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Accounting for Profits Followed by Losses in Long-Duration Contracts Practice Note

Profits Followed By Losses Subgroup

Financial Reporting Committee

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Introduction

- This practice note is intended for:
  - Actuaries preparing, reviewing, or commenting on the Financial Accounting Standards Board's (FASB) Generally Accepted Accounting Principles (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*
- It is a reference tool and is not a substitute for any legal or accounting analysis or interpretation of the regulations or statutes

Introduction

- The practice note is not:
  - A promulgation of the Actuarial Standards Board;
  - An actuarial standard of practice;
  - Binding upon any actuary;
  - A definitive statement as to what constitutes appropriate practice or generally accepted practice; or
  - An official or comprehensive interpretation of any accounting guidance
- Future regulatory and legislative activity may change information presented in this practice note

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Background

- ASC 944-60, *Premium Deficiency and Loss Recognition*, defines situations under which a premium deficiency may be recognized. It:
  - Describes how such deficiencies should be reflected in the insurance entity’s GAAP financial statements
  - Addresses the premium deficiency situation for long-duration contracts under which “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”

Background

- The profits followed by losses (PFBL) situation is not frequently encountered in practice and the related financial reporting guidance is less prescriptive
  - However, there is a range of interpretations to reflect PFBL in GAAP-basis financial statements

Background

- The questions and answers of the practice note document the key issues that actuaries and practitioners may consider when faced with a PFBL situation
- This practice note is intended to apply to long-duration contracts only

Q1. What are profits followed by losses?

- FASB ASC 944-60-25-9, *Long-Duration Contracts*:
  - The potential need to establish an additional liability under GAAP when there is an expectation that long-duration insurance contracts will generate profits in the early years followed by losses in later years

Q2. What are “losses” in Q1?

- A loss in a future accounting period would be expected to be reported if (a) exceeds (b), where:
  - (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; and
  - (b) The sum of premiums earned plus investment income earned on assets supporting the related GAAP liability for future policy benefits

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Q2. What are "losses" in Q1?

- A loss in a future accounting period requires a GAAP income projection, typically for the life of the contract

Q3. Contracts the accounting guidance applies to?

- Long-duration insurance contracts as identified in ASC 944-40-30 include:
  - Traditional long-duration contracts, universal life-type contracts, certain participating life insurance contracts, and financial guarantee insurance contracts
- May also apply to limited-pay insurance contracts and some P&C contracts classified as long-duration
- May be inappropriate to apply to investment contracts

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Q4. Under what circumstances do PFBL occur?

- PFBL could occur on any of a variety of products depending on pricing, contract provisions, and changes to management estimates
- It commonly occurs in:
  - Long-duration, non-participating obligations, such as payout annuities; and
  - Guaranteed renewable contracts, such as long-term care

Q5. At what level should the test be performed?

- The accounting guidance related to testing for PFBL does not specifically state at what level the testing should be done
- However, guidance related to recognition of a premium deficiency (ASC 944-60-25-3) could be used:
  - "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"

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Q6. Should projected business be included in the test?

- Including future new business in a current assessment of PFBL is not common in actual practice
  - The requirements of testing for PFBL are similar to those of testing for premium deficiencies

Q7. Should future premium rate increases be considered in testing?

- Although the accounting guidance does not state whether future premium rate increases may be considered in testing for PFBL, consideration of premium rate increases in testing for PFBL is generally accepted as appropriate
  - Because testing for PFBL is related to premium deficiency testing, the PFBL assumptions used in this testing may be consistent

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Q8. Should new entrants be projected on group contracts?

- Although the accounting guidance does not specify for long-duration group contracts if future entrants should be projected in testing for PFBL, consideration of new entrants generally is appropriate when their cost of insurance rates are guaranteed
  - Because testing for PFBL is related to premium deficiency testing, the PFBL assumptions used in this testing may be consistent

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Q9. Should reinsurance ceded be reflected in the analysis of PFBL?

