ACTA UNIVERSITATIS AGRICULTURAE ET SILVICULTURAE MENDELIANAE BRUNENSIS

Volume 63 201 Number 6, 2015
http://dx.doi.org/10.11118/actaun201563061867

IMPACTS OF REINSURANCE OPERATIONS ON SIGNIFICANT ITEMS OF THE FINANCIAL STATEMENTS OF COMMERCIAL INSURANCE COMPANIES ACCORDING TO CZECH ACCOUNTING LEGISLATION AND INTERNATIONAL ACCOUNTING STANDARDS

Jana Gláserová[1], Eva Vávrová[2]

[1] Department of Accounting and Taxes, Faculty of Business and Economics, Mendel University in Brno, Zemědělská 1, 613 00 Brno, Czech Republic
[2] Department of Finance, Faculty of Business and Economics, Mendel University in Brno, Zemědělská 1, 613 00 Brno, Czech Republic

Abstract

GLÁSEROVÁ JANA, VÁVROVÁ EVA. 2015. Impacts of Reinsurance Operations on Significant Items of the Financial Statements of Commercial Insurance Companies According to Czech Accounting Legislation and International Accounting Standards. *Acta Universitatis Agriculturae et Silviculturae Mendelianae Brunensis,* 63(6): 1867–1877.

The principal aim of the paper is to determine the impact of reinsurance operations in commercial insurance companies, in accordance with the relevant accounting legislation, for certain significant items of the financial statements. In actual fact, the reinsurance operations affect the profit of a commercial insurance company, following the financial statements. The prerequisite for fulfilling the objective of the paper is to analyse the accounting legislation for reinsurance operations in commercial insurance companies. Attention will be devoted also to the method of accounting for reinsurance operations and their specific reporting in various parts of the financial statements of commercial insurance companies. The partial aim of this paper is to identify significant differences in the area of accounting of commercial insurance companies, based on the comparison of accounting practices of the issues examined in accordance with IAS/IFRS. In the conclusion, the authors will address the latest development of necessary steps in adopting the concept of IFRS 4 Phase II and accomplishing the process of the application of IFRS 4 Phase II to the accounts of commercial insurance companies.

Keywords: commercial insurance company, insurance, reinsurance operations, financial statements, result of operations, accounting legislation, IAS/IFRS, IFRS 4 Phase II

INTRODUCTION

The insurance is defined as an instrument to eliminate negative effects of randomness. An economic subject can cope with the consequences of negative events in two ways: it can cover them with own resources, or it may use insurance which means that it transfers the risk to an insurer, i.e. an institution offering insurance. In this case, it is the commercial insurance which is offered by commercial insurance companies. It means that the economic subject must pay the insurance premium for this financial service. The economic subject will obtain the insurance benefits in the moment when the insured event occurs or eventually after the expiry of the insurance period. All the possibilities are precisely defined in insurance contracts and in general insurance policy conditions.

Commercial insurance companies therefore take over the risks mostly based on a contract (insurance policy), in special cases following the law, from individual economic subjects – citizens or companies. Covering large risks, the commercial insurance companies usually diversify risks among several subjects, which means that they reinsure a certain amount of risks. A relation arises between the commercial insurance company and a reinsurer who takes over the part of the risk; this relation represents reinsurance, in other words cession. The part of the risk from insurance policy made by the primary insurer, i.e. insurance company, is transferred to another subject, i.e. the reinsurance company. The primary insurer pays reinsurance premium to the reinsurance company for the transfer of the part of the risk. If an insured event occurs, reinsured insurance company will pay only part of the entire insurance benefits from its assets, in accordance with the conditions of the reinsurance contract (Bokšová *et al.*, 2004).

Cipra (1999) states, that a reinsurer does not have any contractual relationship to insured subjects. According to Cipra (2004), the task of reinsurance is not to remove or to reduce a damage occurred but to reduce the technical risk of an insurer by spreading the insured sum so that in case of insured event the payments of primary insurer and reinsurer do not affect the financial stability of the primary insurer. The reinsurance does not reduce the extent of damage but makes it more economically acceptable for insurance companies and their financial results more stable. Therefore, it is known as a vertical distribution of risk while reinsuring.

The accounting of reinsurance is very specific part of accounting in commercial insurance companies. Other economic subjects neither banks do not account for reinsurance.

