(ii) may not be clear with respect to what disclosures are required related to such deferrals.

If the cedant books premiums, losses, and other amounts under the ceded reinsurance contract over the period beginning at the inception of the ceded reinsurance contract and continuing until the expiration of all ceded subject business⁸, then in many jurisdictions much of the actual profit or loss from the ceded reinsurance contract would not be considered as being recognized at inception, but rather as such profit or loss emerges according to the release from risk. Therefore, if the cedant’s applicable accounting policy recognizes actual profit and loss as it emerges according to the release from risk, then the separate disclosure of actual profit and loss from a ceded reinsurance contract is not required under IFRS 4.

Where a ceded reinsurance contract covers a block of policies, a practical view of recognition or amortisation “at inception” would be to disclose the aggregate amount of recognized, or amortised, profit or loss attributable to the aggregated ceded accounting entries associated with the subject business of the ceded reinsurance contract. That is, if a company recognizes a profit or a loss, or amortises a profit or a loss due to a ceded reinsurance contract, as the ceded premium for the subject business is booked, the aggregate amount of such profit or loss accounting entries would be subject to the IFRS 4 disclosure requirements. However, if the profit or loss is recognized only as the (ceded) risk is released over the lifetime of the policy, then no disclosure is needed.

The recognition of a profit, a loss, or the amortisation of a profit or a loss “on buying reinsurance” could be the result of how an entity records the ceded portion of policy reserves, unearned premiums, or liabilities for unexpired risks. A cedant that uses an accounting policy that recognizes profit or loss more rapidly than the release of risk inherent in the subject business, would be subject to the IFRS 4 disclosure requirements.

⁷ The amortisation of profit or loss as used in this PG refers to a selected period other than the period of exposure or the period when subject business is in-force.

⁸ The phrase “expiration of all subject business” is used herein to refer to the end of the time period when no new losses or benefits can occur. However, final settlement or payment of all losses or benefits under a ceded reinsurance contract can extend well beyond the expiration of the business subject to the ceded reinsurance.

This IFRS 4 requirement is a disclosure of anticipated profit or loss that is reported in the financial statements at the inception of the ceded reinsurance contract or the amount of deferred and amortised profit or loss that is reported at inception and in any subsequent financial statements. Insurance contracts or assumed reinsurance contracts that are issued by an entity do not have a similar disclosure requirement.

If a cedant recognizes the initial ceding commission as income, such income might be considered to contribute to a profit “on buying reinsurance,” but if the ceding commission is actually compensation for corresponding costs actually spent by the cedant for the ceded business, the disclosure would provide that information. Where the ceding commissions are adjusted based on actual ceded losses, as would be the case for reinsurance contracts that include sliding scale commissions, profit or contingent commissions, loss sensitive commissions, etc., the anticipated ceding commissions in excess of the minimum ceding commission would need to be evaluated to determine if the IFRS 4 disclosure requirements would apply as a profit from reinsurance.

Insurers will need to decide if their accounting policy allows for the recognition or amortisation of a profit or a loss “on buying” reinsurance. Records for each affected ceded reinsurance contract will need to be maintained in order to comply with these disclosures.

4.9 Disclosure of reinsurance used for risk mitigation

IFRS 4.38 requires the disclosure of information regarding the nature and extent of risks arising from insurance contracts. IFRS 4.39(a) requires disclosure of the company’s objectives, policies and processes for managing risks arising from insurance contracts and its methods used to manage those risks in order to comply with IFRS 4.38. Where reinsurance is a major element for managing risks from insurance contracts, e.g., managing the concentration of risks due to hurricanes, typhoons, or earthquakes, the use of reinsurance to manage risks and the company’s relevant policies regarding the use of reinsurance will need to be disclosed.

