

On July 1, 2019, Sunland Co. Pays \$17,300 To Oriole Insurance Co. For A 4-year Insurance Contract. Both

On July 1, 2019, Sunland Co. Pays \$17,300 To Oriole Insurance Co. For A 4-year Insurance Contract. Both this transaction and its subsequent accounting implications are vital for understanding how companies handle prepaid expenses, insurance accounting, and financial statement presentation. This comprehensive article explores the details of this transaction, the accounting principles involved, journal entries, and its impact on Sunland Co.'s financial statements. Whether you're a student of accounting, a professional, or a business owner, grasping these concepts is essential for accurate financial reporting and analysis.

Understanding the Nature of the Transaction

What Does the Payment Represent?

When Sunland Co. pays \$17,300 to Oriole Insurance Co. for a 4-year insurance contract, it is essentially purchasing an insurance policy that provides coverage over a four-year period. This payment is considered a prepaid expense because the benefit (insurance coverage) extends beyond the current accounting period.

Key Details of the Transaction

- Date of Payment: July 1, 2019
- Amount Paid: \$17,300
- Duration of Policy: 4 years (48 months)
- Insurance Provider: Oriole Insurance Co.
- Type of Expense: Prepaid insurance (asset initially)
- Accounting Periods Affected: From July 1, 2019, through June 30, 2023

Accounting Principles Involved

Prepaid Expenses

Prepaid expenses are payments made in advance for goods or services to be received in

the future. They are initially recorded as assets on the balance sheet and gradually expensed over time as the benefit is realized.

Matching Principle

This principle dictates that expenses should be recognized in the same period as the revenues they help generate. For prepaid insurance, the cost is allocated over the coverage period to match the expense with the period benefited.

Accrual Accounting

Under accrual accounting, transactions are recorded when they occur, regardless of when cash changes hands. Therefore, the initial payment is recorded as an asset, and then gradually expensed.

Initial Journal Entry on July 1, 2019

When Sunland Co. makes the payment, the following journal entry is recorded:

```plaintext

Debit: Prepaid Insurance \$17,300

Credit: Cash \$17,300

```

- Prepaid Insurance (Asset): Reflects the company's right to insurance coverage over the next four years.
- Cash: Decreases by the amount paid.

This entry recognizes the payment as a current asset, which will be expensed over the policy's coverage period.

Allocating the Insurance Expense Over the Coverage Period

Calculating Monthly Insurance Expense

To properly account for the expense, Sunland Co. must allocate the total payment over the 48 months of coverage.

$$\text{Monthly Insurance Expense} = \frac{\$17,300}{48} = \$360.42$$

Note: Rounded to two decimal places for accuracy.

Monthly and Annual Expense Recognition

- Monthly Expense: \$360.42
- Annual Expense: $\$360.42 \times 12 = \$4,324.92$

Monthly and Year-End Adjustments

As time progresses, Sunland Co. will recognize insurance expenses monthly. For example, at the end of each month, the following adjusting journal entry is made:

```

```plaintext
Debit: Insurance Expense $360.42
Credit: Prepaid Insurance $360.42
```

```

This reduces the asset account and recognizes the expense in the income statement.

Example: End of First Month (July 31, 2019)

- Entry:


```

```plaintext
Debit: Insurance Expense $360.42
Credit: Prepaid Insurance $360.42
```

```
- Remaining Prepaid Insurance: $\$17,300 - (\$360.42 \times 1) = \$16,939.58$

Financial Statement Impact

Balance Sheet

- Prepaid Insurance: Initially recorded as \$17,300, decreases each month by \$360.42.
- Assets: The prepaid insurance asset decreases over time as insurance expense is recognized.

Income Statement

- Insurance Expense: Recognized monthly, totaling approximately \$4,324.92 annually.
- Net Income: Decreases as insurance expenses are recorded, affecting profitability.

Cash Flow Statement

- Operating Activities: Shows a cash outflow of \$17,300 at the time of payment.
- No subsequent cash flows are associated with the insurance expense until renewal or additional payments.

End of Coverage and Final Accounting

Final Year of Coverage (June 30, 2023)

Once the four-year coverage has expired, the prepaid insurance account should be reduced to zero, and any remaining unexpensed amount should be fully recognized as an expense.

Year-End Adjustments

If the company's fiscal year-end does not coincide with the insurance coverage period, adjusting entries are necessary to allocate expenses accurately.

Additional Considerations and Best Practices

Handling Partial Periods

If the company acquires or cancels insurance coverage mid-period, prorated adjustments are necessary to recognize expenses accurately.

Impact of Discounting and Premiums

While not applicable in this scenario, if the insurance premium involved discounts or premiums paid in installments, further accounting complexities arise.

Record-Keeping and Documentation

Maintaining detailed records of insurance policies, payment dates, coverage periods, and related documentation is crucial for audit and compliance purposes.