MATERIALS AND METHODS

The aim of the paper is to determine the impact of reinsurance operations in commercial insurance companies, in accordance with the relevant accounting legislation, for certain significant items of the financial statements. These items include the items of assets of the balance sheet, such as deposits resulting from active reinsurance and receivables from reinsurance operations, and also items of liabilities of the balance sheet, which include deposits resulting from passive reinsurance and liabilities from reinsurance operations, and also various types of technical provisions which include participation of reinsurers. The balance sheet in total and hence the equity of insurance companies belongs to the affected values. Significant items in the profit and loss statement regarding the technical accounts for non-life and life insurance are also directly affected by the reinsurance operations. Particularly premiums ceded to reinsurers, commissions from reinsurers and reinsurers share on the relevant technical provisions are the affected items within these two essential parts of the profit and loss statement. The reinsurance operations affect the profit of a commercial insurance company following the financial statements. The paper will also analyse the impact of reinsurance operations on the income tax base. The prerequisite for fulfilling the objective of the paper is to analyse the accounting legislation for reinsurance operations in commercial insurance companies. Attention will be devoted to the method of accounting for reinsurance operations and their specific reporting in various parts of the financial statements of commercial insurance companies. The partial aim of this paper is to identify significant differences in the area of accounting of commercial insurance companies based on the comparison of accounting practices of the issues examined in accordance with IAS/IFRS. Identified differences are illustratively expressed in particular items of financial statements in the both of accounting legislations. In the conclusion, the authors will address the latest development of necessary steps in adopting the concept of IFRS 4 Phase II.

The starting point for exploring the outlined problem is the analysis of legislation regulating the analysed issues in the Czech Republic, in particular Act No. 277/2009 Coll., on insurance, as well as Decree No. 502/2002 Coll., published by the Ministry of Finance of the Czech Republic, implementing certain regulations of Act No. 563/1991 Coll., on accounting, as amended, for accounting entities that are insurance companies, as amended by subsequent regulation, and Czech Accounting Standard No. 203 "Receivables arising from direct insurance operations and reinsurance operations", Czech Accounting Standard No. 205 "Liabilities arising from direct insurance operations and reinsurance operations", Czech Accounting Standard No. 204 "Gross premiums written" and Czech Accounting Standard No. 213 "Costs and revenues". A valuable source is the Directive 2009/138/EC of the European Parliament and of the Council, of 25 November 2009, on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II).

On the one hand, those legal norms define generally the reinsurance operations, and on the other hand, they define the methods of accounting of receivables and liabilities, incomes and expenses from reinsurance operations always in relation to the definition of the related items of assets and liabilities in the balance sheet and in individual parts of the profit and loss statement. An important determination is the definition of the moment of realization of the accounting transaction regarding receivables and liabilities from reinsurance operations. Also, they define the minimum number of accounts for the commercial insurance companies to be set up in order to report the reinsurance transactions in their accounts, and they define accounting methods for the individual reinsurance operations including their reporting in the relevant parts of the financial statements. Specialized publications considering issues analysed in the Czech Republic and relevant international accounting standards, in particular the International Financial Reporting Standard IFRS 4 "Insurance contracts" are other used sources.

In addition to the basic scientific methods which are the methods of description, comparison and analysis, there are methods used based on principles of logical analysis, particularly the method of deduction. The method of synthesis is used for the purpose of making proposals and own conclusions in the final part of the paper.

The methodological approach of the authors is the result of long-term research focus, which uses methods of comparative analysis for a detailed examination of the accounting and tax implications of reinsurance operations in selected aspects of the financial analysis of commercial insurance companies. A similar approach has been applied in the author's previous joint publication in a scientific journal Acta Universitatis Agriculturae et Silviculturae Mendelianae Brunensis.

RESULTS AND DISCUSSION

Analysis of the Czech Accounting Legislation

The legal regulation of issues related to reinsurance operations in accounting entities that are commercial insurance companies is in the Czech Republic currently regulated with the following legislation: in the Act No. 277/2009 Coll., on insurance; in the Ministry of Finance Decree No. 502/2002 Coll., which implements certain regulations of the Act No. 563/1991 Coll., on accounting, as amended, for accounting entities that are insurance companies, as amended; and in the Czech Accounting Standards No. 203 "Receivables arising from direct insurance operations and reinsurance operations"; and No. 205 "Liabilities arising from direct insurance operations and reinsurance operations" including related Czech Accounting Standards. A valuable source is also the Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II).

Decree No. 502/2002 Coll., which was published by the Ministry of Finance of the Czech Republic, implementing certain provisions of Act No. 563/1991 Coll., on accounting, as amended, for accounting entities that are insurance companies, as amended, defines the content of specific terms within the reinsurance operations in the balance sheet. This is the definition of deposits during active and passive reinsurance, receivables and liabilities arising from reinsurance operations and share of reinsurers on the particular technical provisions. The Decree also deals with the items of profit and loss statement, which arises from the reinsurance operations. These are specific items of costs and of revenues that display duplicated part of the technical accounts for non-life and life insurance. Required items of the annex to the financial statements which are defined and also their determined classification is indicated, are part of the Decree. These items include important facts that are not mentioned in the balance sheet or profit and loss statement, as well as more detailed description of the important items of the balance sheet and profit and loss statement, further used methods of evaluation and methods of accounting.

Czech Accounting Standards No. 203 and No. 205 "Receivables/liabilities arising from direct insurance operations and reinsurance operations" define receivables and liabilities including their definition and the moment of their reporting in accounting that arise in commercial insurance companies while fulfilling their main business activity. They order to establish the minimum number of the relevant income and expense accounts to which the offset accounting of these receivables and liabilities is reflected. They also define requirements for reinsurance contracts that are essential for the subsequent recording in the accountancy. The same facts are actually solved in the Czech Accounting Standards in the case of co-insurance. In the conclusion, it orders to ensure the appropriate level of detailed accounting for deposits during passive reinsurance.

