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Introduction to Financial Accounting

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Preface

The introduction of financial accounting' explores the basic ideas of financial accounting: the way accounting actually works, the logic behind the double-entry recording system, and the contents of the basic financial statements (balance sheet, income statement, and cash flow statement). The following questions are addressed: What does a balance sheet try to show? Why does it balance? How is it that any one transaction has two accounting effects? Which costs lead to assets and which lead to expenses? How do cash flows fit in? How can a profitable company go bust because of a lack of cash?

This book introduces the students to the accounting principles, the accounting cycle including the accounting adjustments, accounting for long-term assets and closing the accounts. Each chapter ends with a list of key-terms that have been discussed in the chapter, as well as, solved questions and self-evaluation exercises.

This book reflects the efforts of the authors and the reviewer. In spite of the significant effort that has been expended by many individuals on this book, it is safe to say that some errors exist. In an attempt to create the most error-free and useful book possible, I strongly encourage both instructors and students to write or email me at t.hassaneen@foc.cu.edu.eg with comments and suggestions for improving the book. I certainly welcome your input.

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Brief Contents

CHAPTER ONE

Overview of Financial Accounting

Learning Objectives

After studying this chapter, you should be able to:

1. Explain what Accounting is.
2. Identify the types of business organizations.
3. Identify the users of Accounting Information.
4. Understand why ethical considerations are important to accounting.
5. Explain Generally Accepted Accounting Principles (GAAP).

1. What is Accounting?

Accounting is an information system. It measures business activities, processes data into reports, and communicates results to people. Accounting is "the language of business." The better you understand the language, the better you can manage your finances.

Accounting consists of three basic activities - it **identifies**, **records**, and **communicates** the economic events (transactions) of an organization to **interested users**.

As a starting point to the accounting process, a company **identifies** the **economic events relevant to its business**. To **identify** economic events, a company selects the economic events relevant to its business. Examples of economic events are the sales transactions by a business organization (for example a company), and payment of wages and salaries to its employees. Once the company identifies economic events, it **records** those events in order to provide a history of its financial activities. Finally, the company **communicates** the collected information to interested users by means of accounting reports. The most common of these reports are called **financial statements**.

Accounting produces **financial statements**, which report information about a business entity. The financial statements measure performance and tell where a business stands in financial terms.

THE ACCOUNTING PROCESS

Identification	→	Recording	→	Communication
Select economic events (transactions)		Record, classify, and summarize		Prepare financial statements

You should understand that the accounting process **includes** the bookkeeping function. **Bookkeeping** usually involves **only** the recording of economic events. It is therefore just one part of the accounting process. In total, accounting involves **the entire process of identifying**, **recording**, **and communicating economic events.**

2. Organizing a Business

Business organizations are **designed to earn** a **return** (profit) on investment for equity investors (owners), operate in a competitive market, and face liquidity concerns. Accounting for Profit-Oriented Enterprises is referred to as ***Financial Accounting***.

A **business organization** can take one of several forms:

- **Proprietorship**
- **Partnership**
- **Corporation**

Proprietorship

A **proprietorship** has a single owner, called the proprietor. For example, Dell Computer started out in the dorm room of Michael Dell, the owner. Proprietorships tend to be small retail stores or a professional service—a physician, an attorney, or an accountant. Legally, the business *is* the proprietor, and the proprietor is personally liable for all the business's debts. But for accounting, a proprietorship is distinct from its proprietor. Thus, the business records do not include the proprietor's personal finances.

Partnership

A **partnership** has two or more persons as co-owners, and each owner is a **partner**. Many retail establishments and some professional organizations are partnerships. Most partnerships are small or medium-sized, but some are gigantic, with 2,000 or more partners. Like proprietorships, the law views a partnership as the partners.

The business is its partners. For this reason, each partner is personally liable for all the partnership's debts. Partnerships are therefore quite risky. This unlimited liability of partners has spawned the creation of limited-liability partnerships (LLPs). A *limited-liability partnership* is one in which a wayward partner cannot create a large liability for the other partners. Therefore, each partner is liable only for his or her own actions and those under his or her control.

Corporation

A **corporation** is a business owned by the **stockholders**, or **shareholders**. These people own **stocks**, which represent shares of ownership in a corporation. Even though proprietorships and partnerships are more numerous, corporations transact much more business and are larger in terms of assets, income, and number of employees. Most well-known companies, such as IBM, Yahoo!, and Dell Computer, are corporations. Their full names include *Corporation* or *Incorporated* (abbreviated *Corp.* and *Inc.*) to indicate that they are corporations—for example, Starbucks Corporation. Some bear the name *Company*, such as Ford Motor Company.

A corporation is formed under state law. Unlike proprietorships and partnerships, a corporation is legally distinct from its owners. The corporation is like an artificial person and possesses many of the rights that a person has. The stockholders have no personal obligation for the corporation's debts. So we say the stockholders have limited liability. Also unlike the other forms of organization, a corporation pays a business income tax.

Ultimate control of a corporation rests with the stockholders, who get 1 vote for each share of stock they own. Stockholders elect the **board of directors**, which sets policy and appoints officers. The board elects a chairperson, who holds the most power in the corporation and often carries the title chief executive officer (CEO). The board also appoints the president as Chief Operating Officer (COO). Corporations have vice presidents in charge of sales, accounting and finance, and other key areas.

Business transactions

Business transactions are a business's economic events recorded by accountants. Transactions may be external or internal. External transactions involve economic events between the company and some outside enterprise. For example, a company's purchases of goods and equipment from a supplier, payments of monthly rent to the landlord, and sale of the company's products to customers are external transactions. Internal transactions are economic events that occur entirely within one company.

3. Who Uses Accounting Information?

Decision makers need information, the information that a user of financial information needs depends upon the kinds of decisions the user makes. There are two broad groups of users of financial information: internal and external users.

Internal users

Internal users of accounting information are those individuals inside a company who plan, organize, and run the business. These include marketing managers, production supervisors, finance directors, and company officers. In running a business, internal users must answer many important questions, such as:

- Is cash sufficient to pay the company's debts and obligations?
- What is the cost of manufacturing each unit of product?
- Can we afford to give employees pay raises this year?
- Which product line is the most profitable?

