Section 10,760

Statement of Position 98-7 Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk

October 19, 1998

NOTE

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the area of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

Summary

This Statement of Position (SOP) provides guidance on how to account for insurance and reinsurance contracts that do not transfer insurance risk. It applies to all entities and all insurance and reinsurance contracts that do not transfer insurance risk, except for long-duration life and health insurance contracts. The method used to account for insurance and reinsurance contracts that do not transfer insurance risk is referred to in this SOP as deposit accounting. The SOP does not address when deposit accounting should be applied.

This SOP specifies the following.

- Insurance and reinsurance contracts for which the deposit method is appropriate should be classified as one of the following, which are those that—
  — Transfer only significant timing risk.
  — Transfer only significant underwriting risk.
  — Transfer neither significant timing nor underwriting risk.
  — Have an indeterminate risk.

- At inception, a deposit asset or liability should be recognized for insurance and reinsurance contracts accounted for under deposit accounting and should be measured based on the consideration paid or received, less any explicitly identified premiums or fees to be retained by the insurer or reinsurer, irrespective of the experience of the contract.
- Insurance and reinsurance contracts that transfer neither significant timing nor underwriting risk, and insurance and reinsurance contracts that transfer only significant timing risk, should be accounted for using the interest method. Changes in estimates of the timing or amounts of recoveries should be accounted for by recalculating the effective yield. The asset or liability should then be adjusted to the amount that would have existed had the new effective yield been applied since the inception of the contract. The revenue and expense recorded for such contracts shall be included in interest income or interest expense.
- Insurance or reinsurance contracts that transfer only significant underwriting risk should be accounted for by measuring the deposit based on the unexpired portion of the coverage provided until losses are incurred that will be reimbursed under the contracts. Once a loss is incurred that will be reimbursed under this kind of contract, then the deposit should be measured by the present value of the expected future cash flows arising from the contract, plus the remaining unexpired portion of the coverage provided. Changes in the recorded amount of the deposit, other than the unexpired portion of the coverage provided, should be included in the income statement of the insured as an offset against the loss recorded by the insured that will be reimbursed under the contract and in an insurer's income statement as an incurred loss. The reduction in the deposit related to the unexpired portion of the coverage provided should be recorded by the insured and the insurer who are insurance enterprises as an adjustment to incurred losses. If the insured is an enterprise other than an insurance enterprise, then the reduction in the deposit related to the unexpired portion of the coverage provided should be recorded as an expense.
- For insurance and reinsurance contracts with indeterminate risk, the guidance in SOP 92-5, *Accounting for Foreign Property and Liability Reinsurance* [section 10,520] as to the open-year method, should be followed. The open-year method should not, however, be used to defer losses that otherwise would be recognized pursuant to Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*. Under the open-year method, the effects of the contracts are not included in the determination of net income until sufficient information becomes available to reasonably estimate and allocate premiums. The open-year method requires that these effects be aggregated in the balance sheet. When sufficient information becomes available to reasonably estimate and allocate premiums, the insurance or reinsurance contract with indeterminate risk should be reclassified into one of the other three categories as an insurance or reinsurance contract that transfers neither significant timing nor underwriting risk, transfers only significant timing risk, or transfers only significant underwriting risk, as appropriate, and accounted for accordingly.

This SOP is effective for financial statements for fiscal years beginning after June 15, 1999, with earlier adoption encouraged. Restatement of previously issued annual financial statements is not permitted. Initial application of this SOP is as of the beginning of an entity's fiscal year (that is, if the SOP were adopted before the effective date and during an interim period, all prior interim periods are required to be restated). The effect of initially adopting this SOP should be reported as a cumulative effect of a change in accounting principle, in accordance with the provisions of Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*.

Foreword

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least ten of AcSEC's fifteen members, and (3) a proposed final document that has been approved by at least ten of AcSEC's fifteen members. The document is cleared if five of the seven FASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft or, after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing the final document.

The criteria applied by the FASB in their review of proposed projects and proposed documents include the following.

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.
2. The proposal will result in an improvement in practice.
3. The AICPA demonstrates the need for the proposal.
4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, prior to clearance, the FASB will propose suggestions, many of which are included in the documents.

Introduction

.01 "Insurance provides indemnification against loss or liability from specified events and circumstances that may occur or be discovered during a specified period. In exchange for a payment from the policyholder (a premium), an insurance enterprise agrees to pay the policyholder if specified events occur or are discovered. Similarly, the insurance enterprise may obtain indemnification against claims associated with contracts it has written by entering into a reinsurance contract with another enterprise."[1] Insurance and reinsurance contracts may be structured in various ways. The premium paid by the policyholder may represent a payment for the transfer of **insurance risk** or it may represent a deposit.[2]

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[1] The source is paragraph 1 of FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*.

[2] Terms defined in the Glossary [paragraph .39] are set in boldface the first time they appear in this SOP.

.02 Paragraph 44 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*, states the following, in part.

> To the extent that an insurance contract or reinsurance contract does not, despite its form, provide for indemnification of the insured or the ceding company by the insurer or reinsurer against loss or liability, the premium paid less the amount of the premium to be retained by the insurer or reinsurer shall be accounted for as a deposit by the insured or ceding company.

.03 FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts,* established certain conditions for determining whether a reinsurance contract indemnifies against loss or liability relating to insurance risk. Although existing accounting literature does not provide similar criteria to evaluate whether an insurance contract indemnifies against loss or liability, generally accepted accounting principles (GAAP) require a determination of whether insurance risk has been transferred (as discussed in paragraph .02 above). This SOP neither addresses *when* deposit accounting should be applied nor provides criteria to make this determination. Such guidance is provided on a case-by-case basis in the applicable pronouncements.