Czech Accounting Standards No. 204 "Gross premiums written" and No. 213 "Costs and revenues" are closely involved in defining the content and methods of accounting for costs and revenues in case of reinsurance contracts. Costs and revenues are reported in gross amount including the share of reinsurers. Subsequently there are separately recorded costs and revenues related to reinsurers in accordance with contracts. In the same manner, there is also accounted for bonuses and rebates, and for commissions from reinsurers and share of profit, to which is special attention given.

Principles of Reinsurance in the Commercial Insurance Companies and Possible Approaches

The reinsurance activity is based on reinsurance contracts. In the contract, the reinsurance company is obliged to provide benefit in contracted amount to insurance company when a random event specified in the contract occurs. The insurance company agrees in the contract to pay back to the reinsurance company a calculated part of premiums written from insurance contracts concluded by insurance company they are subject to reinsurance contracts. The insurance company keeps a part of the risk from concluded insurance contracts. If an insured event occurs, the reinsured insurance company will not pay the entire payment from its own sources, but will follow the reinsurance contract. It means that reinsured insurance company does not need

I: *The Decree No. 502/2002 Coll., in relationship to reinsurance operations*

Factual definition	**Legal purpose**	**Is determined by**	**Financial statements**
Deposits during active reinsurance	Factual definition of deposits during active reinsurance, impossibility of the mutual accounting with certain items, reported securities deponed by insurer	§10 par. 13	Balance sheet
Receivables from reinsurance operations	Definition of receivables from reinsurance operations	§11 par. 3	Balance sheet
Share of reinsurer on the individual technical provisions	Definition of the share of reinsurer reducing gross amount of the relevant technical provisions	§16 par. 2	Balance sheet
Deposits during passive reinsurance	Factual definition of deposits during passive reinsurance, impossibility of the mutual accounting with certain items, reported securities received as guarantee from primary insurer	§16 par. 9	Balance sheet
Liabilities arising from reinsurance operations	Definition of liabilities arising from reinsurance operations	§18 par. 2	Balance sheet
Reinsurance premiums from active reinsurance, share of insurance company on the total premiums in co-insurance	Defining these facts as part of the total gross premiums written	§19 par. 1 d, e, f	Profit and loss statement
Premiums ceded to reinsurers	Definition of all titles, which this item contains	§19 par. 2	Profit and loss statement
Change in the unearned premium provision, net, change in other technical provisions, net, bonuses and rebates, net	Defining the content of the change of the particular technical provisions and also all parts of the bonuses and rebates	§19 par. 3, 4, 6	Profit and loss statement
Costs on insurance benefits, net	Defining parts of the costs on the insurance benefits, a significant amount	§19 par. 5 §22 par. 1 h	Profit and loss statement, Annex
Other technical expenses, net	Defining parts of these specific costs, a significant amount	§20 par. 1 §22 par. l	Profit and loss statement, Annex
Other technical revenues, net	Defining parts of these specific revenues	§20 par. 2 §22 par. 1 l	Profit and loss statement, Annex
Bonuses and rebates	Significant amount	§22 par. 1 i	Annex
Result from reinsurance	As the item shown in the Annex, classified into non-life and life insurance	§23 par. 2 e, par. 6 e	Annex

Own elaborate based on legislation

to create such a high level of technical provisions which are necessary to create in commercial insurance companies to cover liabilities given by insurance contracts (see Zweifel, Eisen, 2012). The relation between an insurance company and a reinsurance company is a contractual relation between two independent entities. A ceding of risk exists from the insurer to the reinsurer at precisely ahead defined contractual conditions. Commercial insurance companies can increase their insurance capacity through reinsurance. They share risks and also profit and income from business with the reinsuring insurers, respectively reinsurers (Čejková, Valouch, 2005).

The reinsurance can be viewed from various perspectives as shown in the Tab. III. The primary point of view is a classification whether the insurer is provider or recipient of reinsurance. Based on this perspective, reinsurance is classified into active reinsurance when reinsurance is provided or passive reinsurance when risk is transferred to reinsurance. Bokšová *et al.* (2004) considers this point of view of reinsurance classification as point of view resulting from the accounting. Bokšová (2010) called this classification as reinsurance according to theme.

Another classification of reinsurance is based on the point whether reinsurance is linked to cash flows, i.e., factual, or not, i.e., formal. In the case of factual reinsurance, there is consequently a cash flow in accordance with the reinsurance contract between an insurance company and a reinsurance company, in the case of formal reinsurance there is not. Only through accountant reporting of correct amount of costs and revenues the relation between two given subjects is reported.