4.10 Disclosure of reinsurance claims development information

IFRS 4.38 requires the disclosure of information regarding the nature and extent of risks arising from insurance contracts. IFRS 4.39(c) lists several areas where such information needs to be disclosed. In particular, IFRS 4.39(c) requires “information about insurance risk (both before and after risk mitigation by reinsurance), followed by a list of information which includes “actual claims compared with previous estimates (i.e., claims development).”

This disclosure requirement considers ceded reinsurance as a risk mitigation measure. Consequently, for disclosures to be consistent with IFRS 4.39(c), the claim development information may need to be reported both “before and after” recoveries from ceded reinsurance. This is consistent with the IFRS 4 requirement to report separately ceded reinsurance assets from insurance liabilities without offset for ceded reinsurance. Also, any adjustments to reinsurance assets for impairment, or for the settlement or commutation of reinsurance contracts, may need to be reflected in the claims development information. The disclosure of information regarding claims development without regard to recoveries from ceded reinsurance might provide appropriate information about insurance risk before risk mitigation by reinsurance.

Because the purchase of reinsurance provides risk mitigation for an insurer, it is also appropriate to disclose information about claims development related to the ceded reinsurance. Also, examples of approaches to disclose the mitigation of insurance risk accomplished by ceded reinsurance might include providing the claims development history net of ceded reinsurance recoveries or providing

the historical development of claims amounts recovered or expected to be recovered from the reinsurance assets held by the company. Thus, separate disclosures of gross, ceded, and net claims development history might illustrate the use of ceded reinsurance to mitigate some of the insurance risks involved, particularly where claim development risk is significant.

Depending on how a particular company uses reinsurance to mitigate insurance risk, a variety of disclosure alternatives may exist. For example, if a company has made material changes in its ceded reinsurance, it may disclose key information regarding such changes. If ceded reinsurance affects only certain material portions of a company's business, the disclosure of that information may be warranted.

4.11 Transition to first-time application of IFRS 4

IFRS 4 is effective for annual periods beginning on or after 1 January 2005. Because financial statements include data and disclosures for the prior annual period for comparative information, the first-time application of IFRS 4 may present some issues when reporting data and disclosures for the prior annual period. IFRS 4.42 exempts an entity from most of the IFRS 4 disclosure requirements related to prior annual periods beginning before 1 January 2005. However, this exemption does not apply with respect to disclosure requirements in IFRS 4.37(a) concerning accounting policies and IFRS 4.37(b) concerning "recognized assets, liabilities, income and expense" (and cash flows if the direct method is used). The remaining portion of IFRS 4.37(b) addresses the disclosure of gains and losses on buying reinsurance, as reflected in recognized income and expense.

However, IFRS 4.10–35 is applied for the prior annual period amounts, unless "it is IMPRACTICABLE to apply a particular requirement" to comparative information for annual periods before 1 January 2005 (IFRS 4.43). The liability adequacy test is mentioned as the requirement that might sometimes be impracticable to apply in the case of such comparative information. When applying such requirements is impracticable, per the IAS 8 definition of "impracticable," then disclosures will need to include a statement about the specific impracticable requirements for the prior annual period.

Insurers will need to provide prior period comparative information regarding unbundling, separate reporting of reinsurance assets from insurance liabilities, reporting of income and expense arising from ceded reinsurance contracts separate from insurance contracts or assumed reinsurance contracts, the impairment of reinsurance assets, and the measurement of insurance contracts including prudence. Note that the liability adequacy test will need to be applied to insurance liabilities without any regard to ceded reinsurance, so that the application of a liability adequacy test to prior periods would also need to be performed on a similar basis. Guidance on the application of a liability adequacy test under IFRS 4 in light of ceded reinsurance is provided in IASP 6.

