Journal of Accountancy

Volume 56 | Issue 1 Article 9

7-1933

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American Institute of Accountants. Bureau of Information

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Recommended Citation
American Institute of Accountants. Bureau of Information (1933) "Accounting Questions: Accounting for an Insurance Agency, Accounting for a Cooperative Agency," *Journal of Accountancy*: Vol. 56 : Iss. 1 , Article 9.
Available at: https://egrove.olemiss.edu/jofa/vol56/iss1/9

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Accounting Questions

[The questions and answers which appear in this section of THE JOURNAL OF ACCOUNTANCY have been received from the bureau of information conducted by the American Institute of Accountants. The questions have been asked and answered by practising accountants and are published here for general information. The executive committee of the American Institute of Accountants, in authorizing the publication of this matter, distinctly disclaims any responsibility for the views expressed. The answers given by those who reply are purely personal opinions. They are not in any sense an expression of the Institute nor of any committee of the Institute, but they are of value because they indicate the opinions held by competent members of the profession. The fact that many differences of opinion are expressed indicates the personal nature of the answers. The questions and answers selected for publication are those believed to be of general interest.—EDITOR.]

ACCOUNTING FOR AN INSURANCE AGENCY

Question: A corporation conducts the business of a general insurance agency, writing all forms except life. It enters into an agreement with a manufacturing corporation, whereby it writes all of its insurance and accepts the corporation's stock at par value ($100) in payment of that portion of the premium represented by commissions, and cash for the balance. Thus, all of its income from this business is represented in stock of the corporation which has no ascertainable market value. Most of the stock thus obtained has been preferred, although some common has been taken. No balance-sheet of the manufacturing company is available, but its president says that the common has a book value of $200; the preferred, $100. It is not known what constitutes these book values.

The agency has been taking this stock into its accounts at par value, thus showing the same income from this business as from any other insurance written and has paid its manager a percentage of the net income of the agency (before deducting manager's commission) in accordance with his contract.

Wherein is this treatment wrong and what adjustments, if any, should be made at the end of the agency's fiscal year?

The same agency has acquired the business of another agency by lending it $6,000 and paying the second agency 75 per cent. of the commissions arising out of renewals obtained from policies formerly written by the selling agency for three years. These commissions are credited to the account of the selling agency and are first to be applied against the $6,000 note. Thereafter, during the remainder of the three-year period, the selling agency will receive cash for its portion of these commissions as premium collections are made by the buying agency.

The buying agency proposes to charge as an expense to commissions paid the 75 per cent. due the seller just as any other insurance written through a sub-agent. In this way the balance-sheet will, of course, reflect no asset value representing the acquisition of the selling agency's business. The buyer took

over none of the tangible assets or liabilities of the seller—merely his expiration date file and agreement not to reënter the insurance business.

Is the accounting treatment proposed by the buying agency proper?

Answer No. 1: In our opinion the general insurance agency corporation would appear to have recorded the transactions with the manufacturing corporation correctly, inasmuch as it has recognized the essential facts that the commission paid by the insurance company represents income and that the stock acquired from the manufacturing corporation, in part liquidation of the amount owing for premiums by that company, represents an investment and is so recorded on its books.

Although the investment is accepted in payment of "that portion of the premium represented by commissions" we consider that this form of acceptance is only a device adopted to determine the amount of stock that is to be acquired and should, therefore, not be regarded as an offset to the commission income receivable from the insurance company. From the data given in the question it would seem that the total value of the stock acquired is in excess of the acquisition price.

We do not consider that any capital value has to be determined in the acquisition of the selling agency's business, inasmuch as no tangible assets were taken over nor liabilities assumed. It would seem that the agency agrees to pay 75 per cent. of the commissions on all renewals obtained from policies formerly written by the selling agency for a period of three years and retain 25 per cent. of the commissions against which expenses of this renewal business would have to be offset. The fact that $6,000 was lent to the selling agency at the time the agreement was entered into does not, in our opinion, raise any question of capital value. The accounting treatment proposed by the buying agency as set forth in the text of the question would appear to be proper.

