Journal of Accountancy

Volume 63 | Issue 3 Article 8

3-1937

Accounting Questions: Accounting Treatment of Proceeds from Life Insurance

American Institute of Accountants. Bureau of Information

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 members of the American Institute of Accountants who are 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 TREATMENT OF PROCEEDS FROM LIFE INSURANCE

Question No. 1: One of our clients, a corporation, has received a large sum of money from an insurance company, representing the proceeds of life-insurance policies on one of the officers of the company.

The question has arisen regarding the propriety of crediting this amount, less the cash surrender value of the insurance which had been given effect on previous statements, to income account or whether same should be credited to earned surplus.

In preparing its annual income statement the company would like to show, "income from operations before inclusion of life-insurance proceeds," and then add to same "net proceeds of life-insurance policies on life of officer," and as a final figure, "net income for the year, after including life-insurance proceeds."

Will you kindly advise what is the accepted method of treating proceeds from life insurance and the reason therefor.

Answer No. 1. It is sometimes maintained that a corporation's income, properly so described, should be restricted to the gains attributable to its usual activities or incident thereto and that extraneous items such as the proceeds of life insurance, the subject of inquiry, should therefore be excluded. On the other hand the position is taken that, even recognizing the restriction with what is considered a reasonable interpretation, life insurance can not be said to be so unusual as to be ruled out of the classification of other income. A contrary view rigidly applied would hold that windfalls of whatever nature should be excluded.

The question, so it seems to us, is really one of classification and description. If, as is proposed, there is full disclosure and adequate description, there is not, in our opinion, any valid objection to the presentation contemplated.

Answer No. 2. We concur in the handling of proceeds of life-insurance policies on officers of a corporation. That is, that so long as the net proceeds of life insurance policies over the cash surrender value and the sum theretofore carried in balance-sheet may be included in the net income for the year provided it is shown as a separate item.

In any case, we concur that such net proceeds may go eventually into earned surplus if it is the practice of the company to insure the lives of their principal officers and all employees. When the question refers to a large sum received in this connection, if it is in the nature of an individual transaction, the insurance of one officer only whose life was thought to be very essential to the successful continuation of the company, special treatment might be called for.

Answer No. 3. Relating to the treatment upon an income statement of an amount representing the proceeds of a life-insurance policy, we see no objection (except under the conditions suggested below) to showing such amount separately (less the cash surrender value included on previous statements) and qualifying the final amount by the phrase "after including life-insurance proceeds," as set forth in your inquiry.

However, if the proceeds of the life-insurance policy represent a substantial portion of the capital of the concern in question, we would then prefer to include such amount as a credit to surplus.

Question No. 2: One of our clients has preferred stock outstanding which provides for redemption each year of an amount equivalent to "one-half the net earnings of the company for the preceding calendar year," in excess of a stated amount. There is no definition of what shall constitute "net earnings" as used in this provision.

During the present calendar year this corporation collected insurance carried by it upon the life of one of its officers. Premiums on this insurance had been paid by the corporation, and, to the extent premium payment increased cash value of policy, were capitalized, the remainder charged as an expense.

The following question is presented: Should any part of such insurance proceeds be included in the "net earnings" of the company for the purpose of determining amount of preferred stock required to be redeemed under the foregoing provision?

It might be contended that, the corporation, having an insurable interest in the officer insured, proceeds of the policy merely replace with money value the loss sustained by the corporation through the death of this officer. On the other hand, it might be contended that amount received in excess of amount paid out for the insurance constitutes net earnings.

While this may be more of a legal problem than an accounting problem, it is certainly an accounting problem to me, in that I am called upon to determine the amount of preferred stock required to be redeemed under the provision mentioned.

Answer No. 1: We have discussed the question raised as to the treatment of proceeds of life insurance collected on the death of one of a corporation's officers. In the absence of a legal decision covering the exact point, of which we are not aware, the matter would seem to be quite debatable, and might well be the matter of negotiation if the corporation's stock was closely held.

The following points occur to the writer, after discussion with others of the partners:

1. It would appear that the profits from which the retirement fund for the preferred stock is calculated should be credited at least with an amount equivalent to the expenses charged to the profit and loss during the period that the retirement arrangement was effective.

2. If the policies were written at the time preferred stock was issued with the idea of being in the nature of a guaranty for the preferred stockholders, as the services of the deceased officer were considered to be particularly valuable from their standpoint, it would certainly appear equitable that, in lieu of the expense referred to above, the profits on which the redemption fund was calculated should include the paper gain on the death of the officer.

3. If on the other hand, the company had established a policy of carrying life insurance on its officers prior to the issue of the preferred stock and had credited the "profit" to surplus direct and not to earnings of the company, that would seem to establish a precedent to justify the exclusion of any portion of such gain from the amount available for preferred stock retirement.

Answer No. 2: Life insurance such as that referred to in the question affords protection against loss expected to be temporarily incurred through the sudden termination of the services of a valued officer; thus the gain on the policy proceeds would be in a measure an offset. In other words, it might be contended that the proceeds of insurance should be the contra for the loss of earnings reflected for a time in the reduced net earnings.

Then again the protection may have ensued as a condition of the preferred stock issue, as a measure of protection to the continuity of preferred dividends or, if of sufficiently large amount, then also a measure of protection to preferred capital. Having regard to the fact that only one-half of the net earnings over a stipulated sum is to be used for redemption purposes, it might be reasonable to assume that the stipulated sum covered at least preferred dividends, and that, of the excess over the stipulated sum, one-half was to be used to reduce the obligation to the preferred, the other half to be available for dividends on the common or for other corporate purposes.

For the reasons set forth it does not seem right that the proceeds of the insurance should be excluded from the computation as to the amount to be made available to the preferred for redemption purposes. Stated in other terms the common should not, in the circumstances, benefit as against the preferred. Moreover, inasmuch as premiums (in excess of increment to cash surrender value) have been charged off in the past in determining net earnings it would seem that the contra benefit must be placed in the same category, i. e., net earnings, even though of an abnormal amount in relation to one year.

It is to be observed, further, that in the absence of a definition, one might contend that "net earnings" should be related to earnings from the usual operations. On the other hand, life insurance can not be said to be unusual and, further, the position might well be taken that "net earnings" for the purpose stated should be regarded as all accretions to the surplus from whatever source arising.

In the absence of a legal interpretation and without further knowledge of the surrounding circumstances and intentions in relation to the creation of the life insurance protection, we are inclined to favor the view that for the stated purpose the gain from the proceeds of the life-insurance policies should be included in the "net earnings."