Appendix A – Excerpts from IFRS 4 concerning reinsurance

IFRS 4 mentions reinsurance and associated terms such as cedant in several places. Examples include the following (the use of these terms has been indicated in bold for convenience):

MAIN FEATURES OF IFRS 4

1. IFRS 4, IN3. The IFRS applies to all insurance contracts (including **reinsurance** contracts) that an entity issues and to **reinsurance** contracts that it holds, except for specified contracts covered by other IFRSs.
2. IFRS 4, IN4. The IFRS exempts an insurer temporarily (i.e., during phase I of this project) from some requirements of other IFRSs, including the requirement to consider the Framework in selecting accounting policies for insurance contracts. However, the IFRS:
 - (a) prohibits provisions for possible claims under contracts that are not in existence at the reporting date (such as catastrophe and equalisation provisions);
 - (b) requires a test for the adequacy of recognised insurance liabilities and an impairment test for **reinsurance** assets.
 - (c) requires an insurer to keep insurance liabilities in its balance sheet until they are discharged or cancelled, or expire, and to present insurance liabilities without offsetting them against related **reinsurance** assets.

SCOPE

3. IFRS 4.2. An entity shall apply this IFRS to:
 - (a) insurance contracts (including **reinsurance** contracts) that it issues and **reinsurance** contracts that it holds.
4. IFRS 4.4. An entity shall not apply this IFRS to:
 - (f) direct insurance contracts that the entity holds (i.e., direct insurance contracts in which the entity is the policyholder). However, a **cedant** shall apply this IFRS to **reinsurance** contracts that it holds.
5. IFRS 4.6. A **reinsurance** contract is a type of insurance contract. Accordingly, all references in this IFRS to insurance contracts also apply to **reinsurance** contracts.
6. IFRS 4.11. The following is an example of a case when an insurer's accounting policies do not require it to recognise all obligations arising from a deposit component. A **cedant** receives compensation for losses from a **reinsurer**, but the contract obliges the **cedant** to repay the compensation in future years. That obligation arises from a deposit component. If the **cedant's** accounting policies would otherwise permit it to recognise the compensation as income without recognising the resulting obligation, unbundling is required.

RECOGNITION AND MEASUREMENT

Temporary exemption from some other IFRSs

7. IFRS 4.13. IAS 8.10–12 *Accounting Policies, Changes in Accounting Estimates and Errors* specify criteria for an entity to use in developing an accounting policy if no IFRS applies specifically to an item. However, this IFRS exempts an insurer from applying those criteria to its accounting policies for:

- (b) **reinsurance** contracts that it holds.
8. IFRS 4.14. Nevertheless, this IFRS does not exempt an insurer from some implications of the criteria in IAS 8.10–12. Specifically, an insurer:
- (a) shall not recognise as a liability any provisions for possible future claims, if those claims arise under insurance contracts that are not in existence at the reporting date (such as catastrophe provisions and equalisation provisions).
 - (b) shall carry out the liability adequacy test described in paragraphs 15–19.
 - (c) shall remove an insurance liability (or a part of an insurance liability) from its balance sheet when, and only when, it is extinguished—i.e., when the obligation specified in the contract is discharged or cancelled or expires.
 - (d) shall not offset:
 - (i) **reinsurance** assets against the related insurance liabilities; or
 - (ii) income or expense from **reinsurance** contracts against the expense or income from the related insurance contracts.
 - (e) shall consider whether its **reinsurance** assets are impaired (see paragraph 20).

Liability adequacy test

9. IFRS 4.17. If an insurer's accounting policies do not require a liability adequacy test that meets the minimum requirements of paragraph 16, the insurer shall:
- (a) determine the carrying amount of the relevant insurance liabilities less the carrying amount of:
 - (i) any related deferred acquisition costs; and
 - (ii) any related intangible asset, such as those acquired in a business combination or portfolio transfer (see paragraphs 31 and 32). However, related **reinsurance** assets are not considered because an insurer accounts for them separately (see paragraph 20).

Impairment of reinsurance assets

10. IFRS 4.20. If a cedant's **reinsurance** asset is impaired, the **cedant** shall reduce its carrying amount accordingly and recognise that impairment loss in profit or loss. A **reinsurance** asset is impaired if, and only if:
- (a) there is objective evidence, as a result of an event that occurred after initial recognition of the **reinsurance** asset, that the **cedant** may not receive all amounts due to it under the terms of the contract; and
 - (b) that event has a reliably measurable impact on the amounts that the **cedant** will receive from the **reinsurer**.

