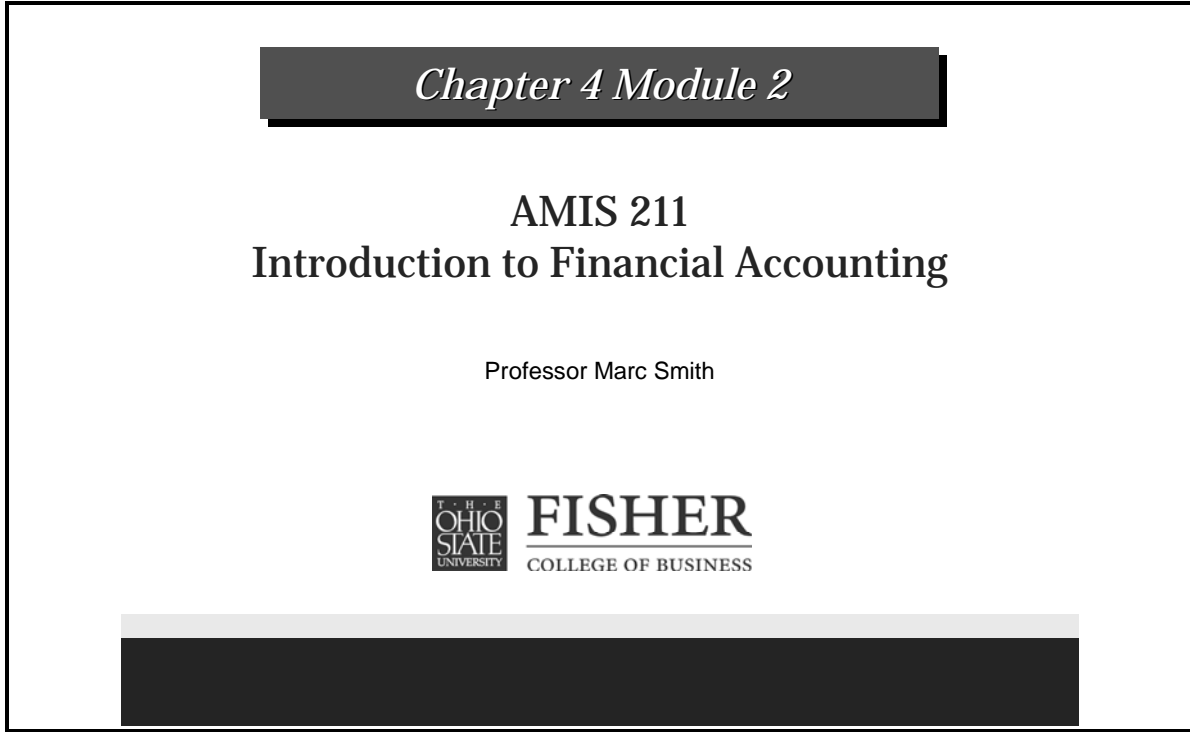


Chapter 4, Module 2


Slide 1

A rectangular box with a black border containing the slide content. At the top, a dark grey horizontal bar contains the text "Chapter 4 Module 2" in a white, italicized serif font. Below this, the text "AMIS 211" and "Introduction to Financial Accounting" is centered in a black serif font. Underneath, "Professor Marc Smith" is centered in a smaller black serif font. The Fisher College of Business logo is centered below that, featuring a square with "T · H · E" above "OHIO STATE UNIVERSITY" and "FISHER" above "COLLEGE OF BUSINESS" to its right. At the bottom of the box, there are two horizontal bars: a light grey one on top and a dark grey one below it.

Chapter 4 Module 2

AMIS 211
Introduction to Financial Accounting

Professor Marc Smith

The logo for Fisher College of Business at Ohio State University, consisting of a square with "T · H · E" above "OHIO STATE UNIVERSITY" and "FISHER" above "COLLEGE OF BUSINESS" to its right.

Hi everyone. Welcome back.

Now that we know what Deferrals and Accruals are; and what Adjusting Entries are; let's go ahead and let's look at some specific examples of these items.

Let's go ahead and get started.

And, let's go to the next slide.