To answer these and other questions, internal users need detailed information on timely bases. **Management accounting** provides internal reports to help users make decisions about their companies.

External users

External users are individuals and organizations outside a company who want financial information about the company. The two most common types of external users are investors and creditors who provide the money to finance the company. **Investors** (owners) use accounting information to make decisions to buy, hold, or sell ownership shares of a company. Investors want to know how much income they can expect to earn on an investment. This requires accounting data. **Creditors** (such as suppliers and bankers) use accounting information to evaluate the risks of granting credit or lending money (for example, A banker decides who gets a loan).

Also, **Taxing authorities** want to know whether the company complies with tax laws. **Regulatory agencies**, such as Egyptian Stock Exchange Authority (EGX), want to know whether the company is operating within prescribed rules. External users must answer many important questions, such as:

- Is the company earning satisfactory income?
- Will the company be able to pay its debts as they come due?

- How does the company compare in size and profitability with its competitors?

Financial accounting answers these questions. It provides economic and financial information for investors, creditors, and other external users.

In brief, since there are *external users* and *internal users* of accounting information. We can therefore classify accounting into **two** branches:

- **Financial accounting:** provides information for people outside the firm, such as investors, bankers, government agencies, and the public. This information must meet standards of relevance and reliability.

- **Management accounting:** generates inside information for the managers of the companies. Management information doesn't have to meet external standards of reliability because only company employees use these data.

4. Ethics in Financial Reporting

In recent years, the financial press has been full of articles about financial scandals at Enron, WorldCom, HealthSouth, AIG, and other companies. As the scandals came to light, mistrust of financial reporting in general grew. Ethical considerations are important to accounting. Companies need money to operate. To attract investors, companies must provide information to the public. Without that information, people won't invest. The United States has laws that require companies to report ***<u>relevant</u>*** and ***<u>reliable</u>*** information to outsiders. ***Relevant*** means "able to affect a decision." ***Reliable*** means "verifiable and free of error and bias."

5. Explain Accounting Concepts, Principles and Assumptions

Generally Accepted Accounting Principles

The accounting profession has developed standards that are generally accepted and universally practiced. This common set of standards is called **generally accepted accounting principles (GAAP)**. These standards indicate how to report economic events. Accountants follow these professional guidelines (**GAAP)** to meet the primary objective of financial reporting, which is to provide information useful for making investment and credit decisions.

Egyptian Accounting Standards (EAS) are developed by the Standards Committee of the Egyptian Society of Accountants and Auditors. A committee headed by the Minister of Investment reviews, approves, and issues the standards. The EASs comply with IFRSs, in all material respects, except in certain EASs where the differences are significant mainly due to the applicable Egyptian laws and regulations. Recently, the Minister of Investment Decree No. 110 of 2015 issued on 07/07/2015 issued the new Egyptian accounting standards, which the third article of this law is effective from January 1, 2016, and its application to establishments whose financial year begins on or after this date.

The Historical Cost Principle

One important accounting principle is the cost principle. The **cost principle** states that assets and services should be recorded at their actual ***historical cost***. This is true not only at the time the asset is purchased, but also over the time the asset is held. For example, if a company purchases land for L.E50, 000, the company initially reports it in its accounting records at L.E50, 000. But what does the company do if, by the end of the next year, the land has increased in value to L.E60,000. Under the cost principle it continues to report the land at L.E50, 000.

The Economic Entity assumption

The most basic accounting concept is the **entity**, which is any organization that stands part as a separate economic unit. Sharp boundaries are drawn around each entity so as not to confuse its affairs with those of others.

An economic entity can be any organization or unit in society. It may be a company (as Microsoft, Inc.), a governmental unit, or a school district. The economic entity assumption requires that the activities of the entity be kept separate and distinct from the activities of its owner and all other economic entities.

The Reliability Principle

To ensure relevance and reliability, accounting records are based on the most objective data available. This is the **reliability principle**, also called the **objectivity principle**. Ideally, accounting records are based on information supported by objective evidence. For example, your purchase of a pizza is supported by a paid receipt, which gives objective evidence of the cost of the pizza, say L.E50. Without the reliability principle, accounting records would be based on opinions and subject to dispute.

The Going-Concern Assumption

The **going-concern concept** assumes that the entity will remain in operation long enough to use existing assets—land, buildings, supplies—for their intended purpose. Consider the alternative to the going-concern concept: going out of business. A store that is going out of business sells all its assets. In that case, the relevant measure of the assets is their current market value. But going out of business is the exception rather than the rule, and so accounting lists a going concern's assets at their historical cost.

The Stable-Monetary-Unit Assumption

The monetary unit assumption requires that companies include in the accounting records only transaction data that can be expressed in money terms. In Egypt, we record transactions in pounds because that is our medium of exchange. British accountants record transactions in pounds sterling, Japanese in yen, and Europeans in euros. This assumption enables accounting to quantify (measure) economic events.

Unlike a liter or a mile, the value of a pound changes over time. A rise in the general price level is called *inflation*. During inflation, a pound will purchase less food, less toothpaste, and less of other goods and services. When prices are stable—there is little inflation—a pound's purchasing power is also stable.

Under the **stable-monetary-unit concept**, accountants assume that the pound's purchasing power is stable. We ignore inflation, and this allows us to add and subtract amounts as though each pound has the same purchasing power.

Summary of Learning Objectives

1. **Explain what accounting is.** Accounting is an information system that identifies, records, and communicates the economic events of an organization to interested users.
2. **Identify the users and uses of accounting.** The major users and uses of accounting are as follows. (a) Management uses accounting information to plan, organize, and run the business. (b) Investors (owners) decide whether to buy, hold, or sell their financial interests on the basis of accounting data. (c) Creditors (suppliers and bankers) evaluate the risks of granting credit or lending money on the basis of accounting information. Other groups that use accounting information are taxing authorities, regulatory agencies, customers, and labour unions.
3. **Understand why ethics is a fundamental business concept.** Ethics are the standards of conduct by which actions are judged as right or wrong. Effective financial reporting depends on sound ethical behaviour.
4. **Explain the monetary unit assumption and the economic entity assumption.** The monetary unit assumption requires that companies include in the accounting records only transaction data that can be expressed in terms of money. The economic entity assumption requires that the activities of each economic entity be kept separate from the activities of its owner(s) and other economic entities.