- Normally, the treatment of reinsurance with respect to the determination of PFBL would align with the treatment of reinsurance for loss recognition testing

Q10. What happens if the test shows PFBL?

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

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Q11. How should the liability be increased?

- The accounting guidance does not indicate the period or pattern over which to recognize (accrue or release) the additional liability for PFBL
  - Consequently, a range of potential approaches has been considered by actuaries and practitioners

Q11. How should the liability be increased?

- Some actuaries and 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 PFBL
  - However, there does not appear to be any support in the GAAP literature for a possible write-down of unamortized acquisition costs to address PFBL

Q12. What are some methods for increasing liabilities to offset future losses?

- Some methods might 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

Q13. What are the considerations for establishing an increase in liabilities?

- One interpretation of the accounting guidance suggests that the cumulative value of projected future losses could be recorded immediately upon recognition of PFBL
  - However, this intepretation would result in a loss in the current reporting period followed by a period of profits

Q13. What are the considerations for establishing an increase in liabilities?

- Because this approach would result in an earnings pattern that is misaligned with the guidance objectives, many actuaries and practitioners believe that this approach to pre-funding the future losses is not reasonable
  - It contradicts 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."

Q14. What are the considerations for accruing an increase in liabilities?

- The primary considerations that arise when accruing liabilities over time are:
  - The pattern that the accrual should take; and
  - The time period over which the liabilities should be accrued

Q14. What are the considerations for accruing an increase in liabilities?

- Two approaches are often seen in practice:
  - Accrue a ratable share of expected revenues or 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; or
  - Accrue a ratable share of revenues or expected profits but target just enough liability to prevent a loss recognition event from occurring at the earliest point at which it is expected to occur in the future

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Q15. What are considerations for adopting a locked-in schedule for the PFBL liability?

- Some actuaries and practitioners believe a locked-in schedule approach to the PFBL liability is appropriate, particularly for traditional Financial Accounting Statement (FAS) 60 business
  - This approach appears to be consistent with the lock-in concept typically applied to reserves for traditional, long-duration insurance contracts and upon recognition of a premium deficiency
  - But other considerations may make a locked-in approach untenable

Q15. What are considerations for adopting a locked-in schedule for the PFBL liability?

- 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 could 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 PFBL was established
  - Multiple sets could be encountered if the expectations of future experience continue to deteriorate

Q15. What are considerations for adopting a locked-in schedule for the PFBL liability?

- A locked-in accrual schedule could result in unexpected losses:
  - As experience emerges in the period during which gains are expected; or
  - If such expected gains turn out to be lower than was projected when the schedule was developed

Q16. What are considerations for adopting a dynamic schedule for the PFBL liability?

- Many actuaries and practitioners believe allowing the accrual of reserves to change based on the expectations of PFBL results in a profit emergence that is aligned with the intent of the accounting guidance
  - Particularly for non-traditional, universal life-type contracts

Q16. What are considerations for adopting a dynamic schedule for the PFBL liability?

- For methods that dynamically adjust, several approaches could be considered:
  - These approaches take some of the profits that would be earned in early years and set them aside in a reserve that would be released once losses develop in the later years
  - A ratable share of expected profits could be accrued if:
    - The PFBL liability is adequate to offset future losses when the future losses are expected to commence or when loss recognition is first projected; or
    - The PFBL liability is adequate to prevent a loss recognition event from occurring at any point in the projected future

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Q16. What are considerations for adopting a dynamic schedule for the PFBL liability?

- At each future reporting date, the projection of PFBL would be reassessed and the accrual pattern adjusted to target the 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, may be used; or
  - 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

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Q16. What are considerations for adopting a dynamic schedule for the PFBL liability?

