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Exposure Draft

GAAP Accounting for Profits Followed by Losses in Long-Duration Contracts

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Developed by the Profits Followed By Losses Subgroup of the Financial Reporting Committee of the American Academy of Actuaries

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This practice note was prepared by the Profits Followed by Losses Subgroup organized by the Financial Reporting Committee within the Risk Management and Financial Reporting Council of the American Academy of Actuaries. This document is intended to provide information to actuaries preparing, reviewing, or commenting on GAAP accounting for profits followed by losses in long-duration contracts, in accordance with the Accounting Standards Codification (ASC) 944-60-25-9 *Long-Duration Contracts* (formerly the Statement of Financial Accounting Standards (FAS) No. 60 *Accounting and Reporting by Insurance Enterprises*) and other relevant information. ASC 944-60-25-9 provides guidance on the required criteria, timing, and location for recording long-duration contracts within financial statements.

This practice note is intended for use as a reference tool only and is not a substitute for any legal or accounting analysis or interpretation of the regulations or statutes. This practice note is not a promulgation of the Actuarial Standards Board (ASB), is not an actuarial standard of practice, is not binding upon any actuary, and is not a definitive statement as to what constitutes appropriate practice or generally accepted practice in the area under discussion. Events occurring subsequent to this publication of the practice note may make the practices described in this practice note irrelevant or obsolete.

This practice note is not an official or comprehensive interpretation of any accounting guidance, including the ASC 944-60-25-9 *Long-Duration Contracts* and FAS 60. Future regulatory and legislative activity may change materially certain information presented in this practice note.

We welcome comments and questions. Please send comments to RMFRCPolicyAnalyst@actuary.org.

EXPOSURE DRAFT
Practice Note on GAAP Accounting for
Profits Followed by Losses in Long-Duration Contracts

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Introduction

This practice note is intended to provide actuaries with additional information on how to record long-duration contracts within financial statements when profits are followed by losses under the Financial Accounting Standards Board's (FASB) Generally Accepted Accounting Principles (GAAP) guidelines. Primary source materials referenced in this practice note include:

1. Statement of Financial Accounting Standards No. 60 *Accounting and Reporting by Insurance Enterprises* (June 1982) http://www.fasb.org/pdf/fas60.pdf

2. Statement of Financial Accounting Standards No. 97 *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments* (December 1987) http://www.fasb.org/pdf/fas97.pdf

3. Financial Accounting Standards Board Accounting Standards Codification Topic 944 *Financial Services — Insurance* https://asc.fasb.org/topic&trid=2303980

4. Financial Accounting Standards Board Accounting Standards Codification Topic 605 *Revenue Recognition* https://asc.fasb.org/topic&trid=2197195

5. Financial Accounting Standards Board Accounting Standards Codification Topic 320 *Investments — Debt and Equity Securities* https://asc.fasb.org/topic&trid=2196928

6. American Institute of Certified Public Accountants' *Audit and Accounting Guide for Life and Health Insurance Entities* (2013)

7. American Institute of Certified Public Accountants' Technical Practice Aids, TIS Section 6300.36, "Prospective Unlocking" (December 2008)

This practice note represents a description of practices the subgroup believes to be common among many, but not all, U.S. actuaries; however, other approaches also may be appropriate. This practice note is also intended to encourage discussion on the issues set forth below, providing a framework to foster dialogue between the actuaries involved in the process.

Background

ASC Long-Duration Contracts

ASC 944-60-25-9 provides accounting guidance on how to appropriately record long-duration contracts within financial statements, according the established protocols of the FASB GAAP. The code lays out the appropriate accounting policy benefit assumptions and premium deficiencies. These provisions were included in FAS 60 previously.

FAS 97 Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments

FAS 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments,* instituted standards of accounting for certain long-duration contracts issued by insurance enterprises, also known as universal life-type contracts, which were not addressed by FAS 60 originally. FAS 97 also established standards of accounting for limited-payment, long-duration insurance contracts and investment contracts and amended FAS 60 to change the reporting of realized gains and losses on investments.

Definitions

Q1. What are profits followed by losses?