Key Terms

- **Accounting (المحاسبة):** The information system that identifies, records, and communicates the economic events (transactions) of an organization to interested users.
- **Business organizations (المنظمات الهادفة للربح)**: The profit oriented organizations that designed to earn a return (profit) on investment for equity investors (owners), operate in a competitive market, and face liquidity concerns.
- **Business transactions (العمليات المالية)**: are a business's economic events recorded by accountants. Transactions may be external or internal
- **Corporation (شركة المساهمة):** A business organized as a separate legal entity under state corporation law, having ownership divided into transferable shares of stock.
- **Drawings (المسحوبات):** Withdrawal of cash or other assets from an unincorporated business for the personal use of the owner(s).
- **Economic entity assumption :(فرض الوحدة المحاسبية)** An assumption that requires that the activities of the entity be kept separate and distinct from the activities of its owner and all other economic entities.
- **Ethics (أخلاقيات المهنة):** The standards of conduct by which one's actions are judged as right or wrong, honest or dishonest, fair or not fair.
- **External users of financial information (المستخدمين الخارجيين للمعلومات المحاسبية)**: are individuals and organizations outside a company who want financial information about the company. The two most common types of external users are investors and creditors.

- **Financial accounting (المحاسبة المالية):** The field of accounting that provides economic and financial information for investors, creditors, and other external users.
- **Financial Accounting Standards Board (FASB):(مجلس معايير المحاسبة المالية)** A private organization that establishes generally accepted accounting principles in the United States (GAAP).
- **Generally Accepted Accounting Principles (GAAP)(المبادئ المحاسبية المتعارف عليها) :** Common standards that indicate how to report economic events.
- **Historical cost principle (مبدأ التكلفة التاريخية) :**An accounting principle that states that companies should record assets at their cost.
- **Internal users of accounting information (المستخدمين الداخليين للمعلومات المحاسبية)** : are those individuals inside a company who plan, organize, and run the business. These include marketing managers, production supervisors, finance directors, and company officers.
- **International Accounting Standards Board (IASB) (مجلس معايير المحاسبة الدولية):** An accounting standard-setting body that issues standards adopted by many countries outside of the United States.
- **International Financial Reporting Standards (IFRS) (معايير التقرير المالي الدولية):** International accounting standards set by the International Accounting Standards Board (IASB).
- **Managerial accounting (المحاسبة الإدارية) :**The field of accounting that provides internal reports to help users make decisions about their companies.
- **Monetary unit assumption (فرض الوحدة النقدية) :**An assumption stating that companies include in the accounting records only transaction data that can be expressed in terms of money.

- **Partnership (شركة التضامن) :**A business owned by two or more persons associated as partners.
- **Proprietorship (المشروع الفردي) :**A business owned by one person.
- **Sarbanes-Oxley Act (SOX) (قانون ساربينز-أوكسلي)** Law passed by Congress intended to reduce unethical corporate behaviour.
- **Securities and Exchange Commission (SEC) هيئة الرقابة على تداول الأوراق المالية بالولايات المتحدة الأمريكية) :**A governmental agency that oversees U.S. financial markets and accounting standard-setting bodies.

End of Chapter Questions

Question (1):

1. "Accounting is ingrained in our society and it is vital to our economic system." Do you agree? Explain.
2. Identify and describe the steps in the accounting process.
3. (a) Who are internal users of accounting data? (b) How does accounting provide relevant data to these users?
4. What uses of financial accounting information are made by (a) investors and (b) creditors?
5. What is the monetary unit assumption?
6. What is the economic entity assumption?
7. What are the three basic forms of business organizations for profit-oriented enterprises?

Question (2): Select the best answer for each of the following statements:

1. Which of the following is **not** a step in the accounting process?

(a) Identification. **(c)** Recording.

(b) Verification. **(d)** Communication.

2. Which of the following statements about users of accounting information is **incorrect**?

(a) Management is an internal user.

(b) Taxing authorities are external users.

(c) Present creditors are external users.

(d) Regulatory authorities are internal users.

3. The historical cost principle states that:

(a) Assets should be initially recorded at cost and adjusted when the fair value changes.

(b) Activities of an entity are to be kept separate and distinct from its owner.

(c) Assets should be recorded at their cost.

(d) Only transaction data capable of being expressed in terms of money be included in the accounting records.

4. Which of the following statements about basic assumptions is **correct**?

(a) Basic assumptions are the same as accounting principles.

(b) The economic entity assumption states that there should be a particular unit of accountability.

(c) The monetary unit assumption enables accounting to measure employee morale.

(d) Partnerships are not economic entities.

5. The three types of business entities are:

(a) Proprietorships, small businesses, and partnerships.

(b) Proprietorships, partnerships, and corporations.

(c) Proprietorships, partnerships, and large businesses.

(d) Financial, manufacturing, and service companies.

6. All of the following statements are true except one. Which statement is false?

(a) A proprietorship is a business with several owners.

(b) Professional accountants are held to a high standard of ethical conduct.

(c) The organization that formulates generally accepted accounting principles is the Financial Accounting Standards Board.

7. The valuation of assets on the balance sheet is generally based on:

(a) Historical cost.

(b) What it would cost to replace the asset.

(c) Current fair market value as established by independent appraisers.

(d) Selling price.

CHAPTER TWO

The Accounting Equation and Introduction to Financial Statements

Learning Objectives

After studying this chapter, you should be able to:

1. Apply the accounting equation to business organizations.
2. Differentiate between assets, liabilities and owner's equity.
3. Analyse the effects of business transaction on the accounting equations.
4. Understand the basic financial statements and how they are prepared.

