

A 12-month Insurance Policy Was Purchased On Dec. 1 For \$4,800 And The Prepaid Insurance Account Was

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When managing business finances, understanding how to record and adjust prepaid expenses is essential for accurate financial reporting. One common example is the purchase of an insurance policy that covers a specific period, such as a 12-month policy purchased at the end of the year. In this article, we will explore the accounting treatment of such a transaction, focusing on the initial recording of the prepaid insurance, subsequent adjustments, and the implications for financial statements.

Understanding Prepaid Insurance and Its Accounting Treatment

What Is Prepaid Insurance?

Prepaid insurance refers to an amount paid in advance for insurance coverage that extends into future periods. It is considered an asset on the balance sheet because it provides future economic benefits—specifically, coverage over a certain duration.

Why Is It Considered an Asset?

Since the insurance coverage spans multiple periods, the expense should be recognized gradually over the coverage period rather than all at once. Until the coverage period has elapsed, the prepayment remains an asset.

Key Principles in Accounting for Prepaid Insurance

- Matching Principle: Expenses should be recognized in the period in which they are incurred.
- Accrual Basis Accounting: Expenses are recorded when incurred, not necessarily when paid.

Initial Purchase of the Insurance Policy

Scenario Details

- Purchase Date: December 1
- Duration: 12 months
- Total Cost: \$4,800

Journal Entry on December 1

When the insurance policy is purchased, the company records the payment as a prepaid asset:

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```plaintext
Debit: Prepaid Insurance $4,800
Credit: Cash $4,800
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This entry reflects the company's possession of insurance coverage covering the next 12 months.

Implication of the Purchase Date

Since the purchase is made on December 1, only one month (December) of coverage has been used by the end of the month. The remaining coverage extends into subsequent periods.

Adjusting Entries at Year-End

Why Adjustments Are Necessary

At the end of the accounting period (December 31), the company must recognize the insurance expense for the coverage used during December. The remaining prepaid amount still represents future coverage and remains on the balance sheet.

Calculating the Monthly Insurance Expense

- Total insurance cost: \$4,800
- Coverage period: 12 months
- Monthly expense: $\$4,800 \div 12 = \400