In the context of this practice note, the term profits followed by losses refers to the potential need to establish an additional liability under GAAP in situations in which there is an expectation that a group of long-duration insurance (and potentially investment – see Q3) contracts will generate profits in the early reporting years followed by losses in later reporting years. The requirement originally was described in FAS 60 in paragraph 37 and is now found under the FASB ASC 944-60-25-9 *Financial Institutions—Insurance-Premium Deficiency and Loss Recognition-Long-Duration Contracts*. The accounting guidance, in its entirety, states:

> "A premium deficiency, at a minimum, shall be recognized if the aggregate liability on an entire line of business is deficient. In some instances, the liability on a particular line of business may not be deficient in the aggregate, but circumstances may be such that profits would be recognized in early years and losses in later years. In those situations, the liability shall be increased by an amount necessary to offset losses that would be recognized in later years."

This paragraph, along with any accounting guidance related to this paragraph, encompasses the scope of this practice note.

The concept of profits followed by losses arises within other GAAP insurance accounting areas, most notably universal life-type contracts that contain "other insurance benefit features." This includes ASC 944-605-25-8 through 11 *Financial Institutions—Insurance-Revenue Recognition-Long-Duration Contracts-Contracts With Death or Other Insurance Benefits*. However, the application of that section of the ASC is not within the scope of this practice note.

Q2. What are "losses" in Q1?

ASC 944-60-25-7 through 9, *Long-Duration Contracts,* describes the components of a premium deficiency as expected benefits, related settlement and maintenance expenses, amortization expense of unamortized acquisition costs, premiums, and the related GAAP liability for future

policy benefits. Thus, a loss in a future accounting period would be expected to be reported if (a) exceeds (b), where for that reporting period:

(a) The sum of claims incurred plus related settlement expenses, maintenance expenses, amortization expense of unamortized acquisition costs, the change in the related liability for future policy benefits, and policyholder dividends. Note, however, that the future period's incurred claims and settlement expenses typically would not include those costs associated with claims that were reported before the current valuation date. Those costs are covered under GAAP by the current claim reserves and not the GAAP liability for future policy benefits of in-force long-duration policies.
(b) The sum of premiums earned plus investment income earned on assets supporting the related GAAP liability for future policy benefits. This requires a GAAP income projection—preferably for the life of the contract.

While some variation in practice may be observed relative to the precise definition of "loss," practitioners commonly align the definition with that of net income reported on the GAAP financial statements.

Application and Considerations

Q3. To what type of contracts does the profits followed by losses accounting guidance apply?

The guidance referenced in Q1 is found in ASC 944 *Financial Institutions-Insurance*, and is defined as relating to long-duration contracts. Long-duration insurance contracts are identified in ASC 944-40-30 as including traditional long-duration contracts, universal life-type contracts, certain participating life insurance contracts, and financial guarantee insurance contracts. The profits-followed-by-losses guidance could also apply to limited-pay insurance contracts because they follow the accounting rules for traditional long-duration contracts for establishing reserves. Depending on the basis on which contracts are grouped for premium deficiency and loss recognition testing, some practitioners have concluded that it may be appropriate to include investment contracts in the analysis of whether profits followed by losses is anticipated for a block of business. However, because increasing contract liabilities on investment contracts for loss recognition is not permitted (ASC 944-60-35-6), increasing liabilities in anticipation of profits followed by losses would be considered inappropriate.

The profits followed by losses accounting guidance also would appear to apply to property and casualty contracts, which are classified as long-duration under the referenced paragraph. However, certain property and casualty contracts that appear to have profits followed by losses characteristics are not within the scope of this practice note because they are covered by other sections of the accounting literature that adjust for profits followed by losses directly. For example, extended warranty contracts often charge level premiums, which, if earned on a pro-rata basis, typically are sufficient to cover expected claims in the early years but are deficient in the later years of a contract. Unearned premium liabilities (and potentially premium deficiency reserves) often are established for such contracts pursuant to ASC 605-20-25 *Revenue Recognition-Services-Recognition* (formerly FASB Technical Bulletin 90-1), thereby eliminating

any potential for the profits followed by losses situation outlined in this practice note from occurring.

Q4. Under what circumstances do profits followed by losses occur?

