

Key Person Insurance Valuation

Concept Applied:

Placing a realistic monetary value on a key employee's contributions to the business is difficult and inexact, but critical to the purchase of key employee insurance designed to protect the business against potential financial loss.

How It Works:

The "multiples of income" method is most common. The value of the policy is simply 5-10 times the insured employee's salary.

The "contribution to earnings" method estimates the employee's annual contribution to earnings, multiplies it by the number of years the employee would have worked, then discounts this earnings stream to its present value.

The "cost to replace" method determines the amount the business would have to pay a new person(s) to do the same job. From that amount, subtract the key employee's compensation. Multiply the difference by the number of years it will take to train a new person—then add in hiring costs.

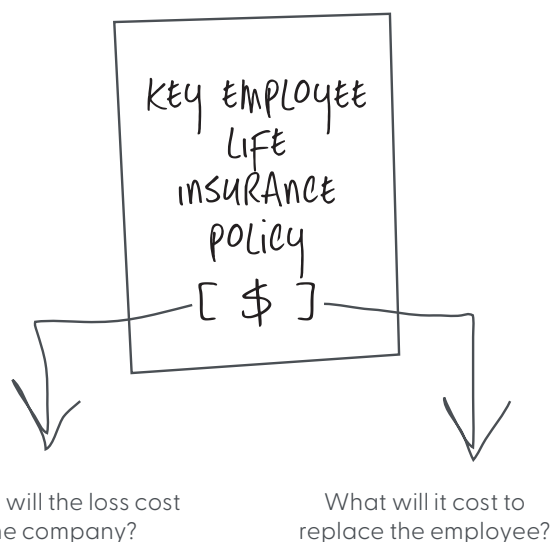
Why Is It Useful?

Because key person insurance is vital for continuing operations when a key employee dies, it's essential that the business have a reliable estimate of the money needed to deal with this potential loss.

50 Words or Less

An employer can determine the insurance value of a key employee critical to the company's success and profitability by calculating:

- the employee's financial contribution to the business, or
- the cost of replacing the employee.



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