DISCLOSURE

Explanation of recognized amounts

11. IFRS 4.36. An insurer shall disclose information that identifies and explains the amounts in its financial statements arising from insurance contracts.
12. IFRS 4.37. To comply with paragraph 36, an insurer shall disclose:
 - (a) its accounting policies for insurance contracts and related assets, liabilities, income and expense.
 - (b) the recognised assets, liabilities, income and expense (and, if it presents its cash flow statement using the direct method, cash flows) arising from insurance contracts.

Furthermore, if the insurer is a **cedant**, it shall disclose:

- (i) gains and losses recognised in profit or loss on buying **reinsurance**; and
- (ii) if the **cedant** defers and amortises gains and losses arising on buying reinsurance, the amortisation for the period and the amounts remaining unamortised at the beginning and end of the period.
- (c) the process used to determine the assumptions that have the greatest effect on the measurement of the recognised amounts described in (a). When practicable, an insurer shall also give quantified disclosure of those assumptions.
- (d) the effect of changes in assumptions used to measure insurance assets and insurance liabilities, showing separately the effect of each change that has a material effect on the financial statements.
- (e) reconciliations of changes in insurance liabilities, **reinsurance** assets and, if any, related deferred acquisition costs.

Nature and extent of risks arising from insurance contracts

13. IFRS 4.38. An insurer shall disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from insurance contracts.
14. IFRS 4.39. To comply with IFRS 4.38, an insurer shall disclose:
 - (a) its objectives, policies and processes for managing risks arising from insurance contracts and the methods used to manage those risks.
 - (b) [deleted]
 - (c) information about insurance risk (both before and after risk mitigation by **reinsurance**), including information about:
 - (i) the sensitivity to insurance risk (see paragraph 39A).
 - (ii) concentrations of insurance risk, including a description of how management determines concentrations and a description of the shared characteristic that identifies each concentration (e.g., type of insured event, geographical area, or currency).
 - (iii) actual claims compared with previous estimates (i.e., claims development). The disclosure about claims development shall go back to the period when the earliest material claim arose for which there is still uncertainty about the amount and timing of

the claims payments, but need not go back more than ten years. An insurer need not disclose this information for claims for which uncertainty about the amount and timing of claims payments is typically resolved within one year.

15. IFRS 4.39A. To comply with paragraph 39(c)(i), an insurer shall disclose either (a) or (b) as follows:
- (a) a sensitivity analysis that shows how profit or loss and equity would have been affected had changes in the relevant risk variable that were reasonably possibly at the balance sheet date occurred; the methods and assumptions used in preparing the sensitivity analysis; and any changes from the previous period in the methods and assumptions used. However, if an insurer uses an alternative method to manage sensitivity to market conditions, such as an embedded value analysis, it may meet this requirement by disclosing that alternative sensitivity analysis and the disclosures required by paragraph 41 of IFRS 7.
 - (b) qualitative information about sensitivity, and information about those terms and conditions of insurance contracts that have a material effect on the amount, timing and uncertainty of the insurer's future cash flows.

Uncertain future event

16. IFRS 4, B4. Some insurance contracts cover events that have already occurred, but whose financial effect is still uncertain. An example is a **reinsurance** contract that covers the direct insurer against adverse development of claims already reported by policyholders. In such contracts, the insured event is the discovery of the ultimate cost of those claims.

Examples of insurance contracts

17. IFRS 4, B18. The following are examples of contracts that are insurance contracts, if the transfer of insurance risk is significant:
- (m) **reinsurance** contracts.
18. IFRS 4, B19. The following are examples of items that are not insurance contracts:
- (b) contracts that have the legal form of insurance, but pass all significant insurance risk back to the policyholder through non-cancellable and enforceable mechanisms that adjust future payments by the policyholder as a direct result of insured losses, for example some financial **reinsurance** contracts or some group contracts (such contracts are normally non-insurance financial instruments or service contracts, see IFRS 4, B20 and IFRS 4, B21).