Answer No. 2: The first question is as to whether or not the treatment stated is incorrect and what adjustments, if any, should be made at the end of the agency's fiscal year. Proper treatment for both accounting and tax purposes would require that the stock received be included in the income account at its fair value. Even though an arbitrary basis might be agreed upon for arriving at the manager's percentage, nevertheless such arbitrary basis should not be used in determining the income of the agency. The question indicates that no information is available as to the fair value, if any, of the stock received. If it appears that such stock has no fair value, then it should be taken up in the accounts at only a nominal value.

With regard to the second question, the accounting treatment proposed by the agency appears proper and conservative. At the same time, it would not be improper to capitalize the payments as an intangible asset, although such treatment is not to be preferred. It is improbable that the treasury department would allow the payments to be taken as deductions in the agency's income-tax returns. The right to the deduction would depend, in part at least, on the language of the agreement between the parties and the apparent intent of it.

Answer No. 3: Since it would be improper for such an agency to make any rebate of any portion of the regular premiums, it would appear that the stock

received as part of the premium should be set up on the books at the difference between the total premium and the portion received in cash. This apears to be the practice followed by the agency. If, however, the actual value of the stock received is different from that calculated on the foregoing basis, naturally the actual value should be set up, but in that case it would appear that the transactions of the agency were improper.

If anything happened between the time the stock was received and the end of the agency's fiscal year to change the actual value of the stock, it would seem to be in order to set up a reserve to bring it to market value at the end of the year.

The practical effect of the arrangement described in the second paragraph appears to be that the buying agency is to pay 75 per cent. of the commissions earned by it on the business of the selling agency for a period of three years. That would appear to be merely a split with another agency of the total commissions earned, and the method of accounting suggested appears in order.

ACCOUNTING FOR A COÖPERATIVE AGENCY

Question: A client is a coöperative marketing agency for canned citrus by-products. It has just completed the first season's operations, during which it handled the products of seven canneries. The products of all the canneries are pooled and each cannery will be paid the pro-rata share of the proceeds of the pool based upon the total number of cases each cannery has in the pool. At the close of the year there remain several thousand cases of unsold products in various warehouses.

A large number of the canneries which shipped during the season just ended will not operate during the new season. The canneries which will pack are now beginning on the new season's pack.

The problem which has presented itself is this: Can the pool for last season be closed before all of last season's products are sold?

We have advised our client that the pool can not be closed until all products are sold. Furthermore, in view of the fact that different canneries will market their products during the ensuing year, it will be absolutely necessary to keep the current season's products separated from last season's products—and also to account for the two season's packs separately. This procedure, in our opinion, is necessary because of the fact that the canning plants marketing their products this season are not the same plants which participated in the previous season's pool, and, consequently the interests of the two different groups of canners can not be merged.

Answer No. 1: I would suggest that the pool for 1931 be closed in the same manner that the pools for previous years' operations have been closed, but that the canneries which will not pack during the season of 1932 will have an interest in the operations of the pool for 1932 to the extent of their inventories at December 31, 1931.

My understanding is that these pools are continuing entities, that there is an accounting for each fiscal or calendar year on the basis of the sales during the period, and that for the purpose of the annual accounting no value is placed upon the inventory at the end of the period. However, those inven-

tories are considered as a part of the contribution of the members of the pool to the succeeding year's operations.

In these circumstances, then, the canneries which will not pack in 1932 will contribute a smaller volume of business to the operations for the pool in 1932 and will, accordingly, receive their smaller pro-rata share of the earnings of the pool in that season.

Answer No. 2: We agree with the statement in the question to the effect that it will be necessary to keep the current season's products separated from last season's products and also to account for the two seasons' packs separately in view of the fact that different canneries will market their products during the ensuing year. As the interests of the former year are different from those of the coming year, this seems to be obvious.

The only way to avoid accounting for the two seasons separately would be for the coming season's pool to come to an arrangement with last season's pool to take the unsold products at an agreed price.