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Accounting Questions

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ACCOUNTING QUESTIONS

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INSURANCE POLICIES

Question

We would like to ask for information on the following point: A corporation has been carrying life insurance on one of its officers in an amount of $500,000. The officer dies. What is the proper practice for the handling of such income?

(a) Should the proceeds of the insurance policy (after applying a part thereof to offset the cash-surrender value as carried on the books) be carried direct to surplus account, or,

(b) Can a proportionate part be carried into the current profit-and-loss account, carrying the remainder forward to be amortized over a period of, say, from three to five years; or,

(c) May the entire net amount be treated as a current profit-and-loss-account item of extraordinary character?

Answer No. 1

The answer to this question depends upon the intent of the officers or directors at the time the life insurance was taken out. If it was intended that the proceeds of the life insurance should be the means of the company obtaining additional capital, the proceeds of the policy after deducting the cash-surrender value which might be carried on the books should be credited to capital surplus. If there was no special intention at the time the policy was taken out, the net proceeds as defined hereinbefore should appear as a special item in the profit-and-loss account after the caption, "Net income for the period," as extraordinary income arising from collection of life insurance.

I do not see how the insurance could be treated as outlined under (b).

Answer No. 2

Replying to your letter regarding the accounting treatment of $500,000 received by a corporation upon the death of an officer upon whose life insurance had been carried, there are several possibilities which need to be taken into consideration.

The purpose of carrying the insurance and the use which is to be made of the $500,000 should be known and considered. It may be that the money is to be so used that the amount should be credited to a reserve account, to a designated capital-surplus account, or even possibly to a liability account. If, for example, the money is to be paid to the estate of the officer for stock of the corporation which he held, then it would appear to be for use to replace the officer's capital in the business and it would presumably not be available for dividends; under such conditions it is believed that the amount should not be credited to earned surplus either directly or indirectly but that it should be taken into the capital section of the accounts either as an item of capital surplus or otherwise, depending upon the financial structure of the corporation and the exact procedure to be followed in connection with acquiring the officer's stock and the disposition to be made of the stock after its acquisition. This is, of course, an example of only one possible condition among many. The existing conditions would need to be known in order to give a practical answer to the question.

If it is assumed that there are no particular obligations to be met with the $500,000, then I believe that the treatment outlined in (a) or in (c) in the inquiry would be acceptable.

If the item is treated as a nonrecurring credit in the income statement then I think it should be credited to a separate income account in the books. In any event, I think the item should be stated separately and adequately described. It should not be included in operating income and I believe the amount of the income should be computed and stated in the income statement before adding the $500,000 credit unless the net income is a large amount so that the item of $500,000 is relatively unimportant.

If the credit is made directly to surplus, I think it should be so handled as to be readily distinguishable and understandable in the accounts and in any reports prepared.

Obviously, it would be necessary to make adequate provision for any cash-surrender-value balance or deferred-insurance-premium balances which are carried in the accounts.

Discount and Reserves on Balance-sheet of Finance Company

Question

We would be glad to receive any information as to the present accepted treatment of the two following items on the balance-sheet of a finance company:

(a) Unearned discount.

This unearned discount is the portion of the discount earnings of the finance company applicable to customers' unpaid loans.

(b) Dealers' reserves.

When a finance company buys paper from a customer and pays, say, 80 per cent of the purchase price, what is the general practice in showing the reserve of 20 per cent on the balance-sheet of the finance company? Is this 20 per cent generally deducted from the notes receivable upon the theory the finance company acquired an equity of only 80 per cent and is acting as collection agent for the dealer with respect to the 20 per cent, or is it generally considered that the dealer purchased the entire note and is merely deferring payment of the 20 per cent, thus making the 20 per cent a direct current liability?

Answer No. 1

Replying to your letter, I wish to advise as follows:

(a) Unearned discount. The general practice with regard to the treatment of this item on the balance-sheet in companies which we examine is to carry this under a heading on the balance-sheet of "Reserves for deferred income and charges (unearned)."

(b) Dealers' reserves. The general practice is to show this item on the liability side of the balance-sheet under the caption "contingent reserves" and to call this particular item under this general caption on the balance-sheet "Dealers' participating loss reserves." In this connection the generally accepted practice seems to be that the finance company purchases the entire note and withholds a certain proportion thereof as a protection against possible default on any of the notes purchased. As the notes are paid in full, settlement is made at stipulated intervals with the dealer and he receives the 20 per cent or other amount withheld, less any known losses in connection with that dealer's account. It will be noted that this is not carried as a direct current liability and it is not the general practice of the larger finance companies to show current assets or current liabilities in their annual statements, but in registration statements the Securities and Exchange Commission has required that these dealers' participating loss reserves, as well as the margin due customers only when receivables are collected, should be included in the total current liabilities.