Significant insurance risk

19. IFRS 4, B24. The additional benefits described in paragraph B23 refer to amounts that exceed those that would be payable if no insured event occurred (excluding scenarios that lack commercial substance). Those additional amounts include claims handling and claims assessment costs, but exclude:
- (d) possible **reinsurance** recoveries. The insurer accounts for these separately.

Excerpts from *GUIDANCE ON IMPLEMENTATING IFRS 4*

Guidance on implementing IFRS 4 mentions reinsurance and associated terms such as cedant, in several places. Examples include:

20. IG2, IG Example 1 illustrates the application of the definition of an insurance contract. The example does not illustrate all possible circumstances.

IG Example 1: Application of the definition of an insurance contract, 1.20.

Contract Type: Catastrophe Bond

Treatment in phase I. The contract is an insurance contract, and contains an insurance component (with the issuer as policyholder and the holder as the insurer) and a deposit component.

- (a) If specified conditions are met, paragraph 10 of the IFRS requires the holder to unbundle the deposit component and apply IAS 39 to it.
- (b) The issuer accounts for the insurance component as **reinsurance** if it uses the bond for that purpose. If the issuer does not use the insurance component as **reinsurance**, it is not within the scope of the IFRS, which does not address accounting by policyholders for direct insurance contracts.

21. IG Example 1: Application of the definition of an insurance contract, 1.28.

Contract Type: A contract meets the definition of an insurance contract. It was issued by one entity in a group (for example a captive insurer) to another entity in the same group.

Treatment in phase I. If the entities present individual or separate financial statements, they treat the contract as an insurance contract in those individual or separate financial statements (see IAS 27).

The transaction is eliminated from the group's consolidated financial statements.

If the intragroup contract is **reinsured** with a third party that is not part of the group, the **reinsurance** contract is treated as a direct insurance contract in the consolidated financial statements because the intragroup contract is eliminated on consolidation.

22. IG Example 1: Application of the definition of an insurance contract, 1.29.

Contract Type: An agreement that entity A will compensate entity B for losses on one or more contracts issued by entity B that do not transfer significant insurance risk.

Treatment in phase I. The contract is an insurance contract if it transfers significant insurance risk from entity B to entity A, even if some or all of the individual contracts do not transfer significant insurance risk to entity B. The contract is a **reinsurance** contract if any of the contracts issued by entity B are insurance contracts. Otherwise, the contract is a direct insurance contract.

23. IG5 Paragraph 10 of the IFRS requires an insurer to unbundle some insurance contracts that contain a deposit component. IG Example 3 illustrates this requirement. Although arrangements of this kind are more common in **reinsurance**, the same principle applies in direct insurance. However, unbundling is not required if the insurer recognises all obligations or rights arising from the deposit component.

IG Example 3: Unbundling a deposit component of a **reinsurance** contract

A **reinsurance** contract has the following features:

- (a) The **cedant** pays premiums of CU10 every year for five years.
- (b) An experience account is established, equal to 90 per cent of cumulative premiums (including the additional premiums discussed in (c) below) less 90 per cent of cumulative claims.
- (c) If the balance in the experience account is negative (i.e., cumulative claims exceed cumulative premiums), the **cedant** pays an additional premium equal to the experience account balance divided by the number of years left to run on the contract.
- (d) At the end of the contract, if the experience account balance is positive (i.e., cumulative premiums exceed cumulative claims), it is refunded to the **cedant**; if the balance is negative, the **cedant** pays the balance to the **reinsurer** as an additional premium.
- (e) Neither party can cancel the contract before maturity.
- (f) The maximum loss that the **reinsurer** is required to pay in any period is CU200.