1. The Basic Accounting Equation

The two basic elements of a business are what it owns and what it owes. ***Assets*** are the resources a business owns. For example, Google has total assets of approximately $40.5 billion. ***Liabilities and owner's equity*** are the rights or claims against these resources. Thus, Google has $40.5 billion of claims against its $40.5 billion of assets. Claims of those to whom the company owes money (creditors) are called liabilities. Claims of owners are called owner's equity. Google has liabilities of $4.5 billion and owners' equity of $36 billion. We can express the relationship of assets, liabilities, and owner's equity as an equation, as follow:

The Basic Accounting Equation

Assets = Liabilities + Owner's equity

This relationship is the **basic accounting equation**. Assets must equal the sum of liabilities and owner's equity. Liabilities appear before owner's equity in the basic accounting equation because they are paid first if a business is liquidated. The accounting equation applies to all economic entities regardless of size, nature of business, or form of business organization. It applies to a small proprietorship such as a corner grocery store as well as to a giant corporation such as PepsiCo. The equation provides the underlying framework for recording and summarizing economic events. Let's look in more detail at the categories in the basic accounting equation.

2. The components of the Accounting Equation

- ***Assets***

As noted above, assets are resources a business owns. The business uses its assets in carrying out such activities as production and sales. The common characteristic possessed by all assets is the **capacity to provide future services or benefits**. In a business, that service potential or future economic benefit eventually results in cash inflows (receipts). For example, consider Campus Pizza, a local restaurant. It owns a delivery truck that provides economic benefits from delivering pizzas. Other assets of Campus Pizza are tables, chairs, jukebox, cash register, oven, tableware, and, of course, cash.

- ***Liabilities***

Liabilities are claims against assets—that is, existing **debts** and **obligations**. Businesses of all sizes usually borrow money and purchase merchandise on credit. These economic activities result in ***payables*** of various sorts:

- Campus Pizza, for instance, purchases cheese, sausage, flour, and beverages **on credit** from suppliers. These obligations are called **accounts payable**.
- Campus Pizza also has a **note payable** to First National Bank for the money borrowed to purchase the delivery truck.
- Campus Pizza may also have **salaries and wages payable** to employees and **sales and real estate taxes payable** to the local government.

All of these persons or entities to whom Campus Pizza owes money are its **creditors**. Creditors may legally force the liquidation of a business that does not pay its debts. In that case, the law requires that creditor claims be paid **before** ownership claims.

- ***Owner's Equity***

The ownership claim on total assets is owner's equity. It is equal to **total assets minus total liabilities**. Here is why: The assets of a business are claimed by either creditors or owners. To find out what belongs to owners, we subtract the creditors' claims (the liabilities) from assets. The remainder is the owner's claim on the assets—the owner's equity. Since the claims of creditors must be paid **before** ownership claims, owner's equity is often referred to as **residual equity**.

INCREASES IN OWNER'S EQUITY

In a proprietorship, owner's investments and revenues increase owner's equity.

INVESTMENTS BY OWNER

Investments by owner are the assets the owner puts into the business. **These investments increase owner's equity**. They are recorded in a category called **owner's capital**.

REVENUES

Revenues are the **gross increase in owner's equity resulting from business activities entered into for the purpose of earning income**. Generally, revenues result from selling merchandise, performing services, renting property, and lending money. Common sources of revenue are sales, fees, services, commissions, interest, dividends, royalties, and rent. **Revenues usually result in an increase in an asset**. They may arise from different sources and are called various names depending on the nature of the business. Campus Pizza, for instance, has two categories of sales revenues—pizza sales and beverage sales.

DECREASES IN OWNER'S EQUITY

In a proprietorship, owner's **drawings** and **expenses** decrease owner's equity.

DRAWINGS

An owner may withdraw cash or other assets for personal use. We use a separate classification called **drawings** to determine the total withdrawals for each accounting period. **Drawings decrease owner's equity**. They are recorded in a category called owner's drawings.

EXPENSES

Expenses are the **cost of assets consumed or services used in the process of earning revenue**. They are **decreases in owner's equity that result from operating the business**. For example, Campus Pizza recognizes the following expenses: cost of ingredients (meat, flour, cheese, tomato paste, mushrooms, etc.); salaries and wages expense; utilities expense (electric, gas, and water expense); delivery expense (gasoline, repairs, licenses, etc.); supplies expense; rent expense; interest expense; and property tax expense.

In summary, owner's equity is increased by an owner's investments and by revenues from business operations. Owner's equity is decreased by an owner's withdrawals of assets and by expenses. The **following Illustration** expands the basic accounting equation by showing the items that comprise owner's equity. This format is referred to as the **expanded accounting equation**.

Basic Accounting Equation	**Assets = Liabilities + Owner's equity**
Expanded Accounting Equation	**Assets= Liabilities + Owner's - Owner's + Revenues - Expenses** **capital drawings**

3. Using the Accounting Equation

Transactions (business transactions) are a business's economic events recorded by accountants. Transactions may be external or internal. **External transactions** involve economic events between the company and some outside enterprise. For example, a company purchases of equipment from a supplier, payment of monthly rent to the landlord, and sale of products to customers. **Internal transactions** are economic events that occur entirely within one company. The use of supplies is internal transactions for the company. Companies carry on many activities that do not represent business transactions. Examples are hiring employees, and placing merchandise orders. Some of these activities may lead to business transactions: Employees will earn wages, and suppliers will deliver ordered merchandise. The company must analyze each event to find out if it affects the components of the accounting equation. If it does, the company will record the transaction.

Each transaction must have a **dual effect on the accounting equation**. For example, if an asset is increased, there must be a corresponding (1) decrease in another asset, (2) increase in a specific liability, or (3) increase in owner's equity. Two or more items could be affected. For example, as one asset is increased LE 10,000, another asset could decrease LE 6,000 and a liability could increase LE 4,000. Any change in a liability or ownership claim is subject to similar analysis.

Transaction Analysis

To demonstrate how to analyze transactions in terms of the accounting equation, we will review the business activities of **Soft tech**, a computer programming business. The following **business transactions** occur during **Soft tech's** <u>**first month**</u> of operations.