Slide 2

Chapter 4 Module 2: Deferred Expenses

Deferrals

**transactions for which cash has been received or paid while the related revenue or expense has not been recorded
(exchange of cash has occurred before the action)**

Deferred Expenses (Prepaid Expenses)

Company pays for an expense item in advance.

This pre-payment is recorded as an *asset*.

It only becomes an expense when the asset ...
is 'used up'.

Examples:

Prepaid Insurance, Prepaid Rent, Supplies

And, let's start with Deferrals.

Remember what Deferrals were: Transactions where the exchange of cash occurs before we record any Revenue or Expense.

A good way of thinking about it:

A Deferral is a transaction where the exchange of cash happens prior to the action—the action, of course, being the recording of the Revenue or the Expense.

Now, in this particular module I want to go ahead and let's talk about Deferred Expenses. You will often hear these things called Prepaid Expenses.

They mean the same thing: Deferred Expenses = Prepaid Expenses.

What these things are: are when the company pays for an Expense item in advance—when a company goes out and pays for an Expense item prior to using it up.

The company pays for the Expense item in advance. The key point; this is something that is worth highlighting, starring, circling, whatever you need to do to remember it:

These prepayments are recorded as Assets.

Even though they are being prepaid for an Expense item—the prepayment is recorded as an Asset.

Now, what the company does, it records it as an Expense only when the Asset is—and this is sort of a buzz-phrase; you want to be comfortable with this. The company records it as an Expense ONLY when the Asset is actually used up.

Let's kind-of go through that one more time.

A Prepaid or Deferred Expense is a situation where the company pays for an Expense item in advance. That prepayment is recorded as an Asset on the Balance Sheet. It only becomes an Expense when that Asset gets used up.

Several examples of Prepaid Expenses:

The examples that we will focus on include:

Prepaid Insurance: You do not call up the insurance company every day and say: "I would like to be insured today please." You say, "I would like to buy a one-year or a two-year or maybe even a three-year insurance policy." And, you pay for it in advance and use it up over time.

Another good example: Prepaid Rent.

Another good example: Supplies.

All three of these are Assets until used up.

Let's go to the next slide.

Slide 3

Chapter 4 Module 2: Deferred Expenses

Adjusting entries for deferred (prepaid) expenses are required to record the portion of the prepayment representing the expense incurred which is the amount of the asset used up.

The adjusting entry results in a debit to an expense account and a credit to an asset account.

Asset		→	Expense	
Unadjusted Balance	Credit Adjusting Entry (↓)		Debit Adjusting Entry (↑)	

And this is also an important slide, here.

Remember, we are dealing with Deferred or Prepaid Expenses.

You need an Adjusting Entry when you use up the Asset. You need to record that fact that the using up of this Asset has turned into an Expense.

So, the Adjusting Entry that we are going to make will always be a debit to an Expense account and a credit to an Asset account.

We will debit the Expense account to record it. We now have an Expense that has been incurred.

We credit the Asset to reduce it. We have used up some of that Asset. It no longer exists.

And, you can see here with the T-Accounts on this slide (Slide 3) how this works.

You have the Asset and you have the Unadjusted Balance—what is there on the debit side—the amount of the Asset not yet used.

As it gets used up, we make an Adjusting Entry. We move it out of the Asset account; we reduce the Asset. And, we move it into an Expense account. We record our Expense.

So, you debit the Expense to increase it. You credit the Asset to reduce it.

I think the first two slides here were awfully crucial to you.

You will want to make sure you are comfortable with those key concepts.

Let's go to the next slide.

Slide 4

<i>Chapter 4 Module 2: Example #1</i>						
Case A:						
May 1, 1999						
Prepaid Insurance	24,000					
Cash	24,000					
Prepaid Insurance	=	Asset				
Cash	=	Asset				
<u>Rev</u>	-	<u>Exp</u>	=	<u>NI</u>	A	=
NE		NE		NE	NE	=
					L	+
					NE	E
					NE	NE

And, let's take a look at Example #1 from the Web site problems.

So, make sure you have that in front of you.