This contract is an insurance contract because it transfers significant insurance risk to the **reinsurer**. For example, in case 2 discussed below, the **reinsurer** is required to pay additional benefits with a present value, in year 1, of CU35, which is clearly significant in relation to the contract.

The following discussion addresses the accounting by the **reinsurer**. Similar principles apply to the accounting by the **cedant**. (See IG Example 3 for complete discussion.)

24. IG17 IAS 1 requires disclosure of accounting policies and paragraph 37(a) of the IFRS highlights this requirement. In developing disclosures about accounting policies for insurance contracts, an insurer might conclude that it needs to address the treatment of, for example, some or all of the following applications:
 - (i) **reinsurance** held.
25. IG20 IAS 1 requires minimum disclosures on the face of the balance sheet. An insurer might conclude that, to satisfy those requirements, it needs to present separately on the face of its balance sheet the following amounts arising from insurance contracts:
 - (a) liabilities under insurance contracts and **reinsurance** contracts issued.
 - (b) assets under insurance contracts and **reinsurance** contracts issued.
 - (c) assets under **reinsurance ceded**. Under paragraph 14(d)(i) of the IFRS, these assets are not offset against the related insurance liabilities.
26. IG23 Similar sub-classifications may also be appropriate for **reinsurance** assets, depending on their materiality and other relevant circumstances. For assets under insurance contracts and **reinsurance** contracts issued, an insurer might conclude that it needs to distinguish:
 - (a) deferred acquisition costs; and
 - (b) intangible assets relating to insurance contracts acquired in business combinations or portfolio transfers.

27. IG24 IAS 1 lists minimum line items that an entity should present on the face of its income statement. It also requires the presentation of additional line items when this is necessary to present fairly the entity's financial performance. An insurer might conclude that, to satisfy these requirements, it needs to disclose the following amounts on the face of its income statement:
- (a) revenue from insurance contracts issued (without any reduction for **reinsurance** held).
 - (b) income from contracts with **reinsurers**.
 - (c) expense for policyholder claims and benefits (without any reduction for **reinsurance** held).
 - (d) expenses arising from **reinsurance** held.
28. IG28. The items described in paragraph IG26 are not offset against income or expense arising from **reinsurance** held (paragraph 14(d)(ii) of the IFRS).
29. IG29 Paragraph 37(b) also requires specific disclosure about gains or losses recognised on buying **reinsurance**. This disclosure informs users about gains or losses that may, using some measurement models, arise from imperfect measurements of the underlying direct insurance liability. Furthermore, some measurement models require a **cedant** to defer some of those gains and losses and amortise them over the period of the related risk exposures, or some other period. Paragraph 37(b) also requires a **cedant** to disclose information about such deferred gains and losses.
30. IG36 An insurer might disclose the effects of changes in assumptions both before and after **reinsurance** held, especially if the insurer expects a significant change in the nature or extent of its **reinsurance** programme or if an analysis before **reinsurance** is relevant for an analysis of the credit risk arising from **reinsurance** held.
31. IG37 Paragraph 37(e) of the IFRS requires an insurer to disclose reconciliations of changes in insurance liabilities. It also requires disclosure of changes in **reinsurance** assets.
32. IG38 An insurer discloses the changes in insurance liabilities and **reinsurance** assets in all prior periods for which it reports full comparative information.
33. IG48 Paragraph 9(a) of the IFRS requires an insurer to disclose its objectives, policies and processes for managing risks arising from insurance contracts and the methods used to manage those risks. Such discussion provides an additional perspective that complements information about contracts outstanding at a particular time. Such disclosure might include information about:
- (e) the methods the insurer employs to limit or transfer insurance risk exposures and avoid undue concentrations of risk, such as retention limits, inclusion of options in contracts, and **reinsurance**.
34. IG51 Paragraph 39(c) of the IFRS requires disclosures about insurance risk. Disclosures to satisfy this requirement might build on the following foundations:
- (a) Information about insurance risk might be consistent with (though less detailed than) the information provided internally to the entity's key management personnel (as defined in IAS 24 Related Party Disclosures) so that users can assess the insurer's financial position, performance and cash flows 'through the eyes of management'.