TRANSACTION (1): INVESTMENT BY OWNER

Mohamed decides to open a computer programming service which he names **Soft tech**. On September 1, 2014, he invests LE 15,000 cash in the business. This transaction results in an equal increase in assets and owner's equity:

Basic Analysis	**The asset Cash increases LE 15,000, and owner's equity (identified as Owner's Capital) increases LE 15,000.**
Equation Analysis	**Assets = liabilities + Owner's equity** **Cash = + Owner's capital** **(1) + LE 15,000 = + LE 15,000 Initial investment**

Observe that **the equality** of the accounting equation has been maintained. Note that the investments by the owner do not represent revenues, and they are excluded in determining net income. Therefore, it is necessary to make clear that the increase is an investment (increasing Owner's Capital) rather than revenue.

TRANSACTION (2): PURCHASE OF EQUIPMENT FOR CASH

Soft tech purchases computer equipment for LE 7,000 cash. This transaction results in an equal increase and decrease in total assets, though the composition of assets changes.

Basic Analysis	**The asset Cash decreases LE 7,000, and and the asset Equipment increases LE 7000**
Equation Analysis	**Assets = liabilities + Owner's equity** **Cash + Equipment =** + Owner's capital **LE 15,000 LE 15,000** **(2) - LE 7,000 + LE 7,000** **LE 8,000 LE 7,000 = LE 15,000** **LE 15,000 LE 15,000**

Observe that total assets are still LE 15,000. Owner's equity also remains at LE 15,000, the amount of **Mohamed's** original investment.

TRANSACTION (3): PURCHASE OF SUPPLIES ON CREDIT

Soft tech purchases for LE 1,600 from **ABC** Supply Company computer paper and other supplies expected to last several months. **ABC** agrees to allow **Soft tech** to pay this bill in October. This transaction is a purchase of supplies on account (a credit purchase). Assets increase because of the expected future benefits of using the paper and supplies, and liabilities increase by the amount due to **ABC Company**.

Basic Analysis	**The asset Supplies increases LE 1,600, and the liability Accounts Payable increases by LE 1,600.**
Equation Analysis	**Assets** = **liabilities** + **Owner's equity** Cash + **Supplies** + Equipment = **Accounts Payable** + Owner's capital **LE 8,000** **LE 7,000** **LE 15,000** **(3)** **+ LE 1,600** **+ LE 1,600** **LE 8,000** **LE 1,600** **LE 7,000** = **LE 1,600** **LE 15,000** **LE 16,600** **LE16,600**

Total assets are now LE 16,600. This total is matched by a LE 1,600 creditor's claim and a LE 15,000 ownership claim.

TRANSACTION (4): SERVICES PERFORMED FOR CASH

Soft tech receives LE 1,200 cash from customers for programming services it has performed. This transaction represents **Soft tech's** principal revenue-producing activity. Recall that **revenue increases owner's equity**.

Basic Analysis	**The asset Cash increases LE 1,200, and owner's equity increases LE 1,200 due to Service Revenue.**
Equation Analysis **(4)**	**Assets** = **liabilities** + **Owner's equity** **Cash** + Supplies + Equipment **=** Accounts Payable + Owner's capital **+ Revenues** 8,000 1,600 7,000 1600 15,000 **+ 1,200** **+ 1,200** **9,200** **1,600** **7,000** = **1,600** **15,000** **1,200** **LE 17,800** **LE 17,800**

The two sides of the equation balance at LE 17,800. Service Revenue is included in determining Soft tech's net income. Note that revenues (and expenses when we get to

them) are summarized under one column heading for Revenues and one for Expenses. However, it is important to keep track of the category (account) titles affected (e.g., Service Revenue) as they will be needed when we prepare financial statements.

TRANSACTION (5): ADVERTISING EXPENSE ON CREDIT

Soft tech receives a bill for LE 250 from the *Pyramids* for advertising but postpones payment until a later date. This transaction results in an increase in liabilities and a decrease in owner's equity.

Basic Analysis	**The liability Accounts Payable increases LE 250, and owner's equity decreases LE 250 due to Advertising Expense.**

Equation Analysis:

	Assets			=	liabilities	+	Owner's equity		
	Cash	+ Supplies	+ Equipment	=	**Accounts Payable**	+	Owner's capital	+ Revenues	**- Expenses**
	9,200	1,600	7,000		1600		15,000	1,200	
(5)					**+ 250**				**- 250**
	9,200 +	**1,600 +**	**7,000**	**=**	**1,850**	**+**	**15,000**	**+ 1,200**	**- 250**

$$\underbrace{9{,}200 + 1{,}600 + 7{,}000}_{\textbf{LE 17,800}} = \underbrace{1{,}850 + 15{,}000 + 1{,}200 - 250}_{\textbf{LE 17,800}}$$

The two sides of the equation still balance at LE 17,800. Owner's equity decreases when **Soft tech** incurs the expense. Expenses are not always paid in cash at the time they are incurred. When **Soft tech** pays at a later date, the liability Accounts Payable will decrease, and the asset Cash will decrease [see Transaction (8)].

The cost of advertising is an expense (rather than an asset) because the company has **used** the benefits. Advertising Expense is included in determining net income.

TRANSACTION (6): SERVICES PERFORMED FOR CASH AND CREDIT

Soft tech performs LE 3,500 of programming services for customers. The company receives cash of LE 1,500 from customers, and it bills the balance of LE 2,000 on account. This transaction results in an equal increase in assets and owner's equity.

Basic Analysis	**Three specific items are affected: The asset Cash increases LE 1,500, the asset Accounts Receivable increases LE 2,000, and owner's equity increases LE 3,500 due to Service Revenue.**

Equation Analysis:

	Assets							=	**liabilities**	+	**Owner's equity**				
	Cash	+	**Accounts Receivable**	+	Supplies	+	Equipment	**=**	Accounts Payable	+	Owner's capital	+	**Revenues**	-	Expenses
	9,200				1,600		7,000		1,850		15,000		1,200		250
(6)	**+ 1,500**		**+2,000**										**+3,500**		
	10,700	**+**	**2,000**	**+**	**1,600**	**+**	**7,000**	**=**	**1,850**	**+**	**15,000**	**+**	**4,700**	**-**	**250**
	LE 21,300								**LE 21,300**						

Soft tech recognizes LE 3,500 in revenue when it performs the service. In exchange for this service, it received LE 1,500 in Cash and Accounts Receivable of LE 2,000. This Accounts Receivable represents customers' promises to pay LE 2,000 to **Soft tech** in the future. When it later receives collections on account, **Soft tech** will increase Cash and will decrease Accounts Receivable [see Transaction (9)].