- 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

Example of a Dynamic Method

Year	Initial Profit	Liability Accrual	Accrued Liability	Profit	Revised Profit Projection at Year 2	Revised Liability Accrual	Revised Accrued Liability	Revised Profit
1	10	2	2	8	10	2	2	8
2	10	2	4	8	8	1	3	7
3	10	2	6	8	8	1	4	7
4	10	2	8	8	8	1	5	7
5	-4	-4	4	0	-2	-2	3	0
6	-4	-4	0	0	-3	-3	0	0

Source: Members of the American Academy of Actuaries Profits Followed by Losses Subgroup

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Q17. Can business written after the prior valuation be added to the PFBL assess.?

- Alignment with premium deficiency accounting policy
- Dynamic versus locked-in method

Q18. If a reserve has been accumulated for losses, how should the liability be released?

- No explicit guidance
- Locked-in method versus dynamic mechanism

Q19. How would a locked-in method for releasing the accrued reserve work?

- Matching with expected losses in the future
- Potential for misalignment of recorded reserves and reserve release as experience develops
- Reconciliation of reserves to in-force amounts

Q20. How would a dynamic method for releasing the additional reserve work?

- Alignment with accounting policies regarding lock-in
- Variety of potential approaches, each with benefits and drawbacks:
  - Draw down to offset losses as they are incurred;
  - Reset to ratably offset new projections of future losses; or
  - Continuation of dynamic mechanism used to accrue the liability
- Relationship of the method to loss recognition

Q21. What happens if there is an expectation of PFBL followed by profits?

- No formal guidance
- Reviewers could consider:
  - The PFBL in isolation of the subsequent profits; or
  - The PFBL only when the losses followed by profits are a net loss

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Q22. How do you accrue a liability if there is an expectation of PFBL followed by profits?

- Possible approaches include:
  - Accruing only for the losses (i.e., ignoring the late-year profits); or
  - Accruing for the cumulative future losses, offset by the future gains

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Example: PFBL followed by profits

Year	Profits	Accrue to PFBL		Accrue to cumulative loss	
		Liability	Profit	Liability	Profit
1	7	4	3	2.5	4.5
2	7	8	3	5.0	4.5
3	7	12	3	7.5	4.5
4	7	16	3	10.0	4.5
5	-5	11	0	6.7	-1.7
6	-6	5	0	3.3	-2.6
7	-5	0	0	0	-1.7
8	3	0	3	0	3
9	3	0	3	0	3

Source: Members of the American Academy of Actuaries Profits Followed by Losses Subgroup

Q23. How would one address two+ cycles of PFBL within a group of contracts?

- Possible approaches include:
  - Considering each cycle separately; or
  - Considering one aggregate event
    - Alignment with PFBL followed by profits approach
    - Considering the point of greatest cumulative future loss

Q24. Are there any special considerations related to participating contracts?

- AICPA's *Audit and Accounting Guide for Life Insurance Entities*:
  - "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."

Q25. Should the change in liability be included in EGP for amortizing DAC?

- Are standard estimated gross profits (EGP) an appropriate basis for amortizing deferred acquisition costs (DAC)?
  - Are significant negative gross profits expected in any period?
- Support for including in EGPs:
  - Alignment with treatment of SOP 03-1 liabilities and other similar reserves

Q25. Should the change in liability be included in EGP for amortizing DAC?

- Support for excluding from EGPs:
  - Not a defined element of EGPs; and
  - Consistency with loss recognition testing

Q26. How should shadow accounting be applied?

- Consider consequences to PFBL if assets classified as “available for sale” were immediately sold and the proceeds reinvested

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Summary

- The practice note only applies to long-duration contracts
- PFBL are being encountered more frequently in practice because of:
  - Low-interest-rate environment; and
  - Premium rate increases under long-term care

Summary

- The existing accounting guidance is not entirely prescriptive and a range of approaches has been considered in practice
- There will be some natural alignment with loss recognition concepts
- Lock-in versus unlocked approaches can yield substantially different results

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Questions?