



## **Accounting for a Windfall**

**By Grace Morin, CPA**

Pierre Michaud has to decide whether to accede to the president's wishes and record the insurance payment as operating income. Can Pierre maintain neutrality?

### ***Abstract***

*The president of Progressive Geriatric Equipment Design is pressuring controller Pierre Michaud to include a recent windfall from life insurance proceeds in the division's operating income. Examine the facts and determine the course of action you believe should be taken.*

### **Background**

Progressive Geriatric Equipment Design, or PGED, was facing a lot of pressure to show an operating profit on the financial statements. The loan covenants were based on the division's operating profits, as was the company contribution to the employees' 401(k) plan. And profits during these last few years were often hard to achieve. Somehow new products and markets just hadn't been found. PGED, one of five divisions owned by Prosthetics, Ltd., was working with a very lean staff in every department, and a commitment to try to minimize costs. Most employees were aware of the division's precarious situation. PGED knew that it could easily be consolidated into one of the other divisions located several states away, or even sold. The jobs of 201 people were on the line, and they all needed to do their best to keep their division going.

Gustav Jacobs was 46 years old when his father's Oldsmobile was struck from the side by another vehicle, severing his leg. When the man was given an artificial limb, Gustav, a mechanical engineer, immediately saw how many improvements he personally could imagine for the device. Diving into the project, Gustav designed and patented over 20 versions of artificial limbs in the next few years. Not satisfied with simply designing these limbs, Gustav found other enthusiastic experts to invent production equipment, run the manufacturing and even patent new materials that were softer to the touch. Led by Gustav, the four founded PGED, which manufactured the product to exacting standards. The company had been purchased by Prosthetics, Ltd. almost 20 years ago. Gustav and the others had approved of the purchase, believing they could achieve even greater growth with their new extensive distribution channels. Gustav had been happy to stay with the company when it was bought, having made a fair profit by the sale of his stock, and having been offered an attractive employment contract. Until computerization ushered in a new era in equipment, almost all of the most popular designs had been the result of his mechanical genius, personal compassion and drive.



Gustav had been responsible for the plant itself, which was located on 72-acres of former farmland, now an island surrounded by tightly-packed newer industrial buildings. Owners of nearby companies frequently offered to buy the PGED location to pack in more buildings and parking lots. Deer often peeked out from the woods in back of the PGED building, and countless nesting birds could be seen from the trails the employees enjoyed during their lunch breaks. Being very aware of the difficulties handicapped people can encounter when finding jobs, PGED tapped the talents of the market its products served, and many of the employees used the very limbs made at the company. The outdoor trails were designed with them in mind, and were used extensively.

On the first of the previous month tragedy had struck when Gustav was stricken with a massive and fatal heart attack. He and the other three founders had life insurance policies paid for by the company. The company deducted the premiums each year. PGED sent the proceeds of Gustav's \$1 million policy to corporate headquarters where cash, though no other accounting functions, had been centralized a year ago. The proceeds were earmarked by corporate headquarters as research and development money for several divisions, though only a pittance was set aside for PGED.

### **The Problem**

Controller Pierre Michaud had been thinking mainly about poor Gustav's death, and also about how to ensure the money allocated by corporate was used most effectively. Month-end came, the financial statements were generated and the assistant controller gave Pierre the first draft of the statements for his review. Unfortunately, as feared, the results of operations showed a small loss. Pierre knew that he could use his creativity to nudge the figure into the black. He had done it before, and shook his head as he looked at his notes from last month to see how he had done it then. The monthly accruals could be cut a little; they were still on the conservative side. Insurance accruals were a little high yet since headcount was being allowed to drop due to attrition, and the final insurance audit would come in lower than his accruals now totaled. The legal accruals could be cut some more, too. He'd issue a memo for everyone to see him first before calling for any advice: patent questions, personnel matters, product and contract issues. He found a few more. He could genuinely justify all of those, but this was the last month he could whittle them down. He gave the changes to the assistant controller, who grimaced and began to enter them into the computer. In about 15 minutes, Pierre had the new financials, which showed a miniscule profit, but at least it didn't show a loss. Pierre called the president to tell her the financials were ready for her review and their discussion any time she could schedule it. She told Pierre to drop off a copy of the statements on her desk and come to her office at 9 a.m. the next morning.

