Journal of Accountancy

Volume 59 | Issue 3 Article 4

3-1935

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Recommended Citation

Knapp, D. G. (1935) "Accounting for Business Life-Insurance," *Journal of Accountancy*: Vol. 59 : Iss. 3 , Article 4.

Available at: https://egrove.olemiss.edu/jofa/vol59/iss3/4

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# Accounting for Business Life-Insurance

By D. G. Knapp

In comparatively recent times it has become common for business executives to be insured for the benefit of the concerns with which they are associated. Probably for this reason the accounting treatment for cash-surrender value and the unexpired premium have not been given a great deal of consideration by writers in the accounting field. In the following paragraphs an attempt is made to present the underlying theory of life insurance as well as the accounting problems relating to it.

Life insurance is unlike most other types of insurance in that there is not only the risk of death during a given period, but, in addition there is the constantly increasing risk as the insured becomes older and the certainty of death at some future time (assumed for insurance computations to be not later than 96 years of age of the insured).

If the insurance rate included only the cost of carrying the risk from year to year and if the rate of premium increased in accordance with the increasing risk, the premium would vary from about $8.50 a thousand at the age of thirty to as much as $70 at seventy years of age. As the increased premiums in later years would result in the cancellation of many policies before death the value of life insurance would be greatly diminished.

To obviate this difficulty the insurance companies accumulate sufficient funds in reserves to level the cost to approximately the same amount from year to year. This leveling process is accomplished in two ways: the amount of risk is reduced by the increase of the reserve fund year by year, and the interest on the reserve helps to carry the increased cost of what risk remains.

This reserve fund, which is required by law and hence called legal reserve by the insurance companies, is the basis of the cash-surrender value of the policies. On account of the varying surrender charges the two do not exactly agree, but they are practically the same except for very new policies.

It is evident, therefore, that an insurance premium (ordinary life is assumed) includes, not only the cost of carrying the risk for a year, but, in addition, an amount to be set aside as legal reserve and available to the owner of the policy for surrender or loan values.

A third problem is found in the "participating" policies. This is an addition, to the annual premium, of a sufficient amount to cover unusual expenses or excessive mortality should they occur, but normally it is returned to the policy holder in annual dividends. The dividends are usually determined for a year in advance and so are not dependent upon the current year's operations. They are normally available at the end of the policy year whether the policy is continued or not. They are, therefore, a good asset payable within one year and are not included in the cash-surrender values.

The premium paid may be divided into three parts: (1) the anticipated dividend, (2) the increase in cash-surrender value, (3) a part of the cost of carrying the risk of death within the year. The balance of the risk is carried by the interest earned on the legal reserve fund.

In twenty-payment contracts an increased premium is required to increase the reserve fund sufficiently to carry the entire cost after twenty years. Likewise an endowment contract requires a still higher premium in order to accumulate an amount equal to the face of the policy in twenty years, or whatever the term of the contract may be.

Several methods have been employed in the handling of these problems. The order of description is from the earliest to the most recent methods.

1. The entire amount of cash paid in is set up as a "life-insurance investment" without regard to cash-surrender value or unexpired premiums.

2. The entire amount paid in is set up as in number one, but carried in two accounts: the cash-surrender value in one and the excess in another.

3. The cash-surrender value at the end of the previous policy year is set up as an asset and the current premium is charged to expense when paid.

4. The cash-surrender value at the end of the previous policy year is set up as an asset and the current year's premium is distributed over the policy year like other types of insurance.

5. The cash-surrender value at the end of the policy year to which premiums have been paid is set up and the excess of the net premium paid over the increase in cash value is distributed over the policy year applicable.

6. The cash-surrender value at the end of the policy year to which premiums have been paid is set up, the dividend receivable at the end of the policy year is set up, and prepaid insurance is charged with the excess of gross premium less estimated dividend over the increase in cash value. The dividend received is of course credited to the receivable set up at the beginning of the previous policy year.
7. The cash-surrender value at the end of the policy year to which premiums have been paid is set up, the dividend receivable at the end of the policy year is set up, prepaid insurance is charged with the excess of the gross premium less estimated dividend over the increase in cash-surrender value and, in addition, an entry is made monthly crediting interest income and charging life-insurance expense with three per cent. of the present cash-surrender value.

Plan one, whereby the entire amount of cash paid is set up as an asset, disregards the fact that part of this payment goes for carrying a risk and is therefore an expense and nothing else.

The second plan is little better than the first and can not be recommended.

The third plan is often used. It disregards two factors, however—the cash-surrender value is substantially less than it should be, and a prepaid expense is overlooked. Montgomery, in *Auditing Theory and Practice*, says "The cash-surrender value is *not* the cash-surrender value or loan value which is stated in the policy at the beginning of the year, but in all cases where premiums are paid in advance (which is the general custom) it is the cash-surrender value or loan value at the end of the policy year less discount to the end of the policy year." The discount is always materially less than the increase in cash value and the two can not reasonably be considered as offsets. It is no more correct to disregard the prepaid life insurance element than any other prepayment.

Plan number four is favored by many public accountants. It states the sum of the cash-surrender value and the prepaid life insurance correctly at the beginning of the policy year, but it includes a substantial portion of the cash-surrender value in prepaid insurance. After the beginning of the year neither the total nor the detail is correct. As the end of the policy year approaches we find that the cash-surrender value is understated by one year's increase and, as the prepaid item has been written off to expense,

this factor does not compensate for the difference in cash-surrender value at the beginning of the year.