Answer No. 2

This is in reply to your letter requesting information with respect to present accepted treatment of the following items in balance-sheets of finance companies:

(a) Unearned Discount. In accordance with the requirements of the accrual basis of accounting, income from finance charges is spread over the periods receiving the benefit. At the close of a given period, the amount of such unearned charges applicable to subsequent periods represents deferred income and usually appears in the balance-sheet on the liability side immediately before the "capital" section.

(b) Dealers' Reserves. When a finance

company buys paper and pays 80 per cent of the purchase price, it buys the whole note, not just part of it. Therefore it acquires an asset represented by the whole note, and there remains a liability of 20 per cent of the purchase price representing the amount withheld from the seller. In our opinion, the 20 per cent withheld is a liability and should be so classified in the balance-sheet rather than deducted from the related asset.

SERVICE GUARANTEE PAYMENTS

Question

Certain corporations manufacturing and selling electric refrigerators guarantee their products for a period of three to five years upon payment by the customer, of a certain nominal sum, which I think is about $5. I would like to know how these payments received from customers for service guarantees are customarily handled on the books of the manufacturer.

Answer No. 1

As the inquirer is no doubt aware, the general procedure is to provide a reserve, based on the company's experience, sufficient to meet the cost of servicing the units up to expiration of the period of the guarantee. The amount of such reserve at the outset is necessarily a matter of judgment, but the data of continuing experience will enable a more exact determination of the required reserve, and correspondingly the amount to be provided therefor in successive accounting periods.

Inquiry is specifically made, however, as to the treatment of the nominal sum, say $5, paid by customers for the servicing which the company undertakes during the period of the guarantee, that is, from three to five years. The position might be taken that such payment is properly regarded as an addition to the selling price, the company's undertaking to service during the agreed extended period for a nominal payment being offered to prospective customers as an added inducement to purchase. We believe, however, it would be preferable to credit the guarantee reserve with the customers' payments specifically designated as applicable thereto, although of course the full amount of such reserve should be maintained at the level which, as we have stated, experience shows to be necessary.

Answer No. 2

The wording of the question would seem to indicate payment by the customer of a certain nominal sum specifically for the guarantee for a period of from three to five years. This seems rather unusual inasmuch as any payment made for a guarantee of this type is usually included in the purchase price of the article and not segregated as a specific payment for the guarantee. The method of payment would have a decided influence upon the accounting treatment to be applied. The response which follows is based upon the payment by the customer specifically earmarked as a guarantee payment.

It is obvious that the payment received from each customer for the guarantee is not immediately income to the manufacturer but should be credited to an appropriately named liability account. Such liability account should be supported by a subsidiary ledger carrying an account with each customer and/or refrigerator serial number. Against this liability should be charged the cost of any replacement parts or services in connection with the fulfilment of the guarantee to the extent of the $5 payment only; any charges in excess of the $5 constitute operating expenses when and as incurred. If, upon the expiration of the guarantee period, any subsidiary account still contains a remaining credit, then this amount should be taken up as income in the accounting period within which the guarantee period expires. It should be noted that each $5 payment is specifically accounted for and either consumed by charges applying to this specific piece of equipment or taken up as income only when the guarantee period has expired. It might also be well to carry more than one liability control account, that is, a liability control account applicable to each year. This will assist materially in the closing out of any remaining balances to income.

Answer No. 3

It has been our experience that the customer does not pay the sum ($5) as such. It is added in to the sales price of the product, but because most companies increased their price about $5 when the five-year guarantee went into effect, there has been some treatment of that increase as a specific reserve in connection with the long-time guarantee.

Thus it has been our experience that the reserve has been created by the manufacturer and is not based upon an agreement with the customer.

It has not been our experience that there is any uniform method of handling these reserves. There is some background for taking into income monthly a pro-rata part of the reserve during the period the guarantee covers. There is also some practice in letting the reserve stand except for necessary charges thereagainst until at or near the close of the guarantee period on the theory that expenses in connection with the guarantee may be higher as the product becomes older. We have felt that the accounting rule which must be considered is to have at the close of each year a reserve estimated to be sufficient to care for the expenses of the long-term guarantee for the remaining life of that guarantee.