Significant classification of reinsurance is based on forms of reinsurance on which basis it is possible to differentiate facultative reinsurance and obligatory reinsurance. For facultative reinsurance, it is typical that for each insured risk or for each insurance contract there is a particular reinsurance contract. In the case of obligatory reinsurance, II: *The Czech Accounting Standards No. 203, 204, 205, 213 in relationship to reinsurance operations*

Factual definition	Legal purpose	Czech Accounting Standard No.
Gross amount of premiums written and share of reinsurers	The obligation to establish at least two income statement accounts	203
Moment of the realization of the accounting transaction for receivables	The moment of the recording of receivables in the accounting	203
Reinsurance contract between primary insurer and reinsurer	Share of reinsurer on the premiums and insurance benefits and commission for primary insurer	203
Co-insurance	Adequate proportion of receivables and costs and revenues on the relevant technical accounts	203
Gross amount of the costs to the insurance benefits and bonuses and rebates and the share of reinsurers	The obligation to establish at least two income statement accounts	205
Moment of the realization of the accounting transaction for liabilities	The moment of the recording of liabilities in the accounting	205
Deposits during passive reinsurance	The obligation to ensure the appropriate level of analytics in the accounting	205
Gross premiums written	Defining the content and method of accounting including reinsurers' shares	204
Costs in gross amount	Defining the content and method of accounting including reinsurers' shares	213
Bonuses and rebates	The method of accounting including reinsurers' shares	213
Revenues in gross amount	Defining the content and method of accounting including reinsurers' shares	213
Commissions from reinsurers and share of profit	The obligation to ensure the appropriate level of analytics in the accounting	213

Own elaborate based on the above Czech Accounting Standards

the reinsurance contract is made for a group of the transactions with the same risk, i.e., that leads to reinsurance protection for one or more insurance branches. There exist possible combinations of these forms: for example facultative obligatory reinsurance, where the insurance company has the right to decide whether certain risks will be ceded to reinsurance or not and the reinsurer must accept these ceded risks. The second combination is obligatory facultative reinsurance, when the insurance company has an obligation to offer all insured risks to reinsurance and the reinsurance company has the right to choose risks that will be accepted for reinsuring.

Based on the point of view of the liability of the reinsurer in relation to the original insurance, proportional and non-proportional reinsurance can be distinguished, which is further classified more detailed. Huleš and Hornigová (1997) call this aspect as aspect of reinsurance calculations. In the case of proportional reinsurance, the transfer of risk between an insurance company and a reinsurance company is based on amount of premiums written, which is divided between the both subjects in accordance with reinsurance contract. There are three possible options – quota reinsurance, surplus reinsurance or their combination. In the case of quota reinsurance the share of risk is constant between the both companies, in the case of surplus reinsurance it is variable, determined for each contract separately. In the case of non-proportional reinsurance, the transfer of risk to the reinsurance company is based on the insured event, i.e., it depends on the actual amount of damage. Within the non-proportional reinsurance, it is possible to distinguish two basic types: XL = excess of loss reinsurance, when the reinsurance company has to pay for damages exceeding insurers limit; and SL = stop loss reinsurance which is reinsurance of excess of time of damage when the reinsurer pays for reinsured aggregate losses incurred in a given year.

Also, reinsurance can be divided to hidden, when the insured has no contractual relation with the reinsurer or he is not aware that the insurance contract is reinsured, and open that depends on the consent of the insured knowing that a part of the responsibility for the insurance contract is transferred from the primary insurer to reinsurer.

Reinsurers apply the upper limit for reinsuring, i.e., the maximum amount of risk that they are willing to reinsure. Reinsurers perform underwriting, i.e., assessment of risk in advance, so they are willing to provide reinsurance also for cases where the primary insurer would have never concluded an insurance contract (Huleš, Hornigová, 1997).

III: *The overview of reinsurance classification*

<table>
<tr><th>Important aspect for the reinsurance classification</th><th colspan="5">Classification of reinsurance</th></tr>
<tr><td>Subject who ceded or received reinsurance</td><td>Active</td><td colspan="4">Passive</td></tr>
<tr><td>Relation to cash flows</td><td>Factual</td><td colspan="4">Formal</td></tr>
<tr><td rowspan="2">Form of reinsurance</td><td rowspan="2">Facultative</td><td colspan="4">Obligatory</td></tr>
<tr><td colspan="3">Facultative obligatory</td><td>Obligatory facultative</td></tr>
<tr><td rowspan="2">Liability of reinsurer</td><td colspan="3">Proportional</td><td colspan="2">Non-proportional</td></tr>
<tr><td>Quota</td><td>Surplus</td><td>Combination of quota and surplus</td><td>XL reinsurance</td><td>SL reinsurance</td></tr>
<tr><td>Relation of insured to reinsurer</td><td colspan="3">Hidden</td><td colspan="2">Open</td></tr>
</table>

Own elaborate

Reporting of Reinsurance in the Accounting of Commercial Insurance Companies

In principle, the insurance company ceases a part of risk into reinsurance. Provisions agreed in the reinsurance contract are essential for the subsequent recording in the accounting. The most often these represent a reinsurer's share on the insurance benefits and consequent share on relevant technical provisions, and a commission for insurer.