Profits followed by losses could occur on any of a variety of products depending on pricing, contract provisions, and changes to management estimates over time. One commonly encountered situation occurs with long-duration, non-participating obligations, such as payout annuities. Locked-in valuation assumptions for such products often use a level interest rate assumption. If the current yield on the assets backing the liabilities exceeds the discount rate on the liabilities but future reinvestment rates are expected to be below the discount rate, there could be an expectation of near-term profits followed by longer-term losses.

A second commonly encountered situation relates to guaranteed renewable contracts, such as long-term care. In this situation, companies may increase premium rates in recognition of deteriorating claims expectations. Because reserve assumptions typically are locked in for such contracts, the increase in premiums may not be accompanied by a change in the pattern of reserve build-up that had been established when the contract was first priced. This could result in a situation in which the premium increases are recognized immediately in net income when received rather than set aside in reserves to fund the expected deterioration in experience in the future. The result may be a pattern of “profits followed by losses.”

Long-term care contracts also can have profits followed by losses in situations in which the conditions are perceived to have improved due to later than originally expected claim costs (e.g., policyholders enter care facilities later than expected). Due to the humpback nature of long-term care active life reserves, the original locked-in active life reserves could decline sooner than projected, which could cause losses to emerge later.

Q5. At what level should the test be performed?

The accounting guidance related to testing for profits followed by losses does not specifically state at what level the testing should be done. Because the accounting guidance resides in the same subsection of ASC 944-60, *Financial Institutions-Insurance—Premium Deficiency and Loss Recognition,* as the guidance related to recognition of a premium deficiency, the identical aggregation criteria could apply. Specifically, these aggregation criteria are described in ASC 944-60-25-6, *Recognition-Short-Duration Contracts,* as follows: “Insurance contracts shall be grouped consistent with the entity's manner of acquiring, servicing, and measuring the profitability of its insurance contracts to determine if a premium deficiency exists.”

Q6. Should business projected to be written in the future (and not yet in-force as of the current valuation date) be included in the profits followed by losses test?

Some have argued that profits followed by losses could be tested using projections of business projected to be sold in the future. The premise behind this argument is that this business will later

be aggregated with the current existing business for the purpose of performing premium deficiency and loss recognition testing in the future and, therefore, profits (or losses) arising from this future business should be considered when determining whether there is a projection of future losses.

Including future new business in a current assessment of profits followed by losses has little support in actual practice. The requirements of testing for profits followed by losses are similar to those of testing for premium deficiencies, and the latter testing is performed only on existing business.

ASC 944-60-25-1, *Recognition-General,* states: "Paragraph 450-20-55-17A states that Subtopic 450-20 does not prohibit (and, in fact, requires) accrual of a net loss (that is, a loss in excess of deferred premiums) that probably will be incurred on insurance policies that are in force, provided that the loss can be reasonably estimated." This implies that loss recognition testing pertains to insurance policies that are "in force."

Section 9.90 of the American Institute of Certified Public Accountants' (AICPA) *Audit and Accounting Guide for Life and Health Insurance Entities* (2013) begins: "Loss recognition tests (issues of all years). Recoverability testing or profitability tests of insurance contract groups in years subsequent to issue should be performed periodically, as deemed necessary." This implies that loss recognition testing pertains to insurance contracts "subsequent to issue" (i.e., not before they are issued).

Q7. Should future premium rate increases be considered in testing for profits followed by losses?

Guaranteed renewable contracts, such as long-term care policies, provide the insurance company with the ability to raise premium rates in recognition of deteriorating experience. Such premium rate increases often are subject to regulatory approval. There is nothing definitive in the accountant guidance that states whether future premium rate increases may be considered in testing for "profits followed by losses." However, because testing for profits followed by losses is closely related to premium deficiency testing, the assumptions used in this testing generally are comparable. Future premium rate increases are typically considered in testing for premium deficiencies and in establishing reserves under loss recognition for guaranteed renewable business. Therefore, many practitioners believe that consideration of premium rate increases in testing for profits followed by losses also would be appropriate.

In determining when and at what level to project future premium rate increases when performing tests for "profits followed by losses," practitioners often include the following considerations:

- Historical and projected experience and the level of premium rate increase that such experience might support under the contracts;
- Management decisions regarding premium rate increases and how far along management is in the process of obtaining approval for the premium rate increase requests with regulators, as the premium rate increases are often included in financial reporting prior to approval;

- The likelihood of regulatory approval (if required) and the likely amount that will be approved;
- Experience related to prior premium rate increases the company has applied for; and/or
- Other industry, business, and regulatory environment considerations.