- (b) Information about risk exposures might report exposures both gross and net of reinsurance (or other risk mitigating elements, such as catastrophe bonds issued or policyholder participation features), especially if the insurer expects a significant change in the nature or extent of its reinsurance programme or if an analysis before **reinsurance** is relevant for an analysis of the credit risk arising from **reinsurance** held.
 - (c) In reporting quantitative information about insurance risk, an insurer might disclose the methods used, the strengths and limitations of those methods, the assumptions made, and the effect of **reinsurance**, policyholder participation and other mitigating elements.
35. IG51A Disclosures about insurance risk might include:
- (a) information about the nature of the risk covered, with a brief summary description of the class (such as annuities, pensions, other life insurance, motor, property and liability).
 - (b) information about the general nature of participation features whereby policyholders share in the performance (and related risks) of individual contracts or pools of contracts or entities, including the general nature of any formula for the participation and the extent of any discretion held by the insurer.
 - (c) information about the terms of any obligation or contingent obligation for the insurer to contribute to government or other guarantee funds (see also IAS 37).
36. IG56 Disclosure of concentrations of insurance risk might include a description of the shared characteristic that identifies each concentration and an indication of the possible exposure, both before and after **reinsurance** held, associated with all insurance liabilities sharing that characteristic.

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Appendix B – Ceded reinsurance

Impact of prudence in financial statements (an example)

IFRS 4 calls for displaying the insurance liabilities on a gross basis, rather than on a net basis. The impact on the balance sheet of any reinsurance then is to be in the form of a “ceded reinsurance asset” rather than as a subtraction from the liabilities.

The attached spreadsheets illustrate an issue arising from this aspect of IFRS 4. The spreadsheets take a hypothetical company with the following characteristics:

1. Assets of 110. Net insurance liabilities of 100. Surplus of 10.
2. The company reinsures out 80% of its business in the first example, and 40% of its business in the second. There are no other liabilities.
3. The margin for prudence in all liability calculations (gross, ceded, and hence net) is assumed to be 14% of best-estimate values. In other words, consistent assumptions are used in the calculation of the actuarial value of the gross and ceded liabilities, which then produce the same 14% margin in the calculation of each one. Not all numbers add, due to rounding.

The spreadsheet then shows the balance sheet under four scenarios. The top portion of the spreadsheet is the supporting detail, while the bottom portion is the result:

1. Scenario I shows the company’s balance sheet as it would stand currently in many jurisdictions, where “credit” is fully taken for ceded reinsurance.
2. Scenario II shows the balance sheet after transposing the value associated with the ceded reinsurance from a deduction from the liabilities to an asset, as required by IFRS 4, but without any change in that value per se. This produces a value of the reinsurance asset that is in excess of its best-estimate value, but one that is consistent with the value determined for the gross liability.
3. Scenario III shows the inconsistent effect of no “prudence” as incorporated in the value of the ceded reinsurance asset under scenario II. Because prudence had been calculated consistently for both the gross and the ceded liabilities, having no “prudence” in the ceded reinsurance asset value results in a smaller reinsurance asset than under Scenario II, as the liability less the asset results in a larger provision and hence results in a much smaller reported surplus (in the case of the entity that reinsures 80% of its business, the surplus becomes a deficit). This result, as well as being inconsistent, would be contrary to IFRS 4.28, which states: “An insurer need not change its accounting policies for insurance contracts to eliminate excessive prudence. However, if an insurer already measures its insurance contracts with sufficient prudence, it shall not introduce additional prudence.”
4. Scenario IV demonstrates one approach to eliminating the inconsistent result produced by Scenario III. Here the gross liability is taken as the sum of its best-estimate value plus the *net* margin for prudence. This approach results in the appropriate reported surplus and does not introduce additional prudence.