.04 As stated above, FASB Statement Nos. 5 and 113 and Emerging Issues Task Force (EITF) Issue Nos. 93-14, *Accounting for Multiple-Year Retrospectively Rated Insurance Contracts by Insurance Enterprises and Other Enterprises*, and 93-6, *Accounting for Multiple-Year Retrospectively Rated Reinsurance Contracts by Ceding and Assuming Enterprises*, each require that the deposit method of accounting be applied when parties enter into insurance or reinsurance contracts that do not transfer insurance risk. Nevertheless, the existing accounting pronouncements do not describe what is meant by deposit accounting in those circumstances or how it should be applied.

.05 The consensus decisions in FASB EITF Issue Nos. 93-14 and 93-6 provide further guidance on when deposit accounting should be applied to reinsurance and insurance contracts.

Applicability and Scope

.06 This SOP provides guidance on how to apply the deposit method of accounting when it is required for insurance and reinsurance contracts that do not transfer insurance risk. These contracts may be prospective or retroactive in nature. This SOP applies to all entities that have entered into the following kinds of insurance and reinsurance contracts:

a. Short-duration insurance and reinsurance contracts that do not transfer insurance risk as described in paragraph 44 of FASB Statement No. 5 and, for reinsurance contracts, as described in paragraphs 8 through 11 and 18(a) of FASB Statement No. 113 and EITF Issue No. 93-6.

b. Multiple-year insurance and reinsurance contracts that do not transfer insurance risk or for which insurance risk transfer is not determinable. (EITF Issue Nos. 93-14 and 93-6 prescribe the deposit method of accounting for multiple-year retrospectively rated insurance and reinsurance contracts, respectively, that do not transfer insurance risk.)

However, FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, and FASB Statement No. 113 explicitly provide that long-duration life and health insurance contracts that do not indemnify against mortality or morbidity risk should be accounted for as investment contracts as defined and described in FASB Statement No. 97. Therefore, such contracts are not covered by this SOP.

.07 This SOP does not address or change existing requirements as to when deposit accounting should be applied. Appendix A [paragraph .37], "Illustrations of Application of Conclusions," herein, provides examples that illustrate the application of certain provisions of this SOP. The illustrations are intended as examples only; it should not be construed that any aspect of the illustrations establishes or changes requirements as to when deposit accounting should be applied. The conclusions in this SOP apply to both the insured and the insurer in an insurance contract. The conclusions in this SOP also apply to the **ceding** and **assuming entity** in a reinsurance contract.

Kinds of Contracts

.08 The transfer of insurance risk requires transferring both **timing risk** and **underwriting risk**. Therefore, four possible categories for deposit arrangements have been identified as follows.

a. *An insurance or reinsurance contract that transfers only significant timing risk*. For an insurance or reinsurance contract to be considered to have transferred significant timing risk, the timing of the loss reimbursement under the contract must be based on the timing of the loss event.[3] An insurance or reinsurance contract that transfers only significant timing risk limits the amount of underwriting risk to which the insurer or reinsurer is subject and is commonly entered into by the insured or ceding entity to provide liquidity. These limitations may result in an insufficient transfer of insurance risk. For example, insurance and reinsurance contracts that provide for **experience adjustments** may indicate that a sufficient amount of underwriting risk has not been transferred. The recovery of the amount of the initial deposit for a contract that transfers only significant timing risk is not substantially dependent on future loss experience of the insured.

b. *An insurance or reinsurance contract that transfers only significant underwriting risk*. For an insurance or reinsurance contract to be considered to have transferred significant underwriting risk, the probability of a significant variation in the amount of payments under the insurance or reinsurance contract must be more than remote. Such variation must also result from variation in the insured's losses, and it must be at least reasonably possible that the insurer will realize a significant loss from the transaction. An insurance or reinsurance contract that transfers only significant underwriting risk may be entered into to lessen the overall economic risks

[3] With respect to insurance contracts, the timing of the loss reimbursement under the contract would be based on the timing of the payment with respect to the loss event. For reinsurance contracts, the timing of the loss reimbursement under the contract would be based on the timing of payment by the insured (reinsured) of the underlying loss, as well as when recovery is expected from the reinsurer.

associated with the contract and permit a greater amount of coverage than would otherwise be obtainable for a comparable premium. Features in insurance or reinsurance contracts that transfer only significant underwriting risk limit the uncertainties about the timing of the receipt and payment of cash flow, thus, limiting the amount of timing risk assumed by the insurer. A delayed reimbursement of losses by the insurer is a possible indication that timing risk has not been transferred.[4] Unlike insurance and reinsurance contracts that transfer only significant timing risk, the recovery of the amount of the initial deposit for an insurance or reinsurance contract that transfers only significant underwriting risk is substantially dependent on the future loss experience of the insured. Depending on such experience, the initial deposit may be recovered or the recovery may be significantly more or less than the original deposit.

c. *An insurance or reinsurance contract that transfers neither significant timing nor significant underwriting risk.* Insurance and reinsurance contracts that transfer neither significant timing nor significant underwriting risk are expected to be rare.

d. *An insurance or reinsurance contract with an indeterminate risk.* These insurance and reinsurance contracts have uncertain terms, or there is insufficient information to reasonably estimate and allocate premiums in proportion to the protection provided. For example, certain insurance and reinsurance contracts allow the insured to obtain some degree of coverage for multiple years without exposing the insurer to a defined level of insurance risk each year. Uncertainties surrounding these insurance and reinsurance contracts are analogous to those often associated with foreign property and liability reinsurance as addressed in SOP 92-5 [section 10,520].