Adjusting Entry on December 31

For December, the company records the insurance expense for one month:

```plaintext

Debit: Insurance Expense \$400

Credit: Prepaid Insurance \$400

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This reduces the prepaid insurance asset and recognizes the expense in the current period.

Impact on Financial Statements

Balance Sheet

- Prepaid Insurance: After the adjustment, the remaining balance reflects 11 months of coverage, totaling \$4,400 (\$4,800 - \$400).

Income Statement

- Insurance Expense: Recognized as \$400 for December, impacting net income.

Future Periods

In subsequent months (January through November), similar adjustments will be made monthly to recognize the appropriate expense, decreasing the prepaid insurance asset accordingly.

Key Points to Remember

- The initial journal entry records the purchase as an asset.
- Monthly adjustments recognize the expense over the policy period.
- Proper timing of expense recognition ensures accurate financial statements.
- The prepaid insurance account acts as a control to track remaining coverage.

Additional Considerations for Businesses

Timing of Purchase

Purchasing insurance late in the year, such as December 1, impacts how much expense is recognized in the current period. Businesses often make accrual adjustments to align expenses with the period they relate to.

End-of-Year Financial Reporting

Ensuring accurate adjustments are made before financial statements are finalized is crucial for compliance and transparency.

Tax Implications

Tax laws may have specific rules regarding deductibility of prepaid expenses, so consulting with tax professionals is advisable.

Summary of Journal Entries

Date	Description	Debit	Credit
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Dec 1	Purchase of 12-month insurance policy	Prepaid Insurance \$4,800	Cash \$4,800
Dec 31	Recognize insurance expense for December	Insurance Expense \$400	Prepaid Insurance \$400

Conclusion

The purchase of a 12-month insurance policy on December 1 for \$4,800 illustrates fundamental accounting principles regarding prepaid expenses. Initially recorded as an asset, the prepaid insurance must be systematically expensed over the coverage period through monthly adjustments. Proper accounting for such transactions ensures that financial statements accurately reflect the company's financial position and performance. Understanding these principles aids business owners and accountants in maintaining compliance and achieving transparent financial reporting.

Keywords: prepaid insurance, insurance expense, adjusting entries, accounting for prepaid expenses, financial reporting, insurance policy, asset accounting, insurance adjustment, December purchase, 12-month insurance policy

Frequently Asked Questions

What is the initial journal entry when purchasing a 12-month insurance policy for \$4,800 on December 1?

The initial journal entry is to debit Prepaid Insurance for \$4,800 and credit Cash for \$4,800.

How is the prepaid insurance account affected at the time of purchase?

The Prepaid Insurance account is increased (debited) by \$4,800, representing an asset.

When should the company recognize insurance expense related to this policy?

The insurance expense should be recognized monthly over the 12 months, starting December 1.

What is the adjusting journal entry at the end of each month for this insurance policy?

At the end of each month, debit Insurance Expense and credit Prepaid Insurance for \$400 ($\$4,800 \div 12$).

How does the prepaid insurance account balance change over the 12 months?

The balance decreases monthly by \$400 as insurance expense is recognized, reaching zero after 12 months.

What is the impact on the financial statements when the prepaid insurance is initially purchased?

Assets increase due to the Prepaid Insurance account, and cash decreases; no effect on liabilities or equity.

If the company forgets to make monthly adjusting entries, what would be the consequence?

Insurance expense would be understated, and prepaid insurance would be overstated on the balance sheet.

Can prepaid insurance be considered a current asset?

Yes, since it is expected to be used up within one year, it is classified as a current asset.

What happens if the policy is canceled before 12 months?

Any unused portion of prepaid insurance should be adjusted and possibly refunded or recorded as a reduction in expense.

Why is it important to record the prepaid insurance correctly over time?

Proper recording ensures accurate financial statements, matching expenses to the period they relate to, and maintaining compliance with accounting principles.

Additional Resources

A 12-month Insurance Policy Was Purchased On Dec. 1 For \$4,800 And The Prepaid Insurance Account Was

In the world of accounting and financial management, understanding how to properly record and adjust for prepaid expenses is essential. One common scenario involves the purchase of an insurance policy that covers a period extending over multiple accounting periods. When a business acquires such a policy, it must recognize the initial transaction appropriately and then make periodic adjustments to reflect the expense as time passes. This article explores the process of accounting for a 12-month insurance policy purchased on December 1 for \$4,800, focusing on the initial recording, subsequent adjustments, and the implications for financial statements.

The Initial Purchase: Recording the Prepaid Insurance

Understanding Prepaid Insurance as an Asset

Prepaid insurance represents an advance payment for coverage that extends into future periods. Because the insurance benefits are expected to be realized over time, the initial transaction does not immediately expense the entire amount. Instead, the cost is initially recorded as an asset—specifically within the Prepaid Insurance account.

The Journal Entry on December 1

When the insurance policy is purchased on December 1 for \$4,800, the company must record this transaction to reflect the asset acquired. The journal entry typically involves:

- Debiting the Prepaid Insurance account to recognize the asset.
- Crediting Cash (or Accounts Payable if paid later) to record the payment.

The entry is as follows:

...

December 1
Debit: Prepaid Insurance \$4,800
Credit: Cash \$4,800

This transaction increases the Prepaid Insurance asset on the balance sheet by \$4,800, representing the right to insurance coverage over the next 12 months. Cash decreases by the same amount, reflecting the payment made.

Significance of Proper Recording

Recording the purchase correctly is critical because it ensures that the company's financial statements accurately reflect its assets and cash position at the outset. Proper classification influences future expense recognition and impacts key financial ratios, such as current ratio and asset turnover.

Recognizing Insurance Expense Over Time: Adjusting Entries

The Concept of Matching Expenses with Revenues

In accrual accounting, expenses should be recognized in the period in which they are incurred to match them with the revenues they help generate. For prepaid insurance, this means spreading the expense over the period of coverage, typically made through adjusting entries at each reporting date.

The Adjustment at Year-End

Suppose the company's fiscal year ends on December 31. Since the insurance policy was purchased on December 1, only one month's worth of coverage (December) has elapsed by the year-end. Therefore, only that portion should be expensed in the current financial period, while the remaining coverage should stay on the balance sheet as an asset.

Calculating the Monthly Insurance Expense

Given the total policy cost of \$4,800 for 12 months, the monthly expense is:

Monthly Insurance Expense = Total Cost / Number of Months
= \$4,800 / 12
= \$400

The Adjusting Journal Entry on December 31

By December 31, one month's insurance has been "used up," so the company should recognize an expense of \$400 and reduce the prepaid asset accordingly:

December 31

Debit: Insurance Expense \$400
Credit: Prepaid Insurance \$400

This entry decreases the Prepaid Insurance asset and records the Insurance Expense on the income statement, aligning expenses with the period in which they are incurred.

Impact on Financial Statements

- Balance Sheet: The Prepaid Insurance asset decreases from \$4,800 to \$4,400.
- Income Statement: The Insurance Expense increases by \$400, reducing net income for the period.

The Complete Year: Recognizing the Full Insurance Expense

Monthly Adjustments Throughout the Year

Following the initial December 31 adjustment, the company should continue to recognize \$400 of insurance expense each subsequent month. For a full 12-month policy, the total insurance expense recognized over the year will sum to \$4,800, matching the initial payment.

Monthly Journal Entries

For each month from January through November, the company makes similar adjusting entries:

[Monthly]

Debit: Insurance Expense \$400
Credit: Prepaid Insurance \$400

By the end of November, the total insurance expense recognized will be:

$\$400 \times 12 \text{ months} = \$4,800$

The Prepaid Insurance account will then be reduced to zero, indicating that the coverage has been fully expensed.

Final Year-End Balance Sheet

At December 1 of the following year, after all adjustments, the Prepaid Insurance account would be zero if the policy was fully used. However, if the policy was canceled early or if coverage extended beyond the 12 months, adjustments would be necessary accordingly.

Special Considerations and Variations

Partial Year Coverage

If the business purchases a policy mid-year or cancels early, the amount of expense recognized must be proportional to the coverage period used. Adjustments are made based on the exact number of days covered.

Prepaid Insurance in Financial Analysis

Prepaid insurance is a non-current asset initially, but as it is expensed over time, it impacts the company's profitability and asset structure. Properly managing and recording prepaid expenses ensures accurate financial ratios and compliance with accounting standards.

Impact of Errors

Incorrect recording of prepaid insurance can lead to overstated assets or understated expenses, distorting net income and financial position. Regular reconciliations and accurate journal entries are vital.

Broader Implications for Financial Reporting

Compliance with Accounting Principles

The treatment of prepaid insurance aligns with Generally Accepted Accounting Principles (GAAP), specifically the matching principle, which advocates for expenses to be recognized in the period they are incurred.

Enhancing Transparency

Clear and consistent recording of prepaid expenses enhances the transparency of financial statements, allowing stakeholders to assess a company's true financial health and operational efficiency.

Effect on Taxation

Since insurance expenses are deductible, proper timing of expense recognition can influence taxable income. Businesses should ensure their accounting for prepaid insurance aligns with tax regulations and standards.

Conclusion

The purchase of a 12-month insurance policy on December 1 for \$4,800 exemplifies key accounting principles related to prepaid expenses. Initially, the company records the payment as a prepaid insurance asset, reflecting the future economic benefit. As time progresses, periodic adjusting entries are made to recognize the insurance expense in the

appropriate periods, ensuring adherence to the matching principle. Proper management of prepaid insurance not only ensures compliance with accounting standards but also provides stakeholders with an accurate view of the company's financial position and performance.

Through diligent application of these principles, businesses can maintain accurate financial records, facilitate better decision-making, and uphold transparency and integrity in their financial reporting processes.

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