TRANSACTION (7): PAYMENT OF EXPENSES

Soft tech pays the following expenses in cash for September: store rent LE 600, salaries and wages of employees LE 900 and utilities LE 200. These payments result in an equal decrease in assets and owner's equity.

Basic Analysis	The asset Cash decreases LE 1,700, and owner's equity decreases LE 1,700 due to the specific expense categories (Rent Expense, Salaries and Wages Expense, and Utilities Expense).

Equation Analysis:

	Assets				=	liabilities	+	Owner's equity		
	Cash	+ Accounts Receivable	+ Supplies	+ Equipment	=	Accounts Payable	+	Owner's capital	+ Revenues	- Expenses
	10,700	2,000	1,600	7,000		1,850		15,000	4,700	250
(7)	- 1,700									- 600
										- 900
										- 200
	9,000	**+ 2,000**	**+ 1,600**	**+ 7,000**	**=**	**1,850**	**+**	**15,000**	**+ 4,700**	**- 1,950**

LE 19,600 **LE 19,600**

The two sides of the equation now balance at LE 19,600. Three lines in the analysis indicate the different types of expenses that have been incurred.

TRANSACTION (8): PAYMENT OF ACCOUNTS PAYABLE

Soft tech pays its LE 250 *Pyramids* bill in cash. The company previously [in Transaction (5)] recorded the bill as an increase in Accounts Payable and a decrease in owner's equity.

Basic Analysis	This cash payment "on account" decreases the asset Cash by LE 250 and also decreases the liability Accounts Payable by LE 250.

Equation Analysis:

	Assets				=	liabilities	+	Owner's equity		
	Cash	+ Accounts Receivable	+ Supplies	+ Equipment	=	Accounts Payable	+	Owner's capital	+ Revenues	- Expenses
	9,000	2,000	1,600	7,000		1,850		15,000	4,700	250
(8)	- 250				=	- 250				
	8,750	**+ 2,000**	**+ 1,600**	**+ 7,000**	**=**	**1,600**	**+**	**15,000**	**+ 4,700**	**- 1,950**

LE 19,350 **LE 19,350**

Observe that the payment of a liability related to an expense that has previously been recorded does not affect owner's equity. The company recorded this expense in Transaction (5) and should not record it again.

TRANSACTION (9): RECEIPT OF CASH ON ACCOUNT

Soft tech receives LE 600 in cash from customers who had been billed for services [in Transaction (6)]. Transaction (9) does not change total assets, but it changes the composition of those assets.

Basic Analysis	The asset Cash increases LE 600, and the asset Accounts Receivable decreases LE 600.

Equation Analysis:

	Assets					=	liabilities	+	Owner's equity						
	Cash	+	Accounts Receivable	+	Supplies	+	Equipment	=	Accounts Payable	+	Owner's capital	+	Revenues	-	Expenses
	8,750		2,000		1,600		7,000		1,600		15,000		4,700		1,950
(9)	**+ 600**		**- 600**												
	9,350	**+**	**1,400**	**+**	**1,600**	**+**	**7,000**	**=**	**1,600**	**+**	**15,000**	**+**	**4,700**	**-**	**1,950**

LE 19,350 **LE 19,350**

Note that the collection of an account receivable for services previously billed and recorded does not affect owner's equity. **Soft tech** already recorded this revenue in Transaction (6) and should not record it again.

TRANSACTION (10): WITHDRAWAL OF CASH BY OWNER

Mohamed withdraws LE 1,300 in cash from the business for his personal use. This transaction results in an equal decrease in assets and owner's equity.

Basic Analysis	**The asset Cash decreases LE 1,300, and owner's equity decreases LE 1,300 due to owner's withdrawal (Owner's Drawings).**

Equation Analysis:

	Assets							=	**liabilities**	+	**Owner's equity**						
	Cash	+	Accounts Receivable	+	Supplies	+	Equipment	=	Accounts Payable	+	Owner's capital	-	**Owner's drawings**	+	Revenues	-	Expenses
	9,350		1,400		1,600		7,000		1,600		15,000				4,700		1,950
(10)	**- 1,300**												**- 1,300**				
	8,050	**+**	**1,400**	**+**	**1,600**	**+**	**7,000**	**=**	**1,600**	**+**	**15,000**	**+**	**1,300**	**+**	**4,700**	**-**	**1,950**

LE 18,050 **LE 18,050**

Observe that the effect of a cash withdrawal by the owner is the opposite of the effect of an investment by the owner. **Owner's drawings are not expenses.** Expenses are incurred for the purpose of earning revenue. Drawings do not generate revenue. They are a **disinvestment**. Like owner's investment, the company excludes owner's drawings in determining net income.

4. The financial Statements

The financial statements present a company to the public in financial terms. Each financial statement relates to a specific date or time period. Companies prepare four financial statements from the summarized accounting data:

1) An **income statement** presents the revenues and expenses and resulting net income or net loss for a specific period of time.
2) An **owner's equity statement** summarizes the changes in owner's equity for a specific period of time.
3) A **balance sheet** reports the assets, liabilities, and owner's equity at a specific date.
4) A **statement of cash flows** summarizes information about the cash inflows (receipts) and outflows (payments) for a specific period of time.

SOFT TECH
Income Statement
For the month ended September 30, 2014

These statements provide **relevant financial data** for internal and external users.

Revenues		
Service revenue		**LE 4,700**
Expenses		
Salaries and wages expense	**LE 900**	
Rent expense	**600**	
Advertising expense	**250**	
Utilities expense	**200**	
Total expenses		**1,950**
Net income		**LE 2,750**

SOFT TECH
Owner's Equity Statement
For the month ended September 30, 2014

Owner's capital, September 1		**LE -0-**
Add: Investments	**LE 15,000**	
Net income	**2,750**	**17,750**
		17,750
Less: Drawings		**1,300**
Owner's capital, September 30		**LE 16,450**

SOFT TECH
Balance Sheet
September 30,2014

Assets

Cash	**LE 8,050**
Accounts receivable	**1,400**
Supplies	**1,600**
Equipment	**7,000**
Total assets	**LE 18,050**

Liabilities and Owner's Equity

Liabilities		
Accounts payable		**LE 1,600**
Owner's equity		
Owner's capital		**16,450**
Total Liabilities and Owner's Equity		**LE 18,050**

SOFT TECH
Statement of Cash Flow
For the month ended September 30, 2014

Cash flows from operating activities		
Cash receipts from revenues		**LE 3,300**
Cash payments for expenses		**(1,950)**
Net cash provided by operating activities		**1,350**
Cash flows from investing activities		
Purchase of equipment		**(7,000)**
Cash flows from financing activities		
Investments by owner	**LE 15,000**	
Drawings by owner	**(1,300)**	**13,700**
Net increase in cash		**8,050**
Cash at the beginning of the period		**0**
Cash at the end of the period		**LE 8,050**

Note that the statements shown above are interrelated:

1. Net income of LE 2,750 on the **income statement** is added to the beginning balance of owner's capital in the **owner's equity statement**.

2. Owner's capital of LE 16,450 at the end of the reporting period shown in the **owner's equity statement** is reported on the **balance sheet**.

3. Cash of LE 8,050 on the **balance sheet** is reported on the **statement of cash flows**. Also, explanatory notes and supporting schedules are an integral part of every set of financial statements.

Be sure to carefully examine the format and content of each statement Illustrated above. We describe the essential features of each in the following sections.

Income Statement

The income statement reports the revenues and expenses for a specific period of time. (In Soft tech's case, this is "For the Month Ended September 30, 2014.") The income statement lists revenues first, followed by expenses. Finally the statement shows net income (or net loss). **Net income** results when revenues exceed expenses. A **net loss** occurs when expenses exceed revenues.

Note that the income statement does **not** include investment and withdrawal transactions between the owner and the business in measuring net income. For example, as explained earlier, **Mohamed's** withdrawal of cash from **Soft tech** was not regarded as a business expense.

Owner's Equity Statement

The owner's equity statement reports the changes in owner's equity for a specific period of time. The time period is the same as that covered by the income statement. The first line of the statement shows the beginning owner's equity amount (which was zero at the start of the business). Then come the owner's investments, net income (or loss), and the owner's drawings. This statement indicates **why** owner's equity has increased or decreased during the period.

What if **Soft tech** had reported a net loss in its first month? Let's assume that during the month of September 2014, **Soft tech** lost LE 10,000. The following Illustration shows the presentation of a net loss in the owner's equity statement.

SOFT TECH
Owner's Equity Statement
For the month ended September 30, 2014

Owner's capital, September 1		**LE -0-**
Add: Investments		**15,000**
		15,000
Less: Drawings	**LE 1,300**	
Net loss	**10,000**	**11,300**
Owner's capital, September 30		**LE 3,700**

If the owner makes any additional investments, the company reports them in the owner's equity statement as investments.

Balance Sheet

Soft tech's balance sheet reports the assets, liabilities, and owner's equity at a specific date (in Soft tech's case, September 30, 2014). Observe that the balance sheet lists assets at the top, followed by liabilities and owner's equity. Total assets must equal total liabilities and owner's equity. Soft tech reports only one liability—accounts payable—in its balance sheet. In most cases, there will be more than one liability. When two or more liabilities are involved, a customary way of listing is as follows.

Liabilities	
Notes payable	**LE 10,000**
Accounts payable	**63,000**
Salaries and wages payable	**18,000**
Total liabilities	**LE 91,000**

Statement of Cash Flows

The statement of cash flows provides information on the cash receipts and payments for specific period of time. The statement of cash flows reports: (1) The cash effects of a company's operations during a period, (2) Its investing activities, (3) Its financing activities, (4) The net increase or decrease in cash during the period, and (5) The cash amount at the end of the period.

Reporting the sources, uses, and change in cash is useful because investors, creditors, and others want to know what is happening to a company's most liquid resource.

The statement of cash flows provides answers to the following simple but important questions.

1. Where did cash come from during the period?

2. What was cash used for during the period?

3. What was the change in the cash balance during the period?

As shown in Soft tech's statement of cash flows, cash increased LE 8,050 during the period. Net cash provided by operating activities increased cash LE 1,350. Cash flow from investing activities decreased cash LE 7,000. And cash flow from financing activities increased cash LE 13,700. At this time, you need not be concerned with how these amounts are determined.

Summary of Learning Objectives

1. **State the accounting equation, and define its components.**

   The basic accounting equation is: **Assets = Liabilities +Owner's Equity**

   Assets are resources a business owns. Liabilities are creditorship claims on total assets. Owner's equity is the ownership claim on total assets.

   The expanded accounting equation is:

   Assets = Liabilities + Owner's Capital - Owner's Drawings + Revenues - Expenses

   Owner's capital is assets the owner puts into the business. Owner's drawings are the assets the owner withdraws for personal use. Revenues are increases in assets resulting from income-earning activities. Expenses are the costs of assets consumed or services used in the process of earning revenue.

2. **Analyze the effects of business transactions on the accounting equation.** Each business transaction must have a dual effect on the accounting equation. For example, if an individual asset increases, there must be a corresponding (1) decrease in another asset, or (2) increase in a specific liability, or (3) increase in owner's equity.

3. **Understand the four financial statements and how they are prepared.** An income statement presents the revenues and expenses, and resulting net income or net loss, for a specific period of time. An owner's equity statement summarizes the changes in owner's equity for a specific period of time. A balance sheet reports the assets, liabilities, and owner's equity at a specific date. A statement of cash flows summarizes information about the cash inflows (receipts) and outflows (payments) for a specific period of time.

Key Terms

- **Assets (الأصول):** Resources a business owns.
- **Balance sheet (الميزانية):** A financial statement that reports the assets, liabilities, and owner's equity at a specific date.
- **Basic accounting equation:(معادلة الميزانية الأساسية)** Assets = Liabilities + Owner's Equity.
- **Drawings (المسحوبات بواسطة المالك-الملاك):** Withdrawal of cash or other assets from an unincorporated business for the personal use of the owner(s).
- **Expanded accounting equation (معادلة الميزانية الموسعة):** Assets = Liabilities + Owner's Capital - Owner's Drawings + Revenues - Expenses.
- **Expenses (المصروفات):** The cost of assets consumed or services used in the process of earning revenue.
- **Income statement (قائمة الدخل):** A financial statement that presents the revenues and expenses and resulting net income or net loss of a company for a specific period of time.
- **Investments by owner (الإستثمارات المقدمة من المالك للمشروع):** The assets an owner puts into the business.
- **Liabilities (الإلتزامات أو الخصوم):** Creditor claims against total assets.
- **Net income (صافي الدخل):** The amount by which revenues exceed expenses.
- **Net loss(صافي الخسارة) :** The amount by which expenses exceed revenues.
- **Owner's equity (حق الملكية):** The ownership claim on total assets.
- **Owner's equity statement (قائمة حقوق الملكية):** A financial statement that summarizes the changes in owner's equity for a specific period of time.
- **Revenue (الإيرادات):** The gross increase in owner's equity resulting from business activities entered into for the purpose of earning income.
- **Statement of cash flows (قائمة التدفقات النقدية):** A financial statement that summarizes information about the cash inflows (receipts) and cash outflows (payments) for a specific period of time.
- **Transactions (المعاملات المالية):** The economic events of a business that are recorded by accountants.

End of Chapter Questions

Question (1)

1. What is the basic accounting equation?
2. **(a)** Define the terms assets, liabilities, and owner's equity. **(b)** What items affect owner's equity?
3. Which of the following items are liabilities of Adel Jewellery Stores?

   (a) Cash.

   (b) Accounts payable.

   (c) Owner's drawings.

   (d) Accounts receivable.

   (e) Supplies.

   (f) Equipment.

   (g) Salaries and wages payable.

   (h) Service revenue.

   (i) Rent expense.
4. Can a business enter into a transaction in which only the left side of the basic accounting equation is affected? If so, give an example.
5. Are the following events recorded in the accounting records? Explain your answer in each case.

   (a) The owner of the company dies.

   (b) Supplies are purchased on account.

   (c) An employee is fired.

   (d) The owner of the business withdraws cash from the business for personal use.

6. Indicate how the following business transactions affect the basic accounting equation.
   (a) Paid cash for janitorial services.
   (b) Purchased equipment for cash.
   (c) Invested cash in the business.
   (d) Paid accounts payable in full.
7. Listed below are some items found in the financial statements of ABC Co. Indicate in which financial statement(s) the following items would appear.
   (a) Service revenue.
   (b) Equipment.
   (c) Advertising expense.
   (d) Accounts receivable.
   (e) Owner's capital.
   (f) Salaries and wages payable.
8. Adam Enterprises had a capital balance of LE 168,000 at the beginning of the period. At the end of the accounting period, the capital balance was LE 198,000.
   (a) Assuming no additional investment or withdrawals during the period, what is the net income for the period?
   (b) Assuming an additional investment of LE 13,000 but no withdrawals during the period, what is the net income for the period?
9. Summarized operations for XYZ Co. for the month of July are as follows:
   Revenues recognized: for cash LE 20,000; on account LE 70,000.
   Expenses incurred: for cash LE 26,000; on account LE 40,000.

Indicate for XYZ Co. (a) the total revenues, (b) the total expenses, and (c) net income for the month of July.

10. Presented below is the basic accounting equation. Determine the missing amounts.

	Assets	= **Liabilities**	+ **Owner's Equity**
(a)	**LE** 90,000	LE 50,000	?
(b)	?	LE 40,000	LE 70,000
(c)	**LE** 94,000	?	LE 53,000

Question (2): Select the best answer for each of the following statements:

1. Net income will result during a time period when:

   (a) Assets exceed liabilities.

   (b) Assets exceed revenues.

   (c) Expenses exceed revenues.

   (d) Revenues exceed expenses.

2. As of December 31, 2014, EL NASR Company has assets of LE 3,500 and owner's equity of LE 2,000. What are the liabilities for EL NASR Company as of December 31, 2014?

   (a) **LE** 1,500.

   (b) **LE** 1,000.

   (c) **LE** 2,500.

   (d) **LE** 2,000.

3. Performing services on account will have the following effects on the components of the basic accounting equation:

   (a) Increase assets and decrease owner's equity.

   (b) Increase assets and increase owner's equity.

(c) Increase assets and increase liabilities.

(d) Increase liabilities and increase owner's equity.

4. Which of the following events is **not** recorded in the accounting records?

   (a) Equipment is purchased on account.

   (b) An employee is terminated.

   (c) A cash investment is made into the business.

   (d) The owner withdraws cash for personal use.

5. During 2014, Cairo Company's assets decreased LE 50,000 and its liabilities decreased LE 90,000. Its owner's equity therefore:

   (a) Increased LE 40,000. **(c) D**ecreased LE 40,000.

   (b) Decreased LE 140,000. **(d) I**ncreased LE 140,000.

6. Payment of an account payable affects the components of the accounting equation in the following way.

   (a) Decreases owner's equity and decreases liabilities.

   (b) Increases assets and decreases liabilities.

   (c) Decreases assets and increases owner's equity.

   (d) Decreases assets and decreases liabilities.

7. Which of the following statements is **false**?

   (a) A statement of cash flows summarizes information about the cash inflows (receipts) and outflows (payments) for a specific period of time.

   (b) A balance sheet reports the assets, liabilities, and owner's equity at a specific date.

   (c) An income statement presents the revenues, expenses, changes in owner's equity, and resulting net income or net loss for a specific period of time.

(d) An owner's equity statement summarizes the changes in owner's equity for a specific period of time.

8. On the last day of the period, Alan ABC Company buys a LE 900 machine on credit. This transaction will affect the:

   (a) Income statement only.

   (b) Balance sheet only.

   (c) Income statement and owner's equity statement only.

   (d) Income statement, owner's equity statement, and balance sheet.

9. The financial statement that reports assets, liabilities, and owner's equity is the:

   (a) Income statement.

   (b) Owner's equity statement.

   (c) Balance sheet.

   (d) Statement of cash flows.

10. Which financial statement