For short-duration reinsurance contracts, FASB Statement No. 113 requires that two conditions be met in order to account for that contract as reinsurance. The first condition is that the contract must transfer significant insurance risk to the reinsurer. The second condition is that the contract must subject the reinsurer to the reasonable possibility of realizing a significant loss from the transaction, unless substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts has been assumed by the reinsurer. If a short-duration reinsurance contract does not meet the second condition but transfers significant insurance risk, then the accounting for contracts that transfer only significant underwriting risk should be followed (see paragraphs .13 through .15 in this SOP).

Conclusions

Initial Measurement

.09 At inception, a deposit asset or liability should be recognized for insurance and reinsurance contracts accounted for under deposit accounting

[4] FASB Statement No. 113, paragraph 9, states, in part, "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."

and should be measured based on the consideration paid or received, less any explicitly identified premiums or fees to be retained by the insurer or reinsurer, irrespective of the experience of the contract. Accounting for such fees should be based on the terms of the contract. Deposit assets and liabilities should be reported on a gross basis, unless the right of offset exists as defined in FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*. The accounting by the insured and insurer are symmetrical, except as noted in paragraph .15 of this SOP.

Subsequent Measurement

Insurance and Reinsurance Contracts That Transfer Only Significant Timing Risk and Insurance and Reinsurance Contracts That Transfer Neither Significant Timing Nor Underwriting Risk

.10 For insurance and reinsurance contracts that transfer only significant timing risk or that transfer neither significant timing nor significant underwriting risk, the amount of the deposit asset or liability should be adjusted at subsequent reporting dates by calculating the effective yield on the deposit to reflect actual payments to date and expected future payments (as discussed in paragraph .11 below), with a corresponding credit or charge to interest income or expense. This approach is consistent with the interest method described in Accounting Principles Board (APB) Opinion No. 21, *Interest on Receivables and Payables*, and FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases.*

.11 The calculation of the effective yield should use the estimated amount and timing of cash flows. Consistent with paragraph 19 of FASB Statement No. 91, if a change in the actual or estimated timing or amount of cash flows occurs, the effective yield should be recalculated to reflect the revised actual or estimated cash flows. The deposit should be adjusted to the amount that would have existed at the balance-sheet date had the new effective yield been applied since the inception of the insurance or reinsurance contract. Changes in the carrying amount of the deposit should be reported as interest income or interest expense.

.12 Significant changes in the expected amounts of aggregate cash flows are expected to occur infrequently because of the nature of these kinds of contracts. Should a significant change occur in the total amount of actual or estimated cash flows, the enterprise should determine whether the change indicates that the contract does include significant underwriting risk and therefore should be converted to the accounting for contracts that transfer only significant underwriting risk. (See paragraphs .13 through .15 for the accounting guidance for insurance and reinsurance contracts that transfer only significant underwriting risk.) In addition, a contract that transfers only significant timing risk, which subsequently is determined also to transfer significant underwriting risk, cannot be accounted for under insurance or reinsurance accounting when the revised determination is made.

Insurance and Reinsurance Contracts That Transfer Only Significant Underwriting Risk

.13 Until such time as a loss is incurred that will be reimbursed under an insurance or reinsurance contract that transfers only significant underwriting risk, the deposit should be measured based on the unexpired portion of the coverage provided. Once a loss is incurred that will be reimbursed under such a contract, then the deposit should be measured by the present value of the expected future cash flows arising from the contract plus the remaining unexpired portion of the coverage provided.

.14 Changes in the recorded amount of the deposit, other than the unexpired portion of the coverage provided, arising from an insurance or reinsurance contract that transfers only significant underwriting risk should be recorded in an insured's income statement as an offset against the loss recorded by the insured that will be reimbursed under the insurance or reinsurance contract and in an insurer's income statement as an incurred loss. Insurance enterprises should record the reduction in the deposit related to the unexpired portion of the coverage provided as an adjustment to incurred losses. Insurance enterprises should disclose the amounts related to those deposit contracts that are reported in incurred losses in their statement of earnings. (See paragraph .19.) If the insured is an enterprise other than an insurance enterprise, the reduction in the deposit related to the unexpired portion of the coverage provided should be recorded as an expense.

.15 For the insured or ceding enterprise, the discount rate used to determine the deposit asset should be the current rate on United States government obligations with similar cash-flow characteristics, adjusted for default risk. Consideration of the default risk, if any, should be based on the assessment of the creditworthiness of the insurer. For the insurer or assuming enterprise, the discount rate used to determine the deposit liability should be the current rate on United States government obligations with similar cash-flow characteristics. These rates should be established at the date of each loss incurred and used for the remaining life of the contract and should not be changed. If numerous losses occur, the use of average rates is permitted because establishing individual rates might require detailed recordkeeping and computations that could be burdensome and unnecessary to produce reasonable approximations of the results.

Insurance and Reinsurance Contracts With Indeterminate Risk

.16 Uncertainties surrounding insurance and reinsurance contracts with indeterminate risk are analogous to those often associated with foreign property and liability reinsurance as addressed in SOP 92-5 [section 10,520]. As a result, the guidance in SOP 92-5 [section 10,520], regarding the open-year method, should be followed. The open-year method should not, however, be used to defer losses that otherwise would be recognized pursuant to FASB Statement No. 5.