As shown in Tab. III, the ceding of risk to reinsurance may be in the form of factual or formal ceding – directly related to the connection with cash flows between insurance company and the reinsurance company. In the case of factual ceding, there is a cash flow between the insurance and reinsurance company, which specifically affects the contractual share on the reinsurance premiums and the proportion on the insurance benefits. The cash flows also occur in the case of cease of expenses on insured events, bonuses and rebates or shares on profit (Bokšová, 2010). In the case of formal ceding of risk, there are no cash flows between the insurance company and the reinsurance company. Very specific is the creation and use of technical provisions which include a provision for unearned premium, provision for insurance payments, life insurance premium provision and provision for bonuses and rebates. All relations between the insurance company and the reinsurance company are accounted simultaneously that means they affect every times a certain item of costs and revenues in relation to the relevant receivable or liability.

The starting point for the relation between insurance companies and reinsurance companies arising from reinsurance contracts is the amount of reinsurance premium. Reinsurance premium reflects the relation to reinsurers and it actually represents a part of gross premiums written which was ceded to reinsurers. In the accounting, it is recorded as a reduction in revenues and at the same time as a creation of liabilities to the reinsurer, so it will affect both balance sheet items and also income from insurance operations, so eventually also the amount of equity.

The ceding of gross premiums written is directly connected to the ceding of technical provisions, which is recorded in the accounting as a reduction in the relevant provision and at the same time as a reduction in the related costs. This fact will affect again both balance sheet items and also the income from insurance operations of the insurance company.

An integral part of the relationship between the insurance company and the reinsurance company is the reinsurance commission which reinsurer provides to the insurance company. This commission is recorded in the accounting of an insurance company as receivable for reinsurer, and revenue. Therefore it affects both balance sheet items and the income from operations of the insurance company. The final consequence of the relation between the insurance and reinsurance company is the costs related to insurance benefits ceded to the reinsurance company which will be recorded as the creation of receivable for the reinsurer and at the same time as a reduction in costs of insurance company. This operation will affect again the balance sheet of the insurance company and also the income from insurance operations.

Relations between insurance company and the reinsurance company can be extensive. This is the reason why the emphasis is given to consistent keeping of analytical evidence in the accounting of the commercial insurance companies in order to correct reporting of share of reinsurers on analysed significant items in connection with their reporting within financial statements.

Tab. IV shows that primary relations between insurance company and the reinsurance company (the logical exception is the subsequent offsetting of these relationships) consist in operations which directly affect the income from operations through the accounting into costs or revenues.

IV: *The recording of accounting of analysed reinsurance operations*

Reinsurance operations	Recording of accounting	
	Debit side	Credit side
Gross premiums written	Increase in receivables	Increase in revenues
Premiums ceded to reinsurer	Decrease in revenues	Increase in liabilities
Commission from reinsurers	Increase in receivables	Increase in revenues
Offsetting of receivables and liabilities to reinsurers	Decrease in liabilities	Decrease in receivables
Ceded bonus to reinsurers	Increase in receivables	Decrease in costs
Ceding of relevant share of the unearned premium provision	Decrease in provision	Decrease in costs
Subsequent use of this provision	Decrease in revenues	Increase in provision
Ceding of relevant share of the provision for bonuses and rebates	Decrease in provision	Decrease in costs
Subsequent use of this provision	Decrease in revenues	Increase in provision
Ceding of relevant share of the provision for insurance payments	Decrease in provision	Decrease in costs
Subsequent use of this provision	Decrease in revenues	Increase in provision
Share of reinsurer to the profit of the primary insurer	Decrease in revenues	Increase in liabilities

Own elaborate based on legislation

Reporting the Reinsurance Operations in the Financial Statements and their Impact on Significant Items of Financial Statements

As shown in Tab. IV, all relations between insurance company and the reinsurance company have ultimately a direct influence on the income from operations of the commercial insurance company (on the other hand, on the income from operations of the reinsurance company, also) in the amount that results from the concluded reinsurance contract between these subjects, and it is derived from the amount of risk that the insurance company transfers to reinsurance. That means that the impact of reinsurance operations can be seen in the balance sheet and also in the profit and loss statement in accordance with its mandatory division. Annex to the financial statements is also

V: *Affected items of the balance sheet as the result of reinsurance operations*

Items of assets in the balance sheet	Items of liabilities in the balance sheet
Deposits during active reinsurance	Deposits during passive reinsurance
Receivables from reinsurance operations	Liabilities from reinsurance operations
	Share of reinsurer on technical provisions
	Income from operations in current accounting period

Own elaborate based on legislation

VI: *Affected items of the profit and loss statement as the result of reinsurance operations*