Summary of Key Points

- The \$17,300 payment on July 1, 2019, is initially recorded as a prepaid insurance asset.
- The expense is recognized monthly over the 4-year period, approximately \$360.42 per month.
- Proper adjusting entries ensure expenses are matched with the periods they benefit.
- Accurate financial statements reflect these transactions, impacting assets, expenses, and net income.
- Effective management of prepaid expenses is vital for accurate financial reporting and compliance with accounting standards.

Conclusion

Understanding how to account for prepaid insurance contracts like the one Sunland Co. entered into with Oriole Insurance Co. is fundamental for accurate financial reporting. The transaction exemplifies core accounting principles such as the matching principle and accrual basis. Proper recording, adjusting, and reporting ensure that the company's financial statements provide a true and fair view of its financial position and performance. Businesses engaging in similar transactions should adhere to best practices in documentation, periodic adjustments, and compliance to ensure transparency and accuracy in their financial reporting processes.

FAQs

1. How do you calculate the monthly insurance expense?

Divide the total insurance premium by the number of months in the coverage period. In this case, \$17,300 divided by 48 months equals approximately \$360.42 per month.

2. When is the insurance expense recognized?

The expense is recognized monthly as the insurance coverage is "used up," via adjusting entries that debit insurance expense and credit prepaid insurance.

3. What happens at the end of the insurance policy period?

The prepaid insurance asset account should be fully amortized, with all expenses recognized, and the remaining balance should be zero.

4. Can prepaid insurance be classified as a current asset?

Initially, yes. As the coverage extends beyond one year, a portion may be classified as a long-term asset until it is fully expensed.

By mastering the accounting treatment of prepaid insurance contracts like Sunland Co.'s transaction, businesses can ensure proper financial reporting, compliance, and insightful financial analysis.

Frequently Asked Questions

What is the accounting treatment for Sunland Co.'s payment of \$17,300 for a 4-year insurance contract on July 1, 2019?

Sunland Co. should record the \$17,300 as a prepaid insurance asset and amortize it over the 4-year period, recognizing insurance expense proportionally each period.

How does Sunland Co. record the initial journal entry for the insurance payment on July 1, 2019?

Debit Prepaid Insurance for \$17,300 and credit Cash for \$17,300 to reflect the payment for the 4-year insurance coverage.

What is the monthly insurance expense that Sunland Co. should recognize from this contract?

The monthly expense is \$17,300 divided by 48 months (4 years), which equals approximately \$360.42 per month.

When will Sunland Co. start recognizing insurance expense related to this contract?

Starting from July 1, 2019, Sunland Co. will begin amortizing the prepaid insurance over the 4-year term, recognizing monthly expenses accordingly.

How should Sunland Co. adjust its books at the end of each month?

Each month, Sunland Co. should debit Insurance Expense for approximately \$360.42 and credit Prepaid Insurance for the same amount to reflect the amortization.

What are the key financial statement impacts of this insurance contract for Sunland Co.?

Initially, assets increase due to prepaid insurance; over time, expenses increase as insurance expense is recognized, reducing net income and assets accordingly.

Are there any disclosures required for this insurance contract in Sunland Co.'s financial statements?

Yes, Sunland Co. should disclose the nature, amount, and amortization policy of prepaid insurance, along with the total amount of insurance expense recognized during the period.

Additional Resources

On July 1, 2019, Sunland Co. Pays \$17,300 To Oriole Insurance Co. For A 4-year Insurance Contract—a significant financial decision that reflects both strategic planning and risk management for the company. This transaction not only secures insurance coverage over a substantial period but also exemplifies how businesses approach long-term risk mitigation in an increasingly complex operational environment. In this detailed review, we will explore the implications of this insurance agreement, examine the contractual details, analyze the benefits and potential drawbacks, and discuss how such arrangements fit into broader corporate risk management strategies.

Understanding the Context of the Insurance Contract

Background of Sunland Co. and Oriole Insurance Co.

Sunland Co., a mid-sized manufacturing firm, operates in an industry where operational risks—ranging from property damage to liability claims—are prevalent. To safeguard its assets and ensure business continuity, the company chooses to invest in comprehensive insurance coverage.

Oriole Insurance Co., a reputable insurer known for tailored business policies, provides such coverage. Their offerings include property, liability, and specialized coverage suited for

manufacturing businesses, making them an attractive partner for Sunland.

The Significance of the July 1, 2019, Payment

Making a payment of \$17,300 on July 1, 2019, signifies a strategic move by Sunland to lock in a four-year insurance policy. This lump sum likely covers multiple types of coverage, possibly including property damage, liability, and business interruption, although specifics depend on the policy details.

Details of the Insurance Contract

Duration and Coverage Period

- Start Date: July 1, 2019
- End Date: June 30, 2023
- Total Duration: 4 years

This long-term contract provides stability and predictability in expense planning, shielding Sunland from potential premium increases or coverage gaps.