.17 Under the open-year method, the effects of the contracts are not included in the determination of net income until sufficient information becomes available to reasonably estimate and allocate premiums. The open-year method requires that these effects be aggregated in the balance sheet. If sufficient information becomes available to reasonably estimate and allocate premiums, the insurance or reinsurance contract with indeterminate risk should be reclassified into one of the three categories as an insurance or reinsurance contract that transfers neither significant timing nor significant underwriting risk, transfers only significant timing risk, or transfers only significant underwriting risk, as appropriate, and accounted for accordingly. The change in deposit assets or liabilities that result if sufficient information becomes available is treated as a change in accounting estimate in accordance with APB Opinion 20, *Accounting Changes*.

Disclosures

.18 Entities should disclose a description of the contracts accounted for as deposits and the separate amounts of total deposit assets and total deposit liabilities reported in the statement of financial position.

.19 Insurance enterprises should disclose the following information regarding the changes in the recorded amount of the deposit arising from an insurance or reinsurance contract that transfers only significant underwriting risk:

a. The present values of initial expected recoveries that will be reimbursed under the insurance or reinsurance contracts that have been recorded as an adjustment to incurred losses

b. Any adjustment of amounts initially recognized for expected recoveries (The individual components of the adjustment (meaning, interest accrual, the present value of additional expected recoveries, and the present value of reductions in expected recoveries) should be disclosed separately.)

c. The amortization expense attributable to the expiration of coverage provided under the contract

Effective Date and Transition

.20 This SOP is effective for financial statements for fiscal years beginning after June 15, 1999, with earlier adoption encouraged. Previously issued annual financial statements should not be restated. The initial application of this SOP should be as of the beginning of an entity's fiscal year (that is, if the SOP is adopted prior to the effective date and during an interim period, all prior interim periods should be restated). The effect of initially adopting this SOP should be reported as a cumulative effect of a change in accounting principle (in accordance with the provisions of APB Opinion 20).

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

Basis for Conclusions

.21 Because of questions raised about the application of the deposit method of accounting to insurance and reinsurance contracts that do not indemnify against loss or liability and the scarcity of guidance concerning the accounting for such contracts, AcSEC believes that guidance is needed for all entities that enter into insurance and reinsurance contracts that are to be accounted for as deposits under FASB Statement Nos. 5, 60, and 113 and EITF Issue Nos. 93-6 and 93-14. Long-duration life and health insurance and reinsurance contracts that do not indemnify against mortality and morbidity risk are not covered under this SOP because FASB Statement Nos. 97 and 113 provide sufficient guidance on accounting for these kinds of insurance and reinsurance contracts.

.22 Paragraph 44 of FASB Statement No. 5 states the following.

> To the extent that an insurance contract or reinsurance contract does not, despite its form, provide for indemnification of the insured or the ceding company by the insurer or reinsurer against loss or liability, the premium paid

> less the amount of the premium to be retained by the insurer or reinsurer shall be accounted for as a deposit by the insured or ceding company. Those contracts may be structured in various ways, but if, regardless of form, their substance is that all or part of the premium paid by the insured or the ceding company is a deposit, it shall be accounted for as such.[5]

That guidance also is incorporated in paragraph 18(a) of FASB Statement No.113.

.23 The consensus in EITF Issue No. 93-6 states, the following, in part.

> The Task Force reached a consensus that in order to be accounted for as reinsurance, a contract that reinsures risk arising from short-duration insurance contracts must meet all of the following conditions: (1) the contract must qualify as a short-duration contract under paragraph 7(a) of Statement 60, (2) the contract must not contain features that prevent the risk transfer criteria in paragraphs 8 through 13 of Statement 113 from being reasonably applied (and those criteria must be met), and (3) the ultimate premium expected to be paid or received under the contract must be reasonably estimable and allocable in proportion to the reinsurance protection provided as required by paragraph 14(a) and (b) of Statement 60 and paragraph 21 of Statement 113. If any of these conditions are not met, a deposit method of accounting should be applied by the ceding and assuming enterprises.

The consensus in EITF No. 93-14 states, the following, in part.

> The Task Force reached a consensus that in order to be accounted for as insurance, an insurance contract must indemnify the insured as required by paragraph 44 of Statement 5. For those contracts that do not provide indemnification, the premium paid, less the amount of the premium to be retained by the insurer, should be accounted for as a deposit by the insured.

Initial Measurement

.24 This SOP states that, at inception, insurance and reinsurance contracts accounted for under deposit accounting should be measured based on the consideration paid or received, less any explicitly identified premiums or fees to be retained by the insurer or reinsurer, irrespective of the experience of the contract. The provisions of paragraph 44 of FASB Statement No. 5 and paragraph 18a of FASB Statement No. 113 state that "for those contracts that do not provide indemnification, the premium paid, less the amount of the premium to be retained by the insurer, should be accounted for as a deposit by the insured." AcSEC believes that it may be difficult, if not impossible, to reasonably determine the amount of the premium to be retained by the insurer when initially measuring the deposit unless it is explicitly identified in the contract because the implicit rate of interest in the contract reflects a combination of considerations including prevailing market rates, uncertainty regarding amounts and timing of cash flows, as well as ranges of possible margins that may be retained by the insurer. The accounting provided in this SOP is similar to accounting for prepaid insurance.

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[5] FASB Statement No. 113 amended FASB Statement No. 5 to include the following footnote at the end of paragraph 44: "Paragraphs 8 to 13 of FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, identify conditions that are required for a reinsurance contract to indemnify the ceding enterprise against loss or liability and to be accounted for as reinsurance. Any transaction between enterprises to which FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, applies must meet those conditions to be accounted for as reinsurance."

