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C. L. Kelly

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BY C. L. KELLY

WHILE the question of handling life insurance purchased by a business for business purposes has been treated in accounting texts and in questions and answers, it does not appear that there is full appreciation of the fundamental issues in any one place. Furthermore, in practically every case, the discussion appears to lack understanding of the functions of business life insurance. The short discussion that follows is an attempt to get at the problem from the viewpoint of the business manager as well as the auditor.

Life insurance proper embodies only protection—in other words, a hedge against some possible or probable loss. Such a hedge can be arranged with term insurance. Perhaps the only justification for buying a higher-premium contract is the term limit placed on contracts by some life-insurance companies and the possibility that the third party—the life on which the insurance is placed—may outlive the term period. The only other reason is the desire of the management to build up a cash fund which usually will be available on short notice. It should be understood, however, that a life-insurance company does not act as a banking institution.

Unless the management desires to use life insurance to create a fund by a certain time and for a definite purpose, he more often uses an ordinary or whole-life contract to hedge a risk. Excepting the term contract, the whole life affords the maximum protection with the minimum accumulation or reserve for the money expended. Furthermore, this contract carries assurance that the life insured will not outlast the contract if there is continuity of premium payments.

If the management should decide on a higher premium contract than whole life, the accumulation of a fund is emphasized. This may be wise if the business can stand the cash drain, if there is distinct need of a fund, if the fund cannot be accumulated with safety within the business, and if the yield by investment through life insurance is satisfactory. Another thing to be considered is that the fund at first is actually less than the amount expended for the fund through life insurance or even annuities.

Following are cases illustrating the fundamental issue:

Case 1. The P. and L. Company employed a chemist who had exceptional ability in developing formulae for the company. The management estimated that a distinct loss would be incurred in the premature death of this man and a relatively large expense in replacing him. The latter would result through having to employ and try out a number of chemists until one peculiarly qualified could be obtained. The company, therefore, placed a $50,000 whole-life policy on the life of their chemist, making the company the beneficiary. At the same time it began a plan of employing one or two assistant chemists, mainly for the purpose of finding another exceptional man. It so happened that the chief chemist died before the properly qualified man was found. However, in approximately one and one-half years after this death a suitable chief chemist was secured.

At the time of the death of the chief chemist, the cash value of the $50,000 that was set up on the books was about $4,800. When the $50,000 was received, it appeared proper to credit the $4,800 and pass the remaining credit to a reserve for probable expense to be incurred in securing another man. Subsequently, it appeared proper to charge to this reserve the additional cost of employment incident to such research or experience. After the proper man was secured, the balance of the reserve was passed to surplus. It did not appear proper to credit surplus with the $50,000 less the $4,800 at the time the proceeds were received from the life-insurance company, because the full purpose for which the life-insurance policy was purchased was not accomplished and there was no way of knowing how soon it would be. The point is, that for every business-insurance policy purchased there is a sound business purpose and the accounting should conform thereto.

Case 2. The N. Company was unusually successful under the ownership (87 per cent) and management of one man, the president. When the company was large and in a strong cash position, and when it had attained a smoothly functioning staff of executives, the president conceived the idea of having the company insure his life for $3,500,000 for the purpose of liquidating 36 per cent of his stock holdings; the remaining 51 per cent was to pass to his son upon his, the president's, death. Contracts were properly made to carry this out. The purpose here was definite and an auditor should have no trouble in determining, since the company's stock had a par value, that after adjusting for the difference between the purchase price and the par of the stock, the balance should be to surplus.

Inasmuch as good management would dictate that for every life-insurance contract purchased there should be a definite purpose, it is necessary only that the auditor seek out that purpose and adapt his accounting to it. Unless and until the purpose is known, the auditor cannot make a final decision as to the handling of the accounts relating thereto.