Q8. Should new entrants be projected on group contracts?

Accounting guidance does not specifically address whether new entrants on group contracts may be projected in assessing whether a group of contracts are expected to generate "profits followed by losses." Some practitioners believe that projecting new entrants is similar to projecting new business and, consistent with the conclusion typically reached on new business as discussed in Q5, conclude it is inappropriate. Others view the addition of new entrants on group contracts to be an element of the experience and, therefore, conclude it is appropriate when performing a profits followed by losses test. Two factors that practitioners may wish to consider in developing a position on this issue are:

- The "unit of account" or the level at which accounting policies are applied under the group contract; and
- The approach applied to new entrants when performing premium deficiency testing on the group contracts.

Q9. What happens if the test shows profits followed by losses?

ASC 944-60-25-9, *Long-Duration Contracts,* states that "the liability shall be increased by an amount necessary to offset losses that would be recognized in later years."

Q10. How should the liability be increased?

The accounting guidance does not indicate the period or pattern over which to recognize the additional liability for "profits followed by losses." Consequently, a range of potential approaches has been considered by practitioners. Section 9.94 of the AICPA *Audit and Accounting Guide for Life and Health Insurance Entities* (2013) discusses profits followed by losses situations and states: "Adjustments should always be made when losses first become apparent." While the AICPA guide does not provide insight on how to increase the liability, this does appear to indicate when to start increasing the liability.

Some practitioners draw a parallel to loss recognition accounting guidance and suggest that unamortized acquisition costs could be written down to eliminate an anticipated situation of profits followed by losses. However, there does not appear to be any support in the GAAP literature for a possible write-down of unamortized acquisition costs to address profits followed by losses.

Q11. What are some methods that could be considered for increasing liabilities to offset future losses?

The range of actual, observable practice is somewhat limited, though several potential methods have been considered. Low interest rate environments and the need to implement premium rate increases on some products could result in more methods actually being adopted in practice in the future.

Some methods that practitioners have considered include:

- An immediate increase in liabilities to offset all anticipated losses;
- A locked-in increase schedule to build a liability over time to offset future losses;
- A dynamic increase schedule that changes over time as the projection of future losses change; and
- Variations of these methods.

One overriding consideration that many practitioners take in deciding on a method is the accounting model applied to the contracts. For example, traditional insurance contracts with features that are fixed and guaranteed (i.e., FAS 60 contracts) normally follow a lock-in concept for calculating reserves; therefore, a locked-in method for increasing liabilities may be well aligned for them. Conversely, universal life contracts as originally defined in FAS 97 incorporate dynamic elements in accounting and, therefore, may align better with a dynamic schedule. Similarly, the accrual pattern (i.e., whether the liabilities are accrued in proportion to premiums, estimated gross profits, face amount, or something else) could be aligned to the underlying accounting model.

Q12. What are some considerations around establishing an immediate increase in liabilities?

ASC 944-60-25-9, *Long-Duration Contracts,* states that when "profits would be recognized in early years and losses in later years…the liability shall be increased by an amount necessary to offset losses that would be recognized in later years." One interpretation of this accounting guidance might suggest that the cumulative value of projected future losses should be recorded immediately upon recognition of "profits followed by losses." However, this would result in a loss in the current reporting period followed by a period of profits. Because this would result in an earnings pattern that is misaligned with the apparent objective of the accounting guidance, many practitioners believe that this approach to pre-funding the future losses is not appropriate. Many consider this approach to contradict ASC 944-60-35-5 (FAS 60 paragraph 36) which states: "(n)o loss shall be reported currently if it results in creating future income."

Q13. What are some considerations around accruing an increase in liabilities over time?

Two of the primary considerations that arise when accruing liabilities over time are the pattern the accrual should take and the time period over which the liabilities should be accrued. These following two approaches are often seen in practice:

- One approach accrues a ratable share of expected profits over time up to a liability that is just adequate to offset future losses at such time as the future losses are expected to commence. The measure of future losses may be on a discounted or undiscounted basis.