At 8 a.m. the next day, Pierre got a call from the president. How could there be such a small profit when they just got \$1 million of life insurance proceeds? What was the figure doing below the operating income line in "Other Income"? The premiums had been included in administration expenses every year, hadn't they? The company had to put up with those expenses going against operating income, so why wouldn't it be able to benefit from the proceeds? Pierre wanted very badly to research the accounting treatment of life insurance premiums and proceeds before he started arguing his position with the



president, who was clearly very upset. However, the president wanted him in her office now.

As Pierre walked along the corridor, he thought of what must be going through the president's mind. He knew that she had fought hard with corporate management for the cash from the life insurance proceeds so that new computer engineers could be hired to redesign the products. He also knew that she had lost that fight, with corporate saying that there was more to be gained by investing the cash in other divisions. Now Pierre was telling her that the life insurance proceeds couldn't even help them on the financial statements. Seeing those statement drafts must have been quite a blow, and must have made the president feel desperate to keep the company going somehow, some way.

Still shaken from the president's demeanor, Pierre arrived at her office. He explained that since the proceeds were such a large amount, and an infrequent occurrence, they needed to be accounted for "below the line." Clearly irritated, the president said that didn't make sense. She told Pierre to amortize the proceeds over a period of years, just as the insurance premiums had occurred over a period of years. If he could do that, they could manage to keep an operating profit going for many months, or even many years. She insisted that he try very hard to find a way. This was the company founded by Gustav, and made proud by the valued employees. It was worth fighting for; it was worth bending a few rules. The president told Pierre to make the corrections by the end of the day and give her new copies of the statements. PGED's immediate future was, literally, in Pierre's capable hands.

### ***Comments on "Accounting for a Windfall"***

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*Dan's practice is limited to consulting services, including litigation involving accountant's malpractice issues. His most recent book is Audit Committees: A Guide for Directors, Management, and Consultants (Aspen Law & Business).*

*"Pierre should be mindful of his responsibility under the AICPA Code of Professional Conduct. Rule 501, which prohibits acts discreditable to the profession."*

After leaving the president's office, Pierre should immediately research the accounting issues related to PGED's gain from the life insurance proceeds. In doing the research, Pierre should determine that generally accepted accounting procedures require that the \$1 million gain be reported separately as a component of income from operations (with appropriate footnote disclosure of the facts and circumstances). The gain should not be considered extraordinary because it is a normal business transaction. It may be unusual in nature, but it can be expected to recur (in fact, PGED has life insurance policies on the three remaining company founders). In other words, the gain is not extraordinary (both unusual and infrequent), but it is infrequent; therefore, it merits separate line item



reporting in the income statement as a component of income from operations (displayed as “other revenues and gains” if desired).

Upon completing his review of the relevant GAAP authoritative literature, Pierre may want to discuss and confirm his conclusion by calling the AICPA’s technical accounting and auditing hotline at (888) 777-7077.

Once Pierre has completed his research and consultation, he should meet with the president. He might initiate his discussion as follows: Good morning, I have some good news and some bad news. As the revised financial statements show, we can (and, in fact, should) treat the \$1 million as a component of income from operations. That’s the good news. However, under no circumstances can we set up the gain as an asset and amortize it into income over future periods. That’s the bad news. GAAP does not permit the latter since the gain is realized, and it is not contingent on anything in the future. Finally, not only is the amortization of the gain a violation of GAAP, but that treatment also would be illegal.

During this discussion, Pierre, as a CPA and AICPA member, should be mindful of his responsibility under the AICPA *Code of Professional Conduct*. Rule 501 prohibits acts discreditable to the profession. If Pierre were to (1) make false or misleading journal entries, (2) sign a materially false or misleading financial statement, or (3) allow or direct others to do such things, he would be committing an act discreditable to the profession.

**Steven M. Mintz, Ph.D., is a leading expert in the field of professional ethics for CPAs.**

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### **Executive Summary**

The president of PGED is allowing her own self-interests and the perceived interests of the employees to dictate the reporting of the \$1 million life insurance payment for Gustav's death. Pierre Michaud, the company controller, already has lowered the accruals to create a small profit. To generate additional operating income over a number of years, the president asks him to allocate the insurance proceeds as an operating income item rather than report all of it currently as other income. Pierre has a dilemma because the company's very existence is at stake, as well as the jobs of 201 workers.