Insurance and Reinsurance Contracts That Transfer Only Significant Timing Risk and Insurance and Reinsurance Contracts That Transfer Neither Significant Timing Nor Significant Underwriting Risk

.25 AcSEC concluded that the revenue and expense associated with insurance and reinsurance contracts that transfer only significant timing risk, and with insurance and reinsurance contracts that transfer neither significant timing nor significant underwriting risk are attributable primarily to the time value of money. Accordingly, AcSEC concluded that the interest method described in FASB Statement No. 91 is the appropriate model to apply to these kinds of insurance and reinsurance contracts. AcSEC also concluded that changes in actual or estimates of timing and, where applicable, the amount of cash flows under such insurance and reinsurance contracts should be accounted for consistent with paragraph 19 of FASB Statement No. 91 by recalculating the effective yield for the entire contract.

Insurance and Reinsurance Contracts That Transfer Only Significant Underwriting Risk

.26 This SOP requires that deposits under insurance and reinsurance contracts that transfer only significant underwriting risk be measured based on the unexpired portion of the coverage provided until such time as a loss is incurred that will be reimbursed under the contract. Once a loss is incurred that will be reimbursed under the insurance or reinsurance contract that transfers only significant underwriting risk, the deposit is to be measured by the present value of the expected future cash flows arising from the contract plus the remaining unexpired portion of the original deposit for the coverage provided.

.27 AcSEC considered a variety of discount rates and concluded that the deposit should be measured by the present value of expected future cash flows discounted at the current risk-free rate available in the market, adjusted for default risk associated with the insurer's creditworthiness in the case of a deposit asset. AcSEC also discussed whether this rate should continue to be used in subsequent periods (often referred to as the *lock-in concept*) or whether the rate should change throughout the remaining life of the contract. AcSEC concluded that the rate should be established at the date of each loss incurred and used until the expected cash flows associated with the loss are collected. AcSEC believes that changes that occur are only changes in the estimate of cash flows and, therefore, the rate should not change. In those circumstances in which there is more than one loss, there will be different rates for each of the loss occurrences. If numerous losses occur, establishing these rates might require detailed recordkeeping and computations that could be burdensome as well as unnecessary to produce reasonable approximations of the results. Therefore, the use of average rates is permitted.

.28 For insurance and reinsurance contracts that transfer insurance risk (meaning contracts that transfer both underwriting and timing risk), the purchaser (who is in a comparable position to the insured or ceding entity) pays a fixed or determinable amount and receives a right to an uncertain future return. Estimated recoveries under such contracts generally are recorded at undiscounted amounts. For insurance and reinsurance contracts that transfer only significant underwriting risk, the deposit is measured by the present value of the expected future cash flows. AcSEC believes that this difference in measurement—between insurance and reinsurance contracts that transfer insurance risk and those that transfer only significant underwriting risk—appropriately reflects the dissimilarities in these contracts, principally the failure of contracts that transfer only significant underwriting risk to match the timing of the recoveries to the timing of the payments of the loss.

.29 When an asset or liability is measured by discounting expected future cash flows, the present value of such asset or liability will increase from one reporting period to the next as a result of the passage of time (assuming that the actual or expected timing and amount of cash flows remain constant). Nevertheless, the present value of a deposit under an insurance or reinsurance contract that transfers only significant underwriting risk may change from one reporting period to the next as a result of not only the passage of time but also the changes in actual or estimated timing and amount of cash flows.

.30 AcSEC considered whether the change in the present value of the cash flows should be recognized entirely as interest related, entirely as underwriting related (offsetting the recorded loss under the insurance or reinsurance contract), or partly as interest related and partly underwriting related. AcSEC concluded that the entire change should be recognized in the income statement as an offset to the loss recorded by the insured that will be reimbursed under the insurance or reinsurance contract that transfers only significant underwriting risk. With regard to insurance enterprises and because of the significance of amounts recorded as incurred losses by these enterprises, AcSEC believes that disclosure of the components of the deposit that are recorded in incurred losses is appropriate. AcSEC noted that, if the *amount* of expected future cash flows under the deposit contract changes, the reporting entity will report both a change in the deposit and a corresponding change related to the underlying loss accrual; AcSEC concluded that both of those changes should be recognized in a similar manner. Additionally, because this kind of contract transfers significant underwriting risk, AcSEC considered it inappropriate to recognize the entire change in the present value of the cash flows as interest related. AcSEC also concluded that the costs of accounting separately for the interest-related component of the change in the present value of the cash flows outweighed the benefits of such separate accounting. AcSEC noted the following areas in which the interest-related component of a change in the present value of an asset or liability is recognized as an operating item rather than as interest related:

a. Accounting for long-duration insurance liabilities and changes in cash surrender value of life insurance contracts

b. Accounting for pension and other post-retirement benefit expenses

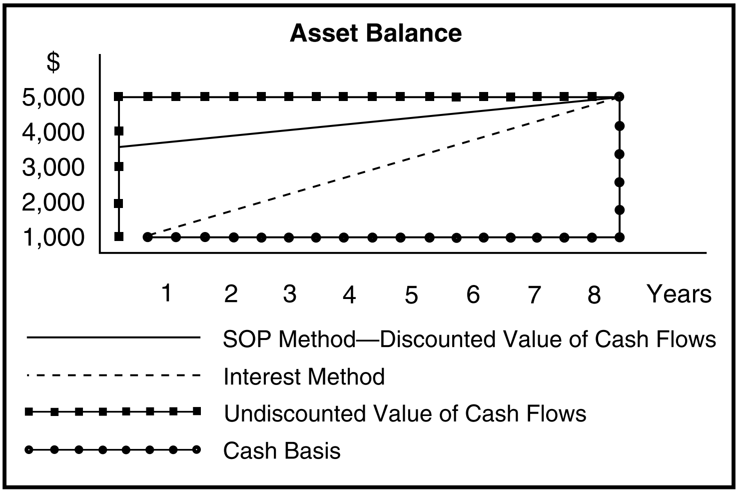
c. Accounting generally used when insurance claim liabilities are measured on a discounted basis