- Another approach accrues a ratable share of expected profits but targets just enough liability to prevent a loss recognition event from occurring at the earliest point at which it is expected to occur the future.

Rather than accrue a ratable share of expected profits, some practitioners may consider other measures as well, such as a ratable share of revenues.

If experience meets expectations exactly, the second approach typically accrues a smaller liability than the first approach until such time as the initial loss recognition event would have occurred. After that, all future profits would be accrued as a liability in order to forestall loss recognition at the next reporting date. This second method targets zero annual profits from the date at which the business would have first entered loss recognition; whereas, the first method targets zero annual profits from the date at which annual losses are first projected to occur.

Q14. What are some considerations around adopting a locked-in schedule to establish an additional liability over time?

Under this approach, a company would establish a locked-in schedule for setting an additional liability to accrete (a) to the sum (or present value) of future projected losses at such time as the future losses are projected to begin or (b) to the projected deficiency arising when the business is first expected to enter loss recognition. The schedule typically would be designed to reduce projected profits ratably over the period during which gains are projected. Consideration could be given to adjusting this accrued liability to account for differences between the actual in-force and the projected in-force at each reporting date. Additional locked-in accrual schedules could be added if the current schedule(s) prove to be insufficient when performing profits followed by losses tests on subsequent reporting dates.

Some practitioners believe that this approach is recommended, particularly for traditional FAS 60 business because it appears to be consistent with the lock-in concept typically applied to reserves for traditional, long-duration insurance contracts at issue and upon recognition of a premium deficiency.

However, there are other considerations that may make a locked-in approach untenable:

- The locked-in nature of the reserve accrual means that a larger-than-needed reserve could result if the projection of future losses declines in the future.

- A locked-in schedule of additional reserves would likely result in two different sets of locked-in assumptions applied to the same contracts (i.e., one set that was applied at issue and a second applied when the accrual for profits followed by losses was established). Multiple sets could be encountered if the expectations of future experience continue to deteriorate.

- A locked-in accrual schedule could result in unexpected losses that might occur as experience emerges in the period during which gains are expected or if such expected gains turn out to be lower than projected when the schedule was developed.

- Some practitioners view a locked-in accrual as being equivalent to the "prospective unlocking" approach commonly applied to guaranteed renewable contracts prior to the industry's widespread discontinuance of the practice for reasons outlined in the AICPA's Technical Questions and Answers TIS Section 6300.36 (December 2008).

For these reasons, many practitioners find a locked-in approach and the anomalous earnings patterns that could result from such an approach to be contrary to the intent of the profits followed by losses accounting guidance.

Q15. What are some considerations around adopting a dynamic method for funding future losses over time?

Many practitioners believe a method that allows the accrual of reserves to change based on changing expectations of profits followed by losses results in a profit emergence that is best aligned with the intent of the "profits-followed-by-losses" accounting guidance, particularly for non-traditional, universal life-type contracts. For methods that dynamically adjust, several approaches could be considered, each with its own attributes that may best align them with accounting principles or produce results that seem most appropriate relative to the intention of the accounting guidance.

Generally speaking, all such approaches seek to take some of the profits that otherwise would be earned in early years and set them aside in a reserve that would be released once losses develop in the later years. Similar to the locked-in method described in Q12, a typical method would start with an accrual pattern that takes a ratable share of expected profits to accrue to a liability that is just adequate to offset future losses at such time as the future losses are expected to commence, or when loss recognition is first projected. Alternatively, the accrual could target just enough liability to prevent a loss recognition event from occurring at any point in the projected future. At each future reporting date, the projection of profits followed by losses would be reassessed and the accrual pattern adjusted to target the revised reserve necessary to fund the future losses. A retrospective unlocking approach, similar to what is used to amortize deferred acquisition cost assets for non-traditional insurance contracts, could be considered. More commonly, a method that starts with the prior period accrual and prospectively re-estimates the portion of profits to be used to accrue a liability also could be used.

