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Accounting Questions

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CASH SURRENDER VALUE OF LIFE-INSURANCE POLICIES

Question: I would like to know the prevailing practice with reference to loans of corporations from life-insurance companies on policies carried on the lives of officers. Should the full cash surrender value be shown as an asset and the loan against the policy shown as a liability, on the theory that a liability should never be deducted from an asset? Or should the loan be deducted from the cash value and the excess, if any, be extended as an asset?

I find that some clients want the cash surrender value put in current assets because it is recognized as such by the federal reserve bank, and it also improves their current position. In fact, in one case, this asset of cash value of life-insurance determined whether or not the paper of the concern was subject to re-discount. What is the prevailing practice in placing this item on the balance-sheet?

Answer No. 1: Certain details in the form of presentation in financial statements are reflections of the views of credit grantors. Some years ago it was more or less general practice to include the cash surrender value of life-insurance policies among current assets. This practice can, we believe, still be justified, though in recent years some bankers have indicated that in their opinion the cash surrender value of such life-insurance policies should not be included in current assets, but should be stated in the balance-sheet below the current asset section. We understand that the reason these bankers give for their opinion is that usually the cash surrender value will not be received in cash within a year from the balance-sheet date.

If you will refer to the January, 1932, number of THE JOURNAL OF ACCOUNTANCY, you will find an article by Anson Herrick, entitled "What should be included in current assets." On page 59 Mr. Herrick submits a balance-sheet prepared in what he terms "the usual procedure." In this balance-sheet the cash surrender value of life-insurance is included in current assets. On page 60 Mr. Herrick gives a balance-sheet prepared in accordance with his suggested procedure, and in this balance-sheet you will find the cash surrender value of life-insurance included under investments.

Occasionally a balance-sheet will be found in which it may not be desirable to include cash surrender value of life-insurance in current assets for the reason that the proceeds when received must be used for some purpose other than payment of liabilities or general corporate purposes. For example, the corporation may have entered into an agreement to purchase the stock of an officer whose life is insured, or perhaps the stockholders may have entered into an agreement by which the proceeds of a policy must be withdrawn from the corporation to carry out a similar purchase agreement between the estate of a deceased stockholder and the surviving stockholders. Under such conditions the cash surrender value of the life-insurance policy probably should be shown below current assets.

If there is a loan on a life-insurance policy, we consider it permissible either to show the cash surrender value as a current asset and any loan against it as a current liability or to show the cash surrender value below the current asset section with the loan as a deduction. Usually the source of the loan does not determine whether or not it should be included in current liabilities. However, since a loan against the cash surrender value of a life-insurance policy need not be repaid until realization of the cash surrender value or the face amount of the policy, there seems to be no good reason for requiring the loan to be included in current liabilities if the cash surrender value of the policy is not included in current assets. On the other hand, if there is a commitment to use the proceeds from the life-insurance policy for some purpose other than payment of current liabilities or general corporate purposes, any loan against the cash surrender value of the policy may be a current liability even though the cash surrender value is not included in current assets. In these circumstances, upon the death of the insured, if the company is to carry out fully its obligations under the contract, it would be obliged immediately to obtain (by borrowing or other means) an amount equal to the loan against the policy, since an amount equal to the proceeds of the policy must be disbursed under the corporation's commitment.

Answer No. 2: The best practice, we believe, is to show the net value of insurance policies immediately following current assets. Such values, though not current in the sense that they are being converted into cash in the normal course of business, still constitute a quick asset almost as liquid as cash in most cases. It is our practice to show the full cash surrender value with deduction for any loans thereon. We do not think it necessary to show the loan among the liabilities for the reason that as a practical matter it never becomes a charge against any of the assets other than the surrender value, and if the loan were included among the liabilities the ratio of assets to liabilities would be deceiving.

ACCOUNTING TREATMENT OF REVALUED ASSETS

Question: In pre-depression periods the tendency was to have an appraisal made of plant, machinery and equipment, to write up the book value thereof to the appraised valuation and to adjust the depreciation accounts in accordance with the appraisal. The net adjustment usually resulted in a credit to capital surplus account. It was the general custom to maintain the original low depreciation charge to profit-and-loss and to charge the excess of depreciation taken on the new valuation to the new capital surplus account which had been created by the adjustment giving effect to the appraisal.

The post-depression trend is to have the same assets appraised, which in almost every instance is a revision downward, with its necessary adjustments in capital surplus, and possibly the earned surplus accounts, and/or the readjustment of capital stock accounts. The reasons given, apparently, are that it will bring values down to present replacement cost; that it will reduce the amount of future depreciation charges; increase earnings of the company, and enable the company, when the depression period is over, to return to its dividend paying basis sooner than would be the case if the valuation remained on a pre-depression basis.

Assume that, on the basis of an appraisal, the plant accounts were written up in 1928 and a capital surplus was created. At that time the accountant wrote off depreciation on the appraised value but charged to operations only an amount equivalent to the depreciation on original cost and charged the difference to capital surplus. In 1932 the plant accounts were written down, again based upon an appraisal, and the capital surplus and part of the earned surplus were eliminated.

1. Should the accountant be consistent with the pre-depression period basis and insist upon charging to profit-and-loss account depreciation on the original cost of the assets for earnings-statement purposes?
2. If so, how should the excess depreciation credit be handled?
3. If the accountant is not to be consistent, please give reasons.
4. If the adjustment writing down the plant values required a reduction of capital stock, and if, in a subsequent year, partly due to decreased depreciation charges, the company operated profitably and resumed the payment of dividends, would not this result in a payment of dividends out of former capital?

Answer: The procedure cited in question 1 involves writing off through depreciation a book value which is already 100 per cent. written off. That can scarcely be regarded as consistent. The year 1928 and current re-valuations are not comparable for depreciation purposes. The one creates an artificial, the other cancels a real, depreciation obligation.

Whatever the accounting opinion on question 4 the legal view necessarily prevails. For that, too long to repeat here, we would refer the inquirer to Montgomery's *Financial Handbook*, particularly page 1590.