d. Accounting for a change in the present value of an impaired loan

.31 AcSEC considered a variety of possible ways to apply deposit accounting to insurance and reinsurance contracts that transfer only significant underwriting risk. The following graph, which is based on the example in Appendix A [paragraph .37], "Illustrations of Application of Conclusions," paragraphs A.6 through A.9, illustrates the effects of four alternative methods of accounting for insurance and reinsurance contracts that transfer only significant underwriting risk that were considered by AcSEC. In this example, the insured or ceding entity pays an initial premium of $1,000 and expects to recover $5,000 at the end of Year 8 based on an actual loss incurred by the insured. A delayed reimbursement clause mitigates timing risk.[6]

.32 AcSEC eliminated from consideration the cash basis and the undiscounted value of cash flows methods because they fail to properly reflect the time value of money, the receivable or payable under the contract, or both.

.33 AcSEC concluded that the interest method fails to recognize that the $5,000 incurred loss is a discrete event that has been recorded under the contract in Year 1 giving rise to the ultimate recovery of $5,000 in Year 8.



Insurance and Reinsurance Contracts With Indeterminate Risk

.34 In insurance and reinsurance contracts with indeterminate risk, there are uncertain terms, or there is insufficient information to reasonably estimate and allocate premiums in proportion to the protection provided. Paragraph 15 of SOP 92-5 [section 10,520.15] provides that, in circumstances in which a foreign ceding entity cannot provide the information required by the assuming entity to estimate both the ultimate premiums and the appropriate periods of recognition, the open-year method should be used.

.35 AcSEC concluded that uncertainties surrounding these insurance and reinsurance contracts are analogous to those often associated with foreign property and liability reinsurance as addressed in SOP 92-5 [section 10,520]. As a result, the guidance in SOP 92-5 [section 10,520] as to the open-year method should be followed.

.36 If sufficient information becomes available to reasonably estimate and allocate premiums, the insurance or reinsurance contract with indeterminate risk should be reclassified into one of three categories as an insurance or reinsurance contract that transfers neither significant timing nor underwriting risk, transfers only significant timing risk, or transfers only significant underwriting risk, as appropriate, and accounted for accordingly. FASB Statement No. 113 provides that the determination of whether a contract transfers risk should be evaluated at the inception of the contract. There are no provisions in FASB Statement No. 113 that provide for subsequent reevaluation of

[6] The table only presents the recovery under the contract and does not depict the underlying loss associated with the contract.

a contract. Therefore, AcSEC concluded that when sufficient information becomes available to reasonably estimate and allocate premiums, the accounting for an insurance or reinsurance contract, with indeterminate risk at its inception, should be reclassified as an insurance or reinsurance contract that does one of the following:

1. Transfers neither significant timing nor significant underwriting risk
2. Transfers only significant timing risk
3. Transfers only significant underwriting risk

As appropriate, the reclassified contract should be accounted for accordingly using deposit accounting as described in this SOP.

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Appendix A

Illustrations of Application of Conclusions

A.1. The following examples illustrate the application of the conclusions in this SOP. The illustrations are intended as examples only; it should not be construed that any aspect of the illustrations establishes or changes requirements as to when deposit accounting should be applied. Rather, the examples illustrate how deposit accounting is to be applied when it is determined that it should be applied under other accounting literature. These examples illustrate the accounting by the insured. The accounting by the insurer would be symmetrical, except as noted in paragraph .15 of this SOP.

Insurance and Reinsurance Contracts That Transfer Neither Significant Timing Nor Significant Underwriting Risk

A.2. This example illustrates the accounting by the insured for an insurance or reinsurance contract that transfers neither significant timing nor significant underwriting risk. The facts are as shown in the following table.

Premium	$1,000
Coverage period	1 year
Expected recoveries	$250 at the end of each year for five years
Implicit interest rate	8 percent(*)

(*) Present value of $250 per year for five years at 8 percent = $1,000.

A.3. At contract inception, the insured records a $1,000 asset. Changes in the amount or timing of cash flows are not anticipated. As they are received, cash recoveries reduce the carrying amount of the deposit, and the carrying amount of the deposit is increased at each reporting date by the amount of the interest earned during the period. The example assumes that the enterprise is reporting related financial information as of the end of each year, as shown in the following table.

Description	*8-Percent Interest Income*	*Cash Recoveries*	*Deposit Balance*
Initial payment			$1,000
Year 1	$ 80		1,080
End of Year 1		$ (250)	830
Year 2	66		896
End of Year 2		(250)	646
Year 3	52		698
End of Year 3		(250)	448
Year 4	36		484
End of Year 4		(250)	234
Year 5	16		250
End of Year 5		(250)	0
Totals	$250	$(1,250)	$ 0

Insurance and Reinsurance Contracts That Transfer Only Significant Timing Risk

A.4. This example illustrates the accounting by the insured for an insurance or reinsurance contract that transfers only significant timing risk. The facts are as shown in the following table.

Premium	$1,000
Coverage period	1 year
Initial expected recoveries	$225 per year (at end of year) for five years
Initial implicit rate	4 percent(†)

(†) Present value of $225 per year for five years at 4 percent = $1,000.

This implicit rate often will be less than the current risk-free rate because of the uncertainties as to the timing of cash flows in the insurance or reinsurance contract.