Scenario I is not permitted under IFRS 4. Scenario III produces a result that is both inconsistent and contrary to the IFRS 4 principle of not introducing additional prudence into the calculations. Scenario IV produces appropriate results, but is awkward to calculate and explain. Scenarios II and IV appear to be an appropriate and consistent approaches.

Example A Ceded Reinsurance - Impact of Prudence in Financial Statements

Percentage reinsured 80.00%

Margin for prudence 14.00%

Scenario	I. Current		II. Reinsurance asset with "prudence" related to liabilities		III. No "prudence" in reinsurance asset		IV. Net prudence in gross liability	
	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
Detail								
Gross – best estimate		439		439		439		439
– margin for prudence		61		61		61		12
– total	110	500	110	500	110	500	110	451
Ceded – best estimate		-351		-351		351		351
– margin for prudence		-49		-49		0		0
– total		-400		400		351		351
Total	110	100	510	500	461	500	461	451
Surplus		10		10		-39		10
Balance sheet presentation								
Gross	110	500	110	500	110	500	110	451
Ceded		-400		400		351		351
Total	110	100	510	500	461	500	461	451
Surplus		10		10		-39		10

Example B Ceded Reinsurance - Impact of Prudence in Financial Statements

Percentage reinsured 40.00%
 Margin for prudence 14.00%

Scenario	I. Current		II. Reinsurance asset with "prudence" related to liabilities		III. No "prudence" in reinsurance asset		IV. Net prudence in gross liability	
	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
Detail								
Gross – best estimate		146		146	146			146
– margin for prudence		20		20	20			12
– total	110	167	110	167	110	167	110	158
Ceded – best estimate		-58		-58	58			58
– margin for prudence		-8		-8	0			0
– total		-67		-67	58			58
Total	110	100	177	167	168	167	168	158
Surplus		10		10		2		10
Balance sheet presentation								
Gross	110	167	110	167	110	167	110	158
Ceded		-67		-67	58			58
Total	110	100	177	167	168	167	168	158
Surplus		10		10		2		10

Appendix C – Relevant IFRSs

The most relevant International Financial Reporting Standards and International Accounting Standards are listed below.

- IAS 1 (2001 April) Presentation of Financial Statements
- IAS 8 (2004 March) Accounting Policies, Changes in Accounting Estimates and Errors
- IAS 18 (2004 March) Revenue
- IAS 19 (2004 December) Employee Benefits
- IAS 27 (2003 December) Consolidated Financial Statements and Accounting for Investments in Subsidiaries
- IAS 32 (2005 December) Financial Instruments: Presentation
- IAS 37 (1999 July) Provisions, Contingent Liabilities and Contingent Assets
- IAS 39 (2005 August) Financial Instruments: Recognition and Measurement
- IFRS 1 (2005 June) First-Time Adoption of International Financial Reporting Standards
- IFRS 4 (2005 December) Insurance Contracts
- IFRS 7 (2005 December) Financial Instruments: Disclosure

In addition, the IASB *Framework* is relevant.

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Appendix D – List of terms defined in the Glossary

The first time that these terms are used in this IASP, they are shown in small capital letters. The definitions of these terms are included in the IAA Glossary.

Accounting policy
Acquisition cost
Actuary
Amortised cost
Benefit
Cedant
Component
Contract
Cost
Deposit component
Financial asset
Financial instrument
Financial reporting
Financial risk
Financial statement
Impracticable
Insurance contract
Insurance liability
Insurance risk
Insured event
Insurer
International Accounting Standard (IAS)
International Actuarial Association (IAA)
International Actuarial Standard of Practice (IASP)
International Financial Reporting Standard (IFRS)
International Financial Reporting Standards (IFRSs)
Investment contract
Issuer
Liability adequacy test
Policyholder
Practice Guideline (PG)
Practitioner
Professional services
Provision
Reinsurance contract
Reinsurer
Reporting entity
Service contract
Value in use

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