### **Stakeholders and Interests**

The creditors are major stakeholders because they provide the funds to help the company operate. The company's ability to meet the loan covenants, which are based on the division's having operating profits, should be questioned since the dollar amount of accruals is being lowered to achieve desired operating results. Thus, earnings are being managed to achieve a desired result rather than reported in accordance with sound accounting practice.

PGED is one of five divisions owned by Prosthetics, Ltd. The company is a major stakeholder, as are PGED employees, who may lose their jobs if the division is consolidated into another unit or sold. Also, the company's contribution to the 401(k) plan is at risk, since the disputed operating profit is the basis for the contribution.

Pierre Michaud is a stakeholder since he has to decide whether to accede to the president's wishes and record the insurance payment as operating income rather than as he initially recorded it--other income. The president also is a stakeholder since the future viability of PGED as a separate entity is at risk. She is responsible to the employees whose jobs are in jeopardy, and they are users of the limbs made at the company.

### **Ethical Issues**

The creditors' rights to receive accurate and reliable information to evaluate whether the company is meeting the loan covenants are at stake. The arbitrary way in which the PGED division created operating profits misleads the creditors into believing that the division is doing better than it really is.

Pierre's responsibility to the president does not include taking actions to manage earnings to achieve a desired result. Accounting information is supposed to be recorded in an unbiased manner. Pierre has violated neutrality by arbitrarily lowering the accruals to report an operating profit. This action is unfair to the creditors.

PGED's ethical responsibility to its employees does not include managing operating profits to achieve a desired level to prevent the division's demise. If each of the divisions made operating or financial reporting decisions based on this goal, then all of their results would lack reliability and comparability.

### **Alternatives**



Pierre has to weigh his responsibility to the company and its employees, as well as the president's desire to show a larger operating profit, against whether it is right to manage earnings to enhance PGED's short-term chances to continue as a separate division. He can go along with the president and allocate the insurance proceeds as operating income over a period of time or refuse to do so, since it is an improper practice. In making a decision, Pierre should consider PGED's responsibility to its creditors and the company's ability to demonstrate that it honestly met the loan covenant requirements.

Pierre may want to discuss the matter with a trusted adviser. However, he should not violate the creditors' rights regardless of the pressure applied by the president. As controller, he has an obligation to be objective in determining how to report the insurance proceeds.

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*Clyde Associates is a boutique consulting firm located in Dallas, TX where Nita specializes in accounting education with a particular emphasis on issues of professional ethics. She chairs the AICPA/NASBA Joint Committee on Continuing Professional Education Standards, as well as a Special Committee on Ethics in the CPA Profession. She is a past member of the AICPA Board of Directors, and is currently a member of its governing Council. Nita was a university professor for almost 20 years.*

*“Pierre has obligations to the corporate office and to the company's shareholders to provide them with financial information that is useful for their decision-making.”*

Pierre's ethical issues in this case relate as much to his competence as to other issues. Without a sound knowledge of the proper accounting treatment for proceeds from life insurance policies, he cannot adequately address the demands of the president or justify to himself and others why a position was taken. However, even without resolving or discussing the accounting issues, there are some general lessons to be learned.

First, financial statements are filled with estimates based on sound professional judgment, which allows for differences of opinions and sometimes differences in treatment of what appear to be identical situations. The adjustments that Pierre made initially, bringing the bottom line from a loss to a small profit, appear to be within ethical boundaries. He was able to justify why the preliminary insurance accruals were too high and to limit legal expenses by offering to provide some advice himself. He also acknowledged that there was no more room for such adjustments in subsequent months.

Pierre's real dilemma may arise from the president's demands that the financial statements portray the receipt of the insurance proceeds in a manner that increases operating income, even if it means “bending a few rules.” Although Pierre is undoubtedly sympathetic to the president's concern for the company and its employees, he also has obligations to the corporate office and to the company's shareholders to provide them



with financial information that is useful for their decision making. Independent of how the current reporting issue is resolved, Pierre must ultimately decide whether he wants to continue in this environment. The constant pressure to find accounting treatments that benefit the company at the risk of placing himself in violation of professional reporting standards may be too high a price to pay.