If projections of future profits and losses change so as to render the accrued liability higher than necessary to offset all future projected losses, then consideration must be taken as to how and when to release the excess liability. Under an unlocked approach, some practitioners might consider releasing the excess liability over some future period (e.g., the period originally contemplated as the liability was being established). Another approach would be to release the entire accrued liability in excess of the total necessary to offset all projected losses immediately. Some actuaries believe this is more consistent with GAAP because it prevents an additional liability from being recorded, which will serve only to generate profit in the future. The nature of the underlying contracts (i.e., whether the business follows a traditional, locked-in FAS 60 model or an unlocked FAS 97 approach) also could influence the method of releasing excess liabilities.

Whatever the method, the expectation is that the liability accrual would be adjusted continuously to arrive at the desired liability to fund all future losses at the point in time at which profits ultimately turn to losses, or at the point at which loss recognition is expected to commence if such an accrual target is used.

Q16. Can business written since the prior valuation date (and in-force as of the current valuation date) that meets the company's aggregation criteria be added to the current assessment of profits followed by losses of a block of business that was in force at the prior valuation date?

Many practitioners consider the recognition of profits followed by losses to be similar to recognition of a premium deficiency. Thus, the profits followed by losses aggregation criteria are commonly aligned with the entity's accounting policy for premium deficiency testing.

One practice could be to separate the old business with the expected profits followed by losses pattern and treat it as a single, closed block in the future.

Another approach might be to include subsequently sold business in the updated profits followed by losses tests, provided it meets the aggregation criteria.

Some practitioners consider the inclusion of subsequently sold business (in future tests) appropriate when a dynamic method for accruing the additional liability is used. Under this view, the locked-in concept does not apply. This extends to the definition of the block of business, which can change as the in-force business changes. A consequence of this view is that subsequently sold business could be added to the future profits followed by losses test, provided the business meets the aggregation criteria of the block it will be associated with. As discussed in Q6, business projected to be written in the future (and not yet in-force as of the current valuation date) is usually not included in the profits followed by losses test.

Q17. Once a reserve has been accumulated to cover future losses, how should the additional liability be released into income?

Similar to the accrual of a liability during the phase when profits are being recognized, there is no explicit accounting guidance that suggests how the liability should be released into income once losses are being recognized.

In cases in which the liability has been accrued using a locked-in method, a locked-in method for releasing the liability might be considered as well.

In cases in which the liability has been accrued using a dynamic approach, the release of the accrued liability using a similar dynamic mechanism might be considered. This typically means reassessing the expected future losses at each reporting period and releasing any reserves in excess of those needed to offset the present value of future losses exactly. Other methods could be considered, but any run off of the liability that follows some other pattern is likely to result in future profits or full loss recognition, which will then prevent premature run off of any additional liability.

Q18. How would a locked-in method for releasing the accrued reserve work and under what circumstances might it be considered?

A locked-in method for releasing the additional reserve would establish a release pattern that best matches the loss projected in the future. This approach would fit well with a locked-in approach for accruing the liability, though the locked-in release could result in misalignment of recorded losses and reserve release as expectations change from the time when the reserve release pattern was locked-in. This locked-in approach would seem consistent with the locked-in nature of reserve assumptions when applied to traditional insurance contracts following loss recognition events. Reconciling reserve amounts to the actual in-force could also be considered.

Q19. How would a dynamic method for releasing the additional reserve work and under what circumstances might it be considered?

There is potentially a wide range of dynamic approaches that could be considered, if a company concludes that such methods do not violate accounting policies related to reserve lock-in. One approach would be to draw down the reserve to identically offset losses as they are realized.

This approach runs the risk of either exhausting the reserve before all losses have been recognized (and consequently generating a loss recognition event along the way), or needing to release a liability once the last policy has matured if the reserve turns out to have been unnecessarily large. A second approach would be to reset the release pattern at each reporting period to ratably offset projected future losses. This approach might break down in practice,

however, because it either results in excess reserves that generate future profits or results in insufficient reserves to fund future losses, which may put the block into loss recognition.

A third approach would be to continue the same dynamic mechanism that is used for establishing the liability. For example, the projected losses could be projected at the valuation date and any reserve in excess of that needed to offset the projected future losses (either the sum or present value, as applicable) could be released. This same method could be used to release excess reserves in a case in which profits followed by losses are still expected, but the reserve accrued to date is higher than the projected future losses due to improving expectations of future conditions. This method assures that at any point in time, the expectation is that the additional liability either currently recorded or expected to be recorded over time will offset the projected negative profits in the later years either on a nominal or discounted basis, depending on the policy adopted. Many actuaries/practitioners believe that this approach is the most consistent with GAAP because it prevents recording a liability that will generate future profits and aligns with ordinary loss recognition testing. However, others believe this method is inappropriate for contracts for which the ordinary accounting is subject to lock-in because it allows for the unlocking of assumptions subsequent to what would normally be considered a loss recognition event.