A.5. At contract inception, the insured records a $1,000 asset. Though the total amount ($1,125) is likely to be paid, changes in estimates of the timing of cash flows are expected. At each subsequent reporting date, the amount of the deposit would be increased by the amount of interest earned during the period, calculated using the estimated future cash flows to determine the then-current implicit discount rate (this is consistent with the retrospective approach in applying the interest method). At the end of Year 2, the timing of anticipated recoveries under the insurance or reinsurance contract is revised. A reevaluation of the implicit interest rate produces a rate of 3.63 percent and an asset of $640 at the end of the year. Given the change in the expected timing of cash flows at the end of Year 2, the carrying amount of the asset would be calculated as shown in the following table.

Description	*Interest Income*	*Cash Recoveries*	*Deposit Balance*
Initial payment			$1,000
Year 1 (4 percent)(‡)	$ 40		1,040
End of Year 1		$ (225)	815
Year 2 (4 percent)	33		848
End of Year 2		(200)	648
Yield adjustment	(8)		640
Year 3 (3.63 percent)	23		663
End of Year 3		(175)	488
Year 4 (3.63 percent)	18		506
End of Year 4		(175)	331
Year 5 (3.63 percent)	12		343
End of Year 5		(175)	168
Year 6 (3.63 percent)	7		175
End of Year 6		(175)	0
Totals	$125	$(1,125)	$ 0

(‡) Implicit rate at the inception of the insurance or reinsurance contract.

Insurance and Reinsurance Contracts That Transfer Only Significant Underwriting Risk

A.6. This example illustrates the accounting by the insured for an insurance or reinsurance contract that transfers only significant underwriting risk. The facts are as shown in the following table.

Initial Premium	$1,000
Coverage period	1 year
Expected recoveries	Could aggregate up to $10,000 with none paid prior to Year 8 regardless of when the insured incurs or pays a loss

A.7. A delayed reimbursement clause, which provides that the full amount will be paid to the insured or ceding entity at the end of Year 8, mitigates timing risk. A $5,000 loss is incurred at the end of Year 1 and is expected to be recovered at the end of Year 8. The risk-free rate of interest in Year 1 for the period from the loss to the expected payment date, adjusted for default risk, is 6 percent. (For the insurer, the risk-free rate would be used but it would not be adjusted for default risk.) At the end of Year 3, the estimated loss is increased from $5,000 to $6,000.

A.8. At contract inception, the insured records a $1,000 asset. The $1,000 amount is amortized over the coverage period of one year. If the $5,000 loss is incurred, the insured increases the amount of the asset by the present value of the $5,000. (Note that the insured has recorded the entire $5,000 loss from the underlying event in the same period.) At each subsequent reporting date, the portion of the carrying amount of the asset attributable to the incurred loss would be recalculated by discounting the estimated future cash flows.

A.9. The carrying amount of the asset would be calculated as shown in the following table.

Description	*Amortization*	*Offset to Recorded Losses*	*Cash Recoveries at End of Year*	*Deposit Balance*
Initial payment				$1,000
Amortization	$1,000			0
Year 1		$3,325[||]		3,325[#]
Year 2		200		3,525
Year 3		211		3,736
Adjustment		**747**		4,483[**]
Year 4		270		4,753
Year 5		284		5,037
Year 6		303		5,340
Year 7		320		5,660
Year 8		340	$6,000	0
Totals	$1,000	$6,000	$6,000	$ 0

[||] The loss occurred on the last day of the year.

[#] The present value of $5,000 received after seven years discounted at 6 percent. At the end of Year 1, there is no remaining deposit applicable to the unexpired portion of the coverage because it is a one-year contract.

[**] The present value of $6,000 received after five years discounted at 6 percent.

Conversion From a Contract That Transfers Neither Significant Timing Risk Nor Significant Underwriting Risk or a Contract That Transfers Only Significant Timing Risk to a Contract That Transfers Significant Underwriting Risk

A.10. The following illustration builds on the examples in paragraphs A.4 and A.5. It uses the same assumptions and facts as that example for the first two years; however, at the end of Year 3, the estimated recovery is increased from $1,125 to $1,950 (with the remaining recovery to be $450 per year for the remaining three years). For purposes of this example, assume the magnitude of the change in the estimated recovery is such that a determination should be reached that the contract does include significant underwriting risk. The risk-free rate of interest at Year 1 is 6 percent adjusted for default risk. In addition, this rate would be utilized when appropriate for the life of the contract.

Description	*Interest Income*	*Offset to Recorded Losses*	*Cash Recoveries at End of Year*	*Deposit Balance*
Initial payment				$1,000
Year 1 (4 percent)	$40		$ (225)	815
Year 2 (4 percent)	25(††)		(200)	640
Year 3 (3.63 percent)	23		(175)	488
Adjustment		$715(‡‡)		1,203(‖‖)
Year 4 (6 percent)		72	(450)	825
Year 5 (6 percent)		50	(450)	425
Year 6 (6 percent)		25	(450)	0
Totals	$88	$862	$(1,950)	$ 0

(††) The interest income adjustment at 4 percent of $33 less the yield adjustment of $8 equals $25.

(‡‡) At the end of Year 3, there is a change in the estimated recovery to $1950. The payment of the remaining losses will occur over three years, in Years 4, 5, and 6.

(‖‖) The present value of $450 per year for three years discounted at 6 percent (the risk-free rate at the time of the loss adjusted for default risk).