The fifth method is believed sound as to the proper statement of cash-surrender value and the prepaid insurance expense. It does, however, overlook the dividend receivable and fails to state the true cost of the insurance, particularly in the later years of the policy, as it makes no provision for the portion of the insurance cost carried by the interest income on the legal reserve. The journal entry to record the payment of a premium would be:

| | | | |
|---|---|---|---|
| Cash-surrender value life insurance | | $10,000 | |
| Prepaid life insurance | | 4,000 | |
| To cash | | | $14,000 |
| To take up increase in cash-surrender value as computed below and charge net insurance cost to prepaid expense. | | | |
| Total premium policy No. 16843 | | $20,000 | |
| Less dividend | | 6,000 | |
| Net premium payment | | $14,000 | |
| Cash-surrender value at end of next policy year | $100,000 | | |
| Less value on books | 90,000 | 10,000 | |
| Net insurance cost | | $ 4,000 | |

Plan number six is like number five, except that the dividend receivable at the end of the year is set up in addition to the cash-surrender value and the prepaid insurance. This receivable is due within a period of one year without further payments of any kind and is, therefore, a valid asset.

The journal entry for the premium payment under this plan would be as follows:

| | | |
|---|---|---|
| Cash-surrender value life insurance | $10,000 | |
| Dividend receivable | 6,000 | |
| Prepaid life insurance | 4,000 | |
| To cash | | $14,000 |
| Dividend receivable (set up in prior year) | | 6,000 |

Number seven is the same as number six, except that an entry is made monthly charging life insurance expense and crediting interest income with interest on the cash-surrender value at the rate of three per cent. per annum. This entry brings to the at-

tention of the management the true cost of the insurance carried from year to year. The necessity for this treatment becomes increasingly evident as the cash-surrender value increases. In the case of a twenty-pay life participating contract, which has been in force twenty-two years, we have an apparent earning from our insurance policy in the annual dividends received. If, however, we make allowance for interest on the very substantial cash-surrender value we find that the insurance is costing a considerable amount per thousand of protection. In considering this cost it must be borne in mind that the actual protection is the difference between the face value of the policy and the amount of the cash-surrender value.

In case premiums are paid quarterly the treatment is the same as when on the annual basis except that one-fourth, only, of increase in cash-surrender value and dividend may properly be taken up at the time of each payment.

In my opinion the various methods mentioned range in desirability in the opposite order from that of listing. Numbers five, six and seven are all acceptable for general use, depending on the amounts involved and the degree of refinement necessary.

In addition to the method of computation we have the problem of the classification of the cash-surrender value on the balance-sheet and the treatment of policy loans.

There are two distinct schools of thought regarding the balance-sheet treatment of cash-surrender value. One school treats it as an investment which is not properly classified as a current asset unless the company has definite intention of surrendering the policy.

The second school treats cash-surrender value as a current asset on account of its liquidity.

The argument advanced by the first school is that the purpose of the insurance will be destroyed if the cash value is used in the ordinary conduct of the business and that, therefore, it is a long-term investment. On this theory liberty bonds or cash which the management has set aside for a building fund or other purpose, which does not contemplate current expenditure, would likewise be an investment and not a current asset even if legally available for general use.

The argument for treatment as a current asset is based entirely on liquidity. As this cash is available for withdrawal at any time for payment of current indebtedness its treatment as a cur-

rent asset is not unsound. In fact the frequency with which such use of the loan values has been made during recent years bears out this contention.

The treatment of policy loans on the balance-sheet is a question about which considerable difference of opinion exists. This probably arises from the fact that the term "loan" is used and interest is paid on the amounts advanced.

To be properly treated as a liability such a loan would have to be a valid obligation to pay the insurance company, on which the insurance company could collect by legal process if necessary. Instead, this so-called loan is in fact a withdrawal of cash on deposit with the insurance company and available at any time on demand. There is no liability to return it either now or at any future time. The interest payment is necessary to provide for the portion of the insurance cost previously carried by the interest on the reserve and is properly charged to life-insurance expense rather than interest. If the entire cash-surrender value is "borrowed" the entry suggested in plan seven whereby insurance expense is charged and interest income is credited is eliminated and the charge to insurance expense comes direct from the additional payments made to the insurance company.

It is my opinion, therefore, that policy loans may best be shown as a deduction from the cash-surrender value and the net amount extended as a current asset.

If the dividend receivable is set up as suggested above it should likewise be treated as a current asset. This treatment is based on the fact that it will be converted into cash within a period of one year.

The classification of prepaid life insurance presents no problems, as it would be handled in the same manner as other prepaid expenses.

Audit verification of life-insurance cash-surrender value, dividends receivable and prepaid life insurance present no difficult problems. The auditor should examine the policy and the last premium receipt, noting the company name, the policy number, name of insured, face of policy, beneficiary, right of change of beneficiary, assignments, cash-surrender value at the beginning and end of the current policy year, amount of policy loans, gross premium and dividend received. The cash-surrender value, beneficiary, dividend, and loan status should then be confirmed by direct communication with the insurance company. The neces-

sity for confirmation can not be overestimated. For example, it is possible to obtain from the insurance company a certificate of insurance or duplicate in lieu of a lost policy. Should such a certificate or duplicate policy be obtained a loan might be negotiated and endorsed thereon. The original policy might then be submitted to the auditor and appear to have a cash surrender value when, in fact, none existed.

It is essential that the letter of confirmation ask for specific information as to the amount of the cash-surrender value at the end of the policy year to which premiums have been paid, the amount of the actual or estimated dividend, the beneficiary and right to change the beneficiary and the status of loans against the policy.

The increasing demand for exactness in the preparation of financial statements requires that simplicity in the handling of life-insurance problems give way to a more detailed analysis of the principles involved and their proper presentation.