Part I. Technical account for non-life insurance	Part II. Technical account for life insurance	Part III. Non-technical account
Premiums ceded to reinsurers	Premiums ceded to reinsurers	Result of technical account to non life insurance
Share of reinsurers in the change in unearned premium provision	Share of reinsurers in the change in unearned premium provision	Result of technical account to life insurance
Other technical revenues, net	Other technical revenues, net	Profit or loss for the accounting period
Share of reinsurers on the costs on insurance benefits	Share of reinsurers on the costs on insurance benefits	
Share of reinsurers in the change in provision for insurance payments	Share of reinsurers in the change in provision for insurance payments	
Change in other technical provisions, net	Change in other technical reserves, net	
Bonuses and rebates, net	Bonuses and rebates, net	
Commissions from reinsurers and share in profit	Commissions from reinsurers and share in profit	
Other technical costs, net		

Own elaborate based on legislation

the compulsory part of the reporting of reinsurance operations.

Tab. V shows that both items of assets and items of liabilities in the balance sheet can be affected by reinsurance operations. As a consequence, the resulting impact of these operations is on the amount of the equity.

These given items of the above parts of the profit and loss statement of the commercial insurance companies are the items of costs and revenues arising from reinsurance operations. In the profit and loss statement, there is always listed the relevant item of costs and revenues in gross amount and consequently, there is given the share of reinsurers on this item. In the effect, all reinsurance operations are entering into income from operations of the insurance company.

In the annex to the financial statements, commercial insurance companies are in accordance with the Decree of Ministry of Finance No. 502/2002 Coll., in the current version, liable to report detailed information for the items: costs on insurance benefits, net, bonuses and rebates, net, and share of reinsurers on items: other technical expenses or other technical revenues, and also the result from reinsurance that includes the relevant balance sheet items and the profit and loss statement items, and which must be presented separately for life and non-life insurance. Subsequently, the result from reinsurance must be divided into direct insurance and active reinsurance, if this reinsurance reaches 10% or more of gross premiums written, and then within the direct non-life insurance into the groups according to the insurance branches.

Impacts of Reinsurance Operations on the Income Tax Base

All income operations arising from reinsurance operations are entering into the income tax base in commercial insurance companies. This means that costs in the full amount reduce the income tax base and revenues are subject to taxation.

Specific cost/revenue items arising from reinsurance operations are premiums ceded to reinsurer, commission from reinsurer, ceded bonus to reinsurer and cease of respective shares of unearned premium provision, provision for bonuses and rebates and provision for insurance payments, including their subsequent use. It includes also share of reinsurers on profit of the primary insurer.

IAS/IFRS Approach to Reinsurance in Comparison with Czech Accounting Legislation

The advancing globalization and the development of the international capital markets bring the need for multinational globally accepted accounting rules, according to Fabozzi, Neave and Zhou (2012). International Financial Reporting Standards (IFRS) meet this requirement. Dvořáková (2011) states, that IFRS were chosen as a tool for the regulation of the European accounting. But on the other hand, Krupová (2009) added that it is not possible to rely on their absolute universality in terms of a single correct answer to any problem.

IFRS 4 “Insurance contracts” issued in March, 2004, ended the first phase of the project on accounting for insurance contracts dedicated to the sector of insurance. The second phase began in the same year. The standard does not provide a specific accounting in individual cases, it only defines. Jílek and Svobodová (2012) introduce the method of reporting the insurance contracts in accordance with this standard in relation to the probability of the estimates of contractual cash flows, market interest rate and the risk margin portfolio of insurance contracts. The standard IFRS 4 “Insurance contracts” defines the basic terms of reinsurance unlike the Czech accounting legislation. A reinsurance contract is understood as a type of insurance contract (see Tab. VII).

The Czech accounting legislation does not define the reinsurance assets, which is clearly defined in the IAS/IFRS (see above). On the contrary, the IAS/IFRS do not follow the concept of technical provisions. The content of both terms is solved in the accounting legislation in the accounting of commercial insurance companies, completely different is the reporting of these concepts in the financial reporting.

According to IAS/IFRS, financial statements consists of a statement of financial position at the end of the period, a statement of profit or loss and other comprehensive income for the period, a statement of changes in equity for the period and a statement of cash flows for the period. In accordance with Czech accounting legislation, components of annual financial statements are a balance sheet, a profit and loss statement and an appendix which consists a statement of changes in equity. Content of the financial statements by both legislations is the same, there is only different

VII: *The definition of terms under IFRS 4 related to reinsurance*

Term	Definition
Reinsurance assets	Net contractual rights of the ceding insurer under the reinsurance contract
Reinsurance contract	Insurance contract issued by one insurer (reinsurer) to compensate losses of another insurer (ceding insurer) from one or more insurance contracts issued by the ceding insurer
Reinsurer	The party that has the liability based on reinsurance contract to compensate for the ceding insurer if an insured event occurs

Own elaborate based on the IFRS 4 “Insurance contracts” designation. According to the Czech accounting legislation, the statement of cash flows is not a part of the annual financial statements, nevertheless the Czech National Bank as the supervisory authority on commercial insurance companies in the Czech Republic also requires reporting of a statement of solvency which content is identical to the statement of cash flows.