Premium Payment and Accounting Implications

Paying \$17,300 upfront suggests either a single premium payment or part of a payment plan. From an accounting perspective:

- The payment is likely recorded as a prepaid expense initially.
- Amortized over the coverage period, the expense is recognized gradually.
- This aligns with the matching principle, matching the expense with the period benefits.

Policy Features and Coverage Details

While the exact policy specifics are not provided, typical features of such a contract include:

- Property Insurance: Coverage against damages to physical assets.
- Liability Insurance: Protection against legal claims.
- Business Interruption: Compensation for income loss during covered perils.
- Additional Coverages: Equipment breakdown, cyber liability, etc.

The policy's flexibility and scope are crucial for tailoring coverage to Sunland's unique needs.

Financial and Strategic Implications

Advantages of Long-term Insurance Contracts

- Cost Stability: Locking in premiums prevents future increases.
- Budgeting Ease: Predictable expenses aid financial planning.
- Risk Management: Ensures continuous coverage without lapses.
- Potential Discounts: Longer commitments sometimes attract premium discounts or favorable terms.
- Reduced Administrative Burden: Fewer renewal negotiations over the period.

Potential Drawbacks

- Upfront Capital Outlay: Large initial payment may impact cash flow.
- Inflexibility: Changes in business size or risk profile may render some coverage less optimal.
- Premium Inefficiency: If coverage needs decrease or risks diminish, the company may overpay.
- Uncertain Future Needs: Long-term contracts may not adapt quickly to unforeseen circumstances.

Impact on Financial Statements

- Prepaid Expenses: The initial payment appears as a current asset.
- Expense Recognition: Progressive recognition over the policy period aligns with the matching principle.
- Impact on Profitability: Initial expenses may reduce net income, but benefits accrue over time.

Risk Management and Business Continuity

Mitigating Operational Risks

Having a comprehensive insurance policy helps Sunland manage risks associated with:

- Property damage from accidents or natural disasters.
- Liability claims from customers, vendors, or employees.
- Disruptions in production or supply chain interruptions.
- Cybersecurity breaches, if covered.

This proactive approach ensures that the company can recover swiftly from adverse events, maintaining stability and stakeholder confidence.

Insurance as a Strategic Tool

Beyond mere risk transfer, insurance can serve as a strategic asset:

- Enhancing credibility with lenders and investors.
- Enabling compliance with contractual or regulatory requirements.
- Supporting growth initiatives by reducing perceived risks.

Comparison with Industry Standards and Best Practices

Typical Insurance Spending for Similar Companies

- Industry benchmarks often suggest that manufacturing firms allocate 1-3% of revenue to insurance.
- A four-year commitment at \$17,300 indicates a moderate coverage level, possibly tailored for Sunland's specific risk profile.

Best Practices in Long-term Insurance Planning

- Regularly reviewing coverage to adapt to changing business conditions.
- Negotiating renewal terms to optimize coverage and costs.
- Balancing upfront payments with flexible payment plans to manage cash flow.

Critical Analysis of the Contract and Payment

Pros

- Financial Predictability: Fixed premium over four years simplifies budgeting.
- Risk Reduction: Continuous coverage minimizes exposure to uninsured risks.
- Potential Cost Savings: Longer-term policies sometimes come with discounts or favorable terms.
- Operational Stability: Ensures no coverage gaps during renewal periods.

Cons

- Cash Flow Impact: Large upfront payment could strain liquidity, especially if unexpected expenses arise.
- Inflexibility: Changes in business operations or insurance needs may necessitate policy adjustments, difficult to implement mid-term.
- Potential for Overcoverage: If business risks decrease, the company might pay for more coverage than necessary.
- Market Changes: Premium rates or coverage options could evolve, making the locked-in rate less competitive.

Features to Consider

- Renewal Conditions: Terms for renewing or modifying the policy after four years.
- Cancellation Policies: Conditions under which the policy can be canceled or modified.
- Coverage Limits and Deductibles: Clarify thresholds for claims and out-of-pocket expenses.
- Premium Adjustment Clauses: Whether premiums are fixed or subject to adjustments based on claims experience or market rates.

Conclusion: Evaluating the Long-term Investment in Insurance

The decision by Sunland Co. to pay \$17,300 for a four-year insurance contract with Oriole Insurance Co. reflects a strategic commitment to risk management and financial stability. While the upfront payment may seem significant, the benefits of long-term coverage—such as cost predictability, risk mitigation, and operational continuity—often outweigh the drawbacks, especially for a manufacturing business exposed to various operational hazards.

However, it is vital for Sunland to continuously assess its coverage needs, monitor policy terms, and remain prepared for changes in the business environment. Proper management and periodic review of the insurance arrangement will ensure that the company maximizes its investment, maintains adequate risk protection, and optimizes financial performance.

In summary, this insurance contract exemplifies prudent risk management aligned with strategic business planning. When executed thoughtfully, such long-term commitments can provide peace of mind, financial stability, and a competitive edge in managing operational risks effectively.

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