A One-year Insurance Policy Was Purchased On June 1 For $2,400. The Adjusting Entry On December 31 Would

A One-year Insurance Policy Was Purchased On June 1 For $2,400. The Adjusting Entry On December 31 Would be a crucial accounting step in ensuring that the company's financial statements accurately reflect its expenses and liabilities for the period. When a business purchases an insurance policy that covers a specified period, such as one year, it must recognize the expense gradually over that period rather than all at once. This process aligns with the matching principle in accounting, which states that expenses should be recognized in the same period as the revenues they help generate.

In this article, we will explore the details of such an insurance purchase, how to determine the appropriate adjusting entry at year-end, and the broader implications for financial reporting. Understanding these concepts is essential for accountants, business owners, and anyone involved in financial statement preparation.

Understanding the Purchase of a One-Year Insurance Policy

Details of the Purchase

When a company buys an insurance policy for one year at a cost of $2,400 on June 1, it is effectively paying for coverage that spans from June 1 through the following May 31. The total premium represents the insurance expense for the entire period, but since the coverage extends over multiple accounting periods, it cannot be fully expensed immediately.

The key points include:
- Purchase date: June 1
- Coverage period: June 1 to May 31 of the following year
- Total premium: $2,400
- Monthly expense: $2,400 / 12 months = $200

Understanding these details helps in determining how much of the insurance cost should be recognized as an expense at any given date, especially at the end of the current accounting period, December 31.

Initial Journal Entry at Purchase

When the insurance policy is purchased, the journal entry typically involves:
- Debiting Prepaid Insurance (an asset account)

- Crediting Cash or Accounts Payable

Example:
```plaintext
June 1
Debit: Prepaid Insurance $2,400
Credit: Cash $2,400
```

This entry reflects that the company has paid for coverage extending into future periods and, therefore, it is recorded as an asset until the coverage is used.

Importance of Adjusting Entries at Year-End

Why Adjustments Are Necessary

At December 31, which falls within the coverage period, the company must recognize the insurance expense incurred during the period. Since the prepaid amount initially recorded covers the entire year, only the portion used up to December 31 should be expensed.

Failure to make this adjustment would result in:
- Overstated assets (Prepaid Insurance)
- Understated expenses (Insurance Expense)
- Overstated net income

Therefore, adjusting entries are essential to accurately reflect the company's financial position.

Matching Principle in Practice

The matching principle guides the recognition of expenses in the period they are incurred, not necessarily when they are paid. Since the insurance policy spans multiple periods, the expense must be allocated proportionally over the coverage period.

Calculating the Insurance Expense for the Period

Determine the Coverage Period

From June 1 to December 31, there are 7 months:
- June, July, August, September, October, November, December

Calculate the Expense to Recognize

Given:
- Total premium: $2,400
- Monthly expense: $200
- Number of months to expense: 7

Calculation:
```plaintext
Insurance Expense = $200 x 7 months = $1,400
```

This amount represents the expense that should be recorded on December 31 to match the period's consumption of the prepaid insurance.

The Adjusting Entry on December 31

Journal Entry for Insurance Expense

To record the insurance expense incurred from June 1 to December 31, the company makes the following adjusting entry:

```plaintext
December 31
Debit: Insurance Expense $1,400
Credit: Prepaid Insurance $1,400
```

This entry reduces the asset account (Prepaid Insurance) and increases the expense account (Insurance Expense), reflecting the consumption of insurance coverage during the period.

Impact on Financial Statements

- Income Statement: The insurance expense increases by $1,400, decreasing net income.
- Balance Sheet: The Prepaid Insurance asset decreases by $1,400, reflecting the amount of coverage used.

Post-Adjustment Balances and Future Periods

Remaining Prepaid Insurance

After the December 31 adjustment, the remaining balance in Prepaid Insurance will be:

```plaintext
Original prepaid balance: $2,400
Less: Expensed amount: $1,400
Remaining balance: $1,000
```

This remaining $1,000 corresponds to the coverage from January 1 to May 31 of the following year.

Subsequent Adjustments

At the end of the next fiscal period, similar adjustments will be made to recognize the expense for coverage from January 1 to May 31.

Broader Implications for Financial Reporting

Accuracy and Compliance

Making correct adjusting entries ensures compliance with Generally Accepted Accounting Principles (GAAP) and provides accurate financial data for stakeholders.

Impact on Financial Ratios

Proper expense recognition affects key financial ratios, such as:
- Profitability ratios
- Asset turnover ratios
- Return on assets

Incorrect adjustments could mislead investors, creditors, and management.

Tax Considerations

Accurate expense recognition can also influence taxable income calculations, affecting the company's tax liabilities.

Summary and Best Practices

- Always record the initial purchase as a prepaid asset when the payment covers future periods.
- Calculate the expense proportionally based on the coverage period and time elapsed.
- Make timely adjusting entries at the end of each accounting period to reflect the used portion of prepaid expenses.
- Maintain detailed records to support the calculations and adjustments.
- Review policies regularly to ensure compliance with accounting standards.

Conclusion

The purchase of a one-year insurance policy for $2,400 on June 1 requires careful accounting treatment to ensure that expenses are properly matched to the period they relate to. The adjusting entry on December 31 involves recognizing the insurance expense for the seven months of coverage used up to that date, which amounts to $1,400. This process ensures that financial statements accurately reflect the company's financial position and performance, adhering to accounting principles and providing reliable data for decision-making.

Understanding and accurately executing such adjustments are fundamental skills for accountants and finance professionals, contributing to transparent and compliant financial reporting.

Frequently Asked Questions

What is the purpose of an adjusting entry for a one-year insurance policy purchased on June 1?

To recognize the insurance expense incurred during the accounting period and update the prepaid insurance asset to reflect the amount used up by December 31.

How do you calculate the insurance expense to be recognized by December 31 for a one-year policy purchased on June 1 for $2,400?

Calculate the monthly expense by dividing $2,400 by 12 months, which equals $200 per month. Then, multiply $200 by the number of months expired from June 1 to December 31 (7 months), resulting in $1,400.

What is the journal entry to record the insurance expense on December 31 for this policy?

Debit Insurance Expense for $1,400 and credit Prepaid Insurance for $1,400.

Why is an adjusting entry necessary at year-end for prepaid insurance?

To match the insurance expense to the period it relates to, ensuring accurate financial statements in accordance with the matching principle.

What is the remaining balance of prepaid insurance after the adjusting entry on December 31?

The remaining balance would be $1,000, representing the prepaid amount for the remaining months (January to May).

Would the adjusting entry on December 31 affect net income, and how?

Yes, increasing the insurance expense reduces net income, accurately reflecting the expenses incurred during the period.

If the policy was purchased on June 1 and the fiscal year ends on December 31, when should the insurance expense be recognized?

The expense should be recognized through an adjusting entry at year-end for the period from June 1 to December 31, totaling 7 months.

What is the importance of making the correct adjusting entry for prepaid insurance at year-end?

It ensures that the financial statements accurately represent expenses and assets, providing reliable information to stakeholders and complying with accounting standards.

Additional Resources

A one-year insurance policy was purchased on June 1 for $2,400. The adjusting entry on December 31 would play a crucial role in ensuring that the company's financial statements accurately reflect the expense incurred during the period. Understanding how to properly account for prepaid insurance and the necessary adjusting entries is fundamental for accurate financial reporting and compliance with accounting principles. In this comprehensive guide, we will explore the nature of such transactions, why adjusting entries are necessary, and step-by-step procedures to record them correctly.

Understanding the Context: Purchasing a One-Year Insurance Policy

When a business purchases an insurance policy that provides coverage over a specified period—say, one year—it records the transaction as a prepaid expense at the time of purchase. This is because the benefit (insurance coverage) extends beyond the current accounting period.

Key Details:
- Purchase Date: June 1
- Policy Duration: 12 months
- Total Cost: $2,400
- Cost per Month: $2,400 ÷ 12 = $200

The initial journal entry on June 1 would typically be:

Debit: Prepaid Insurance $2,400
Credit: Cash $2,400

This entry reflects that the company has paid for insurance coverage that applies over the upcoming year, but the expense is not immediately recognized.

The Need for Adjusting Entries

At the end of the accounting period—December 31 in this case—it's important to recognize the portion of the insurance coverage that has expired during the period. Since the company paid for 12 months of coverage upfront, but only a part of that coverage applies to the current fiscal year, an adjusting entry is necessary.

Why Adjust?
- Accurate Expense Recognition: To match expenses with the revenues they help generate, following the Matching Principle.
- Proper Financial Statements: To reflect current liabilities and assets accurately.
- Compliance: To adhere to Generally Accepted Accounting Principles (GAAP).

Timeline of the Insurance Coverage

Let’s map out the coverage period:

Coverage Period	Dates	Months Covered	Expense Recognition Period
Start	June 1, 2023	June – December	7 months (June to December)
End	May 31, 2024	January – May	Remaining months after December

Since the policy was purchased on June 1, 2023, and the adjustment occurs as of December 31, 2023, the company has consumed 7 months of the coverage:

- June, July, August, September, October, November, December

Calculating the Insurance Expense for the Period

To determine the amount of insurance expense to recognize on December 31, 2023:

- Monthly Insurance Expense: $200
- Months Expired (June–December): 7 months

Total Insurance Expense for 7 months:
$200 x 7 = $1,400

This amount reflects the insurance expense that the company has "used up" during the period from June 1 to December 31.

Recording the Adjusting Entry on December 31

Step-by-Step Process:

1. Identify the Expense to Recognize:
The $1,400 worth of insurance coverage has expired and should be recognized as an expense.

2. Determine the Remaining Prepaid Insurance:
Original prepaid amount: $2,400
Less expired amount: $1,400
Remaining prepaid insurance (asset): $1,000

3. Journal Entry:

Debit: Insurance Expense $1,400
Credit: Prepaid Insurance $1,400

This entry reduces the asset account (Prepaid Insurance) and recognizes the expense in the current period.

Implications for Financial Statements

Income Statement:
- Increase in Insurance Expense: $1,400
- Result: Net income decreases by this amount, reflecting the expense incurred during the period.

Balance Sheet:
- Prepaid Insurance (Asset): Now shows $1,000 (remaining coverage)
- No change in liabilities

This adjustment ensures that the company's assets and expenses are accurately reported, aligning with the accrual basis of accounting.

Additional Considerations

Timing and Frequency of Adjusting Entries:
- Adjusting entries are typically made at the end of each accounting period—monthly, quarterly, or annually—depending on the company's reporting schedule.

Other Similar Transactions:
- Prepaid rent, supplies, or service contracts often require similar adjustments.

Impact of Errors:
- Failing to record proper adjustments can lead to overstated assets or understated expenses, affecting profitability and financial position.

Summary: Key Takeaways

- When purchasing a one-year insurance policy, record the initial payment as a prepaid expense.
- At period-end, recognize the portion of insurance coverage that has expired by making an adjusting journal entry.
- The adjusting entry on December 31 for this scenario involves debiting Insurance Expense and crediting Prepaid Insurance for $1,400.
- Proper adjustments ensure accurate financial statements and adherence to accounting principles.

Final Thoughts

Understanding how to handle insurance policies and other prepaid expenses is essential for maintaining accurate and compliant financial records. The process involves recognizing the initial payment as an asset and then systematically allocating the expense over the coverage period through adjusting entries. This disciplined approach not only upholds accounting standards but also provides stakeholders with a true picture of the company's financial health.

Remember: Regularly reviewing and adjusting prepaid expenses like insurance ensures your financial statements reflect the true economic activity of your business, facilitating better decision-making and reporting accuracy.

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400 The Adjusting Entry On December 31 Would

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