According to the IAS/IFRS, the share of reinsurer on technical provisions represents the reinsurance assets, so this is a claim of insurer on reinsurer. Reinsurance assets are therefore presented in the assets in the statement of financial position according to IAS/IFRS. On the contrary, in the balance sheet according to the Czech Accounting Standards they are presented in the context of external sources as a correction to the gross value of technical provisions in liabilities and equity in the balance sheet. There is a different amount of total assets as a result of different reporting under both legislations. The balance sum total in the statement of financial position is higher by the share of reinsurers in the case of reinsurance contracts in comparison to the balance sheet. It may cause a significant difference in summary for the accounting period and for concluded reinsurance contracts.

Fig. 1 implies that the consequence of reinsurance operations in the Czech accounting legislation is a decrease of total assets in the balance sheet and also a change in the structure of liabilities (a decrease of liabilities for the benefit of equity) at the level of reinsurers' share.

Assets	Liabilities and equity
	Equity
	Liabilities – Share of reinsurers on technical provisions
Total	Total

– Expenses
Revenues
Profit/Loss

1: *Display of impact of reinsurance operations into the accounting statements according to the Czech accounting legislation (balance sheet, profit and loss statement)*
Own elaborate

Assets	Equity and liabilities
Reinsurance assets	
Total	Total

Expenses
Revenues
Profit/Loss

2: *Display of impact of reinsurance operations into the accounting statements according to IAS/IFRS (statement of financial position, statement of profit or loss)*
Own elaborate

The consequence of reinsurance operations according to IAS/IFRS is an increase of total assets in the balance sheet in the statement of financial position at the level of reinsurers' share. According to the both accounting legislations, the impact on profit/loss is identical, only the form of accounting presentation is different. In the Czech accounting legislation, the expenses are being decreased; and within IAS/IFRS approaches, there is a rise of revenues.

Another difference that arises from the provisions of IFRS 4 is the impact of the classification of certain insurance contracts. This means that some insurance contracts contain both, an insurance component and a deposit component. In some cases, it is required or allowed that an insurer divides those components. The Czech accounting legislation does not classify the insurance contracts with regard to these aspects. The following situation is the impact of this fact in the case of reinsurance: if the accounting principles of an insurer do not require to account for all liabilities arising from the deposit component, then ceding insurer receives payments for loss from the reinsurer but the reinsurance contract obliges the ceding insurer to repay the compensation in future years. Otherwise, if the accounting principles of the ceding insurer would permit to account for the compensation as for an income without recognizing the resulting liability, a separation of the two components is required. During division of the contract, the insurer has to proceed in the case of an insurance component in accordance with IFRS 4 "Insurance contracts", but in the case of a deposit component it has to proceed according to IAS 39 "Financial Instruments: Accounting and valuation".

The last major difference between Czech accounting legislation and IFRS 4 "Insurance contracts" is the liability of a ceding insurer in the case of reducing the value of reinsurance asset which consists in the reduction of the accounting value of the reinsurance asset and the accounting for the loss from this reduction in the income statement. Reinsurance assets are assessed from the point of view of the reduction of their value to the reporting date or more frequently, if during the reporting period indication appears of reducing the value of these assets. That means in the case, if there is an objective evidence in consequence of an occurred event after the initial accounting of those assets which suggests that the insurance company may not be able to get paid all claims arising under the relevant reinsurance contract, and the impact of this event on the payments from the reinsurer can be reliably measured. Due to different presentation of the fact that the reinsurance assets item does not exist, the Czech accounting legislation does not use this accounting method.

IFRS 4 contains requirements related to reducing the value of reinsurance assets but it does not regard to any specific indicators or accounting methods how to evaluate this reduction. Otherwise, there cannot be any accounting case. Standards do not deal with a method of presentation of loss incurred by a decrease of the reinsurance assets value. As an appropriate method we can consider an indirect method of creation of adjustments. That is caused by the fact that reinsurance assets represent receivables which the indirect method is applied to in the accounting practise (especially while reporting a decrease of financial receivables in accounting of commercial banks).

Consistently, Czech accounting legislation and IFRS 4 prohibit compensating the reinsurance assets with the related insurance liabilities, and revenues and expenses from reinsurance contracts with expenses or income resulting from the related insurance contracts.

CONCLUSION

The relation between an insurance company and a reinsurance company is a contractual relation between two independent entities. A ceding of risk exists from the insurer to the reinsurer at precisely ahead defined contractual conditions. Commercial insurance companies can increase their insurance capacity through reinsurance. They share risks and also profit and income from business with the reinsuring insurers, respectively reinsurers. The accounting of reinsurance operations is very specific part of accounting in commercial insurance companies. Other economic subjects neither banks do not account for reinsurance. All relations between insurance company and the reinsurance company have ultimately direct influence on the income from operations of the commercial insurance company, and on the other hand, on the income from operations of the reinsurance company also, in the amount that results from the concluded reinsurance contract between these subjects and it is derived from the amount of risk that the insurance company transfers to reinsurance. That means that the impact of reinsurance operations can be seen in the balance sheet and also in the profit and loss statement in accordance with its mandatory division. Annex to the financial statements is also the compulsory part of the reporting of reinsurance operations.