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Appendix B

Discussion of Comments Received on the Exposure Draft

B.1. An exposure draft of a proposed Statement of Position, *Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk*, was issued for public comment on June 30, 1997, and distributed to a variety of interested parties to encourage comment by those who would be affected by the proposal. Twenty-three comment letters were received in response on the exposure draft. The most significant and pervasive comments received were in the following areas:

a. Scope

b. Kinds of contracts

c. Risk transfer criteria for direct insurance contracts

d. Recognition of fees to be retained by the insurer or reinsurer

e. Discount rate

f. Accounting for contracts that transfer only significant underwriting risk

Scope

B.2. The guidance regarding scope in the exposure draft caused some confusion. Several respondents requested clarification about the kinds of insurance contracts that would be covered by the SOP. AcSEC clarified the guidance to explain that the SOP applies to contracts that do not transfer insurance risk, except for those contracts which Financial Accounting Standards Board (FASB) Statements of Financial Accounting Standards Nos. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments* and 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, provide explicit guidance.

Kinds of Contracts

B.3. Several comment letters expressed concern about the complexity of the various contract types. AcSEC continues to believe that the various deposit categories are appropriate and adequately capture the majority of potential kinds of contracts.

B.4. For short-duration reinsurance contracts, FASB Statement No. 113 requires that two conditions be met in order to account for that contract as reinsurance. The first condition is that the contract must transfer significant insurance risk to the reinsurer. The SOP provides guidance on accounting for contracts that fail to transfer one or both of these risks, which must be transferred for a contract to be considered to have transferred significant insurance risk. FASB Statement No. 113 also provides a second condition that must be met for a contract to receive reinsurance accounting. The second condition is that the contract must subject the reinsurer to the reasonable possibility of realizing a significant loss from the transaction, unless substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts has been assumed by the reinsurer. The exposure draft did not specifically identify this situation. The SOP has been changed to state that for short-duration reinsurance contracts that do not meet the second condition, but that do transfer significant insurance risk, the accounting for these reinsurance contracts should be the same as the accounting for contracts that transfer only significant underwriting risk. AcSEC believes that for short-duration reinsurance contracts to satisfy the requirements of paragraph 9a of FASB Statement No. 113, there is an expectation that there is variability in the amount and timing of expected cash flows. Therefore, the accounting for contracts that transfer only significant underwriting risk would be appropriate.

Risk Transfer Criteria for Direct Insurance Contracts

B.5. Several comment letters expressed concern that the risk transfer criteria from FASB Statement No. 113 were being applied to direct insurance contracts. Paragraph 44 of FASB Statement No. 5, *Accounting for Contingencies*, and FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, do not specifically state risk transfer criteria in the same manner as does FASB Statement No. 113. The SOP's objective is to address how to account for contracts that do not transfer insurance risk and consequently must be accounted for as deposit accounting. The SOP is not intended to provide a method to determine whether risk transfer exists.

Recognition of Fees to Be Retained by the Insurer or Reinsurer

B.6. Several comments were received on the initial measurement of the deposit asset or liability relating to the recognition of fees to be retained by the insurer or reinsurer. AcSEC continues to believe that such fees should be measured based on the consideration paid or received, less any explicitly identified premiums or fees to be retained by the insurer or reinsurer, based upon the terms and conditions of the contract. AcSEC believes that a reasonable determination of premiums or fees is ordinarily not possible at the inception of the contract. Each contract should be evaluated based on its relevant terms and conditions.

Discount Rate

B.7. The use of a risk-free interest rate locked in at the loss event was addressed in several comment letters. Several respondents believe that this method is inconsistent with other accounting literature and believe the rate does not fully recognize the current market value of the deposit. AcSEC believes that the method chosen is consistent with other recent literature issued. The SOP has been changed to explicitly document that AcSEC believes that changes that occur are only changes in the estimate of expected cash flows resulting from the previous loss event and, therefore, the rate should not change. It is not AcSEC's intention to measure the deposit amount on a fair-value basis.

Accounting for Contracts That Transfer Only Significant Underwriting Risk

B.8. The accounting in the SOP prescribes that recoveries for contracts that transfer only significant underwriting risk to be recognized through underwriting income. Some respondents believe that the accounting is inconsistent with FASB Statement No. 113. Other respondents believe that these kinds of contracts should receive reinsurance accounting under FASB Statement No. 113 when a recovery under the contract occurs. Some changes in the balance of the amount recoverable are related to underwriting activities and it is, therefore, reasonable to include that activity in the underwriting account. AcSEC believes that bifurcation or a financial approach that would allocate underwriting and interest components would be preferable; however, current insurance company GAAP does not permit that approach. Therefore, AcSEC continues to believe that the accounting described in the SOP is appropriate.

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Glossary

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

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

Experience adjustment. A provision in an insurance or reinsurance contract that modifies the premium, coverage, commission, or a combination of the three, in whole or in part, based on experience under the contract.

Insurance risk. The risk arising from uncertainties about both underwriting risk and timing risk. Actual or imputed investment returns are not an element of insurance risk. Insurance risk is fortuitous; the possibility of adverse events occurring is outside the control of the insured.

Timing risk. The risk arising from uncertainties about the timing of the receipt and payments of the net cash flows from premiums, commissions, claims, and claim settlement expenses paid under a contract.

Underwriting risk. The risk arising from uncertainties about the ultimate amount of net cash flows from premiums, commissions, claims, and claim settlement expenses paid under a contract.

Accounting Standards Executive Committee (1997–1998)

Insurance Companies Committee (1997–1998)

Deposit Accounting Task Force

AICPA Staff

The AICPA gratefully acknowledges the contributions made to the development of this Statement of Position by George O'Shaughnessy and Thomas Genrich.

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