Example # 1 says this:

“Hey look, here is a whole bunch of different cases that we are going to deal with. For each case, let’s make the necessary Adjusting Journal Entry (AJE) and let’s analyze the effects of that Adjustment on our financial statement accounts”—just like we saw in the last chapter where we analyzed effects of transactions on the Income Statement and Balance Sheet.

And, let’s start with Case A: Prepaid Insurance.

Here is what it says:

“On May 1st 1999, M.T. Glass purchased a two-year insurance policy for \$24,000.”

Let’s start.

Before we even worry about any Adjusting entries, let’s just make the regular old Entry on May the 1st to reflect the fact that we have now purchased a two-year insurance policy.

In this case, we are going to debit our account: Prepaid Insurance. We now have insurance that has been prepaid for a couple of years.

So, we will debit our Prepaid Insurance and we will credit: Cash. Cash has left us, right? We had to pay the \$24,000 to the Insurance Company.

Now, tell me: What kind of account is Prepaid Insurance?

You should be able to tell me. It is an Asset, right. Prepaid Insurance is an Asset. This prepayment is recorded as an Asset until it is used up.

Of course, we should know this: Cash is also an Asset.

So, we debit the Prepaid Insurance and credit the Cash.

And, now, we want to analyze the effects of that transaction on our financial statements.

This is why we identify the account types in red here on the slide (Slide 4). This is what makes it easy to analyze the effects.

You have two Assets—one is going up; one going down.

So, overall, there is No Effect (NE) on any of the accounting elements.

All you have are two different Asset accounts—one going up and one going down by the same \$24,000.

The overall effect on Assets is nothing. And, nothing else is impacted.

Very good.

Let's go ahead to the next slide.

Slide 5

<i>Chapter 4 Module 2: Example #1</i>	
Case A:	
Question:	Do we need an adjusting entry at December 31, 1999 related to the prepaid insurance?
Answer:	Yes
Question:	Why?
Answer:	Because some of the prepaid insurance has been 'used up' and must be recorded as an expense.

And, I have a question for you—I have a question I would like you to think about before I give you the answer.

Do we need an Adjusting Entry at December 31st, 1999 related to this Prepaid Insurance?

Is it: yes or no?

My guess is that most—if not all—of you said: “Yes.”

Yes. We most certainly need one. It is in the Adjusting Entries chapter, right, so obviously we need it.

Okay. Well, then, the next question is: Why?

What has happened to cause us to need an Adjusting Entry?

The answer is: we have used up some of the prepaid insurance. From May until December, we have used up some of that prepaid insurance.

And, when we use up some of an Asset—Prepaid Insurance is an Asset—when we use up some of that Asset, it becomes an Expense.

So, we need an Adjusting Entry to reflect that.

Let's go to the next slide.

Slide 6

Chapter 4 Module 2: Example #1

Case A:

Prepaid Insurance Used Up:

$$\mathbf{\$24,000 \div 24 = \$1,000 \text{ used up per month}}$$

$$\mathbf{\text{In 1999} \rightarrow \$1,000 \times 8 \text{ months} = \$8,000 \text{ used up}}$$

And, let's figure out how much of the Prepaid Insurance has been used up.

Here is what we know:

We purchased a two-year policy for \$24,000.

Let's take the \$24,000; divide by (/) 24—there are 12 months in each year—so if you divide (/) that tells us how much we have used up per month—two years is 24 total months.

We are using up \$1,000 per month of this insurance policy.

Now, count...

This is something I would like to see everybody doing at the Exam. Put your hands in the air and fingers in the air and then count your months. This is the one way to guarantee no mistakes.

1) May-2) June-3) July-4) August-5) September-6) October-7) November-8) December: if you counted with me, you should have counted eight (8) months—eight (8) fingers in the air.

Be careful which finger you start with.

Eight (8) fingers in the air—eight (8) months used up—a total of \$8,000 used. (1000 bucks (\$1,000) a month—for eight (8) months).

Now that we know that; let's go to the next slide.

Slide 7

<i>Chapter 4 Module 2: Example #1</i>						
Case A:						
December 31, 1999 (AJE)						
Insurance Expense						8,000
	Prepaid Insurance					8,000
Insurance Expense	=	Expense				
Prepaid Insurance	=	Asset				
<u>Rev</u>	-	<u>Exp</u>	=	<u>NI</u>	A	=
NE		↑8,000		↓8,000	↓8,000	NE
						+ E
						↓8,000

And, let's make our Adjusting Entry. It is made at the end of the Accounting Year. And, I have labeled it: AJE: Adjusting Journal Entry.

It is made at the Year-End on December 31st, 1999.

We have used up some of the Asset—some of the Prepaid Insurance.

Think back to a couple of slides ago.

What are the debit and the credit always going to be?

We are always going to debit an Expense account. We have used up Prepaid Insurance so that is going to become Insurance Expense.

And, we credit the Asset account—the Prepaid Insurance—to reduce it; to reflect the fact that we don't have the full \$24,000 because \$8,000 has been used up.

I just said a second ago that Insurance Expense is an Expense account.

We should know that Prepaid Insurance is an Asset account.

So, to figure out the effects on our financial statements:

We have an Expense here.

Expense is going up. That causes Net Income to go down. But, when Net Income goes down, so does Equity—specifically Retained Earnings. So, just get into the habit of taking the effect on Net Income over to Equity.

To balance out the Balance Sheet, we also see that our Assets have decreased. We do not have \$8,000 of the Prepaid Insurance. It was (quote/unquote) “used up.”

Go to the next slide with me.

Slide 8

Chapter 4 Module 2: Example #1

Case A:

Question: What would be the amount of prepaid insurance appearing on the December 31, 1999 balance sheet?

Answer: \$16,000 [24,000 – 8,000]
The asset represents the unused portion of the prepayment

And, I have another question for you.

M.T. Glass—this company that had purchased the prepaid insurance:

How much would appear as Prepaid Insurance on their Year-End Balance Sheet at December 31st, 1999?

Before you answer that for me, here is just a real quick aside:

Have you gotten the joke yet? The M.T. Glass? The Empty Glass? Yeah, yeah, whatever...anyway, it is an Accountant kind of joke.

In any event, let's go back to our question.

How much would appear as Prepaid Insurance on M.T. Glass's Year-End 1999 Balance Sheet?

The answer is: \$16,000.

Remember, on May 1st, we paid \$24,000 for a policy. But, by the end of the year (1999), we had used up \$8,000 that was transferred out of the Asset into the Expense, leaving us with \$16,000.

This Prepaid Insurance—this Asset—that reflects the unused portion of the Asset—the portion of the Asset we have not yet used up—the portion of that prepayment that still remains on the Balance Sheet—that is going to be used at a future point in time.

Very good.

Let's go to our next slide.

Slide 9

Chapter 4 Module 2: Example #1

Case A:

December 31, 2000 (AJE)

Insurance Expense	12,000	
 Prepaid Insurance		12,000

In 2000 → \$1,000 x 12 months = \$12,000 used up

- **Prepaid insurance on the December 31, 2000 balance sheet is equal to \$4,000 (the unused portion as of that date).**
- **\$16,000 (from last year) - \$12,000 (used up in 2000) = above)**

And, here is a final question as it relates to Case A:

M.T. Glass: Will they need another Adjusting Entry at the end of the next year? Will they need an Adjusting Entry at the end of December 2000?

The answer is: Yes, of course! They have used up more of the prepaid insurance.

So, the Adjusting Entry (AJE) is going to look like this: debit Insurance Expense for the expense and credit: Prepaid Insurance to reduce the Asset. This time, reduce it by \$12,000.

The reason being: in the Year 2000, we used up twelve (12) months from January through December, using up \$1,000 a month. The total used is \$12,000.

We, of course, know that the Prepaid Insurance represents the unused portion of that prepayment. So, as of December 31st, 2000, the amount of Prepaid Insurance we still have—the unused portion of that original prepayment is: \$4,000.

We figured that out.

We had \$16,000 from last year. See the previous slide (Slide 8). Minus (-) what was used up this year—the \$12,000. This leaves us with \$4,000 unused—still an Asset—and will get used up in the next year (2001).