The international accounting standard IFRS 4 “Insurance contracts” came in force since January 1st, 2005. It represents the first phase of IFRS 4 project which solves urgent problems in reporting of insurance contracts. The first phase represents just a temporary solution until finishing and accepting more complex solution within the second phase of IFRS 4 project which should comprehensively regulate the whole area of insurance contracts. The aim of the second phase of IFRS 4 is to improve the presentation of results of commercial insurance companies, to raise the transparency of market and to improve the comparison with other financial institutions. This phase should solve an actual problem of complicated accounting methods which are different for each product, each subject and each country.

To the current issues of the second phase of IFRS 4 “Insurance contracts”, it is important to mention that the proposed validity of the standard is scheduled for January 2018. The biggest change, and a problem at the same time, is a different evaluating model for technical provisions. An insurance contract should be accounted at the side of issuer at first in the current output value. Then it should be accounted in the value that the issuer would pay in case of transfer of the insurance contract to another entity. Three factors (according to Jílek, Svobodová, 2012) should be taken into account in determining the actual output value: probability of estimation of contractual cash flows, current market interest rates and the risk margin of portfolio of insurance contracts. The last mentioned factor includes the credit risk of the issuer of the insurance contract. It means that there should be an immediate profit when arranging the insurance contract. All changes in its fair value have to be recorded in the resulting income. A relationship to the client associated with an insurance liability should be recorded as an asset. It is the ability of the entity to achieve the economic benefit from future payments of insurance premiums which the insured must pay in order to have the insurability guaranteed.

REFERENCES

BOKŠOVÁ, J. et al. 2004. *Účetnictví II*. Praha: Institut Svazu účetních.

BOKŠOVÁ, J. 2010. *Účetnictví komerčních pojišťoven – specifika v ČR*. Praha: Wolters Kluwer ČR.

CIPRA, T. 1999. *Pojistná matematika: teorie a praxe*. 1st edition. Praha: Ekopress.

CIPRA, T. 2004. *Zajištění a přenos rizik* v *pojišťovnictví*. 1st edition. Praha: Grada Publishing.

ČEJKOVÁ, V., VALOUCH, P. 2005. *Účetnictví pojišťoven po vstupu do EU*. Praha: Grada Publishing.

ČESKÁ REPUBLIKA. 1992. Zákon ČNR č. 593/1992 o rezervách pro zjištění základu daně z příjmů, ve znění zákona č. 267/2014 Sb. In: *Sbírka zákonů České republiky*. Available at: http://zakony-komentare.cz/aktualne/01.01.2015-c.-593-1992-sb.-zakon-o-rezervach-pro-zjisteni-zakladu-dane-z-prijmu-ve-zneni-267-2014-sb.html.

ČESKÁ REPUBLIKA. 2002. Vyhláška Ministerstva financí č. 502/2002 k provedení zákona o účetnictví pro účetní jednotky, které jsou pojišťovnami, ve znění pozdějších předpisů. In: *Sbírka zákonů České republiky*. Available at: http://www.mfcr.

cz/cs/legislativa/legislativni-dokumenty/2002/vyhlaska-c-502-2002-sb-3441.
ČESKÁ REPUBLIKA. 2003. *České účetní standardy č. 203, 204, 205, 213.* Available at: http://www.kacr.cz/Data/pdf/ucetni_standardy/fz11-2003_51.pdf.
ČESKÁ REPUBLIKA. 2009. Zákon č. 277/2009 ze dne 22. července 2009 o pojišťovnictví. In: *Sbírka zákonů České republiky*. Available at: http://www.finance.cz/pojisteni/zakony/pojistovnictvi/.
DVOŘÁKOVÁ, D. 2001. *Finanční účetnictví a výkaznictví podle mezinárodních standardů IFRS.* 3rd edition. Brno: Computer Press.
FABOZZI, F. J., NEAVE, E. H., ZHOU, G. 2012. *Financial Economics*. Hoboken: John Wiley & Sons.
HULEŠ, J., HORNIGOVÁ, J. 1997. *Účetnictví pojišťoven*. Praha: Linde.
International Financial Reporting Standards 2013 (Red Book). London: IFRS Foundation.
JÍLEK, J., SVOBODOVÁ, J. 2012. *Účetnictví podle mezinárodních standardů účetního výkaznictví 2012.* Praha: Grada Publishing.
KRUPOVÁ, L. 2009. *IFRS Mezinárodní standardy účetního výkaznictví*. Praha: VOX.
ZWEIFEL, P., EISEN, R. 2012. *Insurance Economics*. Berlin: Springer-Verlag.

Contact information

Jana Gláserová: jana.glaserova@mendelu.cz
Eva Vávrová: vavrova@mendelu.cz