Q20. What happens if there is an expectation of "profits followed by losses followed by profits"?

The potential for an expectation of "profits followed by losses followed by profits" can arise in unusual circumstances when best estimate assumptions take on a vastly different pattern than assumptions reflected in reserves. The situation can arise in contracts with distinct and varied contract phases during which profits may emerge more erratically over time. An example might be a level term life insurance policy for which the profit patterns in the level term and post-level term phases may be subject to different considerations. The situation is more commonly encountered, however, on FAS 97 universal life-type contracts.

There is no explicit accounting guidance that addresses "profits followed by losses followed by profits." However, reading the guidance related to profits followed by losses provides no exception for cases in which profits follow losses. Consequently, one interpretation of the accounting guidance suggests that elimination of the losses through a mechanism that establishes reserves out of the early year profits is still appropriate, even if future profits are expected. However, other practitioners feel that this is too narrow a reading and that a liability should be accrued for "profits followed by losses followed by profits" only in those cases in which the aggregate present value of future profits is negative. This approach seems most consistent with common accounting practice whereby companies do not accrue liabilities for sporadic projected losses in income projections.

An actuary also may wish to consider if the profits followed by losses liability will be built up to fund a projected ASC 944-60- 25-7, *Long-Duration Contracts,* premium deficiency at the end of the first profit period (i.e., when the present value of projected losses exceeds the present value of the remaining future gains).

Q21. How would one accrue a liability if there is an expectation of "profits followed by losses followed by profits?"

One potential approach would be to a use a method described for the profits followed by losses situation and to ignore the later profits in the lifetime of the contracts. This approach may be consistent with an interpretation of the accounting guidance under which the late year profits are not a factor in determining whether a liability for "profits followed by losses followed by profits" is required. As discussed in Q20, however, ignoring the late year profits represents a fairly narrow interpretation of the guidance.

Another potential approach would be to include all projected profits in the cumulative future loss calculation used to project the net amount of future losses to be funded by accrual of a liability during the first profit period. This approach, whether applied using a locked-in or dynamic method, has the appeal of eliminating only those profits that will be "given back" via excess losses in the future while not altering unnecessarily the "losses followed by profits" pattern exhibited in the later years.

Q22. Are there any special considerations related to participating contracts?

The AICPA's *Audit and Accounting Guide for Life Insurance Entities* (2013), chapter 9, paragraph 9.95 discusses participating contracts:

> "For participating insurance contracts, the treatment of dividends in loss recognition tests requires special consideration. Generally, the current dividend scale is used to project future dividend benefits. However, if a loss is indicated, the entity should consider whether it has the ability to reduce or eliminate dividends. In such situations, it is reasonable to consider that option in testing for premium deficiencies."

Practitioners who consider testing for profits followed by losses to be closely related to loss recognition testing may wish to consider this accounting guidance when testing for profits followed by losses on participating contracts.

Q23. How should shadow accounting be applied?

Practitioners may wish to consider whether any "shadow" adjustments are necessary in recognition of profits followed by losses in companies that record assets classified as "available for sale." Accounting guidance related to shadow accounting is found in ASC 320-10-S99-2, *Announcements Made by SEC Staff at Emerging Issues Task Force (EITF) Meetings SEC Staff Announcement: Adjustment in Assets and Liabilities for Holding Gains and Losses as Related to the Implementation of Subtopic 320-10* (originally EITF D-41). The accounting guidance suggests that companies record, as an adjustment to surplus through other comprehensive income, the impact on any items that would change were assets immediately sold that are carried as available for sale. With respect to reserves recorded in recognition of "profits followed by losses," such an adjustment could be required were the liquidation of such assets to cause a change in the establishment or release of reserves. This will depend on the methods employed to

accrue and release the reserves, so practitioners may wish to review their methods to determine whether a shadow adjustment is needed.