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Accounting Questions

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Question: Will you be good enough to answer a couple of academic questions as to the location of certain items on a balance-sheet, as follows:

1. *Surrender value of life-insurance policy*

Our client is doing a combination of wholesale merchandising and commission business and has taken out two policies on the two principals in the business. These policies are payable to the company. The company is paying the premiums. On these two policies the client has borrowed from the insurance company notes to within, say, 75% of the surrender value of the policies.

We have heretofore carried the surrender value of these policies, less the notes payable on them, as deferred assets; but we are now asked by our client to place the surrender value, presumably the net surrender equity, among current assets. We are of the opinion that this could be done by including the item among securities readily marketable, on the assumption that the cash surrender value is clearly the most liquid form of an investment. We are, however, in doubt about the advisability of including it among these current assets, for Montgomery's *Auditing* describes current assets as those which are bought for the purpose and with the intention of conversion immediately into cash. It would appear that our client's purpose and intention, judging from past performance, has been to borrow on the surrender value of his life-insurance policies fairly promptly after there was a margin in his favor; and hence his desire to place the item among the current assets is logical. In support of his views, he has seen the balance-sheet of a large eastern correspondent which shows the surrender value among the current assets. On the other hand, our own opinion is, in the absence of a positive practice, that the surrender value for a concern such as his, which is not expecting to go out of business but is doing business in a normal and usual manner, should be shown among investments.

Answer: It is our opinion that it is not proper to include this item under current assets. Our reasons for so doing are, in line with the quotation from Mr. Montgomery's *Auditing*, that the test of current assets involves three things, purpose, intention and marketability. While the cash-surrender value of life-insurance policies may readily be converted into cash, as is evidenced in this case by the client's borrowing on the policies, at the same time it was not the purpose of the corporation in taking out the policies to create current assets but rather to make an investment and to protect the corporation from losses occasioned by the death of its valuable executives and it is not the intention of the corporation to change the original purpose. Accordingly, we believe that the item should be stated as an investment with the loan against the policy shown as a deduction therefrom. Incidentally, this procedure would result in a more favorable current ratio than if the cash-surrender value were shown as a current asset and the loans as a current liability. It would be absolutely improper, of course, to show the net cash-surrender value less loans as a current asset.

Answer: In dealing with the situation here outlined, among others we find as facts:

(a) That the company has set up on its books the cash-surrender value of insurance policies carried on the lives of its principals;

(b) That it considers such cash-surrender value as a current asset;

(c) That where there has been borrowed a part of such cash-surrender value and notes have been executed therefor, the liability on the notes is not included with other liabilities in the balance-sheet but is deducted from the surrender value and the net balance shown as an asset.

As we understand the question, two points are here raised: (a) is the method of accounting correct and, (b), if so, what is the correct place in the balance-sheet for the asset?

To arrive at a correct decision the particular circumstances require to be taken into consideration. A balance-sheet prepared on a "going concern" basis is, of course, not necessarily the same as one prepared on a "liquidation" basis. It is assumed that we are here dealing with a going concern.

Although it is quite common practice to set up—as in this instance—the cash-surrender value of such policies, something might be said in favor of carrying—as a permanent asset but not a current one—the total amount invested as premiums, the payments being looked upon as more in the nature of a funding transaction. Although not inferring that we would favor such a practice we mention it as presenting another viewpoint.

Insurance on the lives of principals in a business must necessarily be for the protection of the business. Surrender of such policies removes the protection. It is evident, therefore, that the premiums represent investment in protection and in no circumstances can they or any part of them be considered "an asset bought for or with the intention of conversion immediately into cash."

That portion of the premiums paid represented by surrender value, however, certainly has an immediately realizable value, but is it not clear that conversion of such value into cash correspondingly reduces the protection provided by the policies and can only be made at the sacrifice of such protection? Is it not more in the nature of an emergency asset, which could be realized—just as machinery or other more permanent assets could be realized—in case of need but is not purchased with that intent?

Within recent years an eminent scientist has popularized the word "relativity." Relativity of a specific item to all others in the balance-sheet and to the business itself are considerations having more or less important bearing on proper presentation of facts.

Current assets ordinarily consist of cash and such other assets as revolve or are being constantly converted into cash as a result of operations incidental to the business. That portion of the surrender value realized, i.e., the cash borrowed, already appears in current assets (although in the instance cited it should again be pointed out that the notes executed do not appear as liabilities). The balance, which by its very nature must be intended to be carried more or less permanently does not seem to possess the ordinarily understood attributes of a current asset except on a liquidation basis. It is an investment—or part of an investment—which to be justified at all must continue with the business, or at least as long as the conditions justifying it exist.

To our mind proper and accurate description of an asset is of importance at least equal to the position it may be assigned in the balance-sheet and we further believe that a "going concern" balance-sheet is strongest when, if classifications are made, doubtful items are conservatively classified according to underlying intent and their relation to the business as a whole.

2. *Current liabilities*

Current liabilities heretofore have included notes and accounts payable, but we have failed to include some items which we have been carrying as "other liabilities" on the balance-sheet. Our recommendation to the client now is to transfer from "other liabilities" to "current liabilities" items which are due and payable within a year, consisting of

(a) Commissions accrued, but not yet due.
(b) Deposits for maintenance of equipment sold.
(c) Local taxes accrued and not yet due.
(d) Reserve for income taxes.
(e) Reserve for legal expense.

The test of current assets as we understand it is that they shall be due within twelve months from the date of the balance-sheet.

We intend showing your reply to our client for the purpose of improving our service to him, as these changes are mildly opposed by the client, who hopes naturally to have us report his current assets as large and his current liabilities as small as possible, thus increasing the ratio of the difference between the two, which heretofore has been about $1.50 of assets to $1.00 of liabilities.

Answer: In practice current liabilities commonly include all ordinary trade or business liabilities other than those of an investment or capital nature, such for instance as long-term notes or other obligations, loans by stockholders, bonds, mortgages, etc.

Some balance-sheets make no distinction between current and other liabilities, but where such distinction is made current liabilities are ordinarily those incurred as a result of operations or transactions of the business which fall due within a cycle of time commensurate with the nature of the business. Usually, but not always, this cycle is considered as being one year.

In the specific cases cited it would appear that:

(a) Commissions, although not immediately due, certainly fall within the usually understood classifications of current liabilities unless—which seems unlikely—the liability has been set up in advance of any other action in connection with which such commissions accrue, is contingent on future profits and is not payable within a year. The use of the word accrued however in the instance cited would seem to preclude any such condition.

(b) Deposits for maintenance indicate a current liability, but its exact nature is not stated. It should be borne in mind that the cash thus deposited is in current assets on the other side of the balance-sheet, although this of course does not determine the currency or otherwise of the obligation.

(c) Local taxes come within the stated definition and are current liabilities.

(d) Reserve for income taxes similarly falls within this classification, as does

(e) Reserve for legal expense.

To provide in the balance-sheet a classification such as "current liabilities" and to include therein notes payable but exclude items of the nature indicated above seems not only unsound accounting but might give rise to the inference of some special purpose to be served.

As already stated, a proper and conservatively stated balance-sheet is at all times stronger than one which in any way appears to have been prepared to make certain showings even if technicalities seem to justify the presentation.

Answer: It is our opinion that the various items indicated should be treated in the following manner:

(a) Commissions accrued not yet due—current liabilities.

(b) Deposits for maintenance of equipment sold—deferred credits to income or other liabilities.

(c) Local taxes accrued and not yet due—current liability.

(d) Reserve for income taxes—current liability.

(e) Reserve for legal expense—treatment of this item should depend upon the nature of the reserve. If it represents really a provision for legal services already performed for which bills have not yet been received it would be shown as a current liability; if, however, it represents a reserve provided tc take care of possible legal expenses resulting from the corporation's operations, or disputes involved as a result of them, it should be treated as a reserve and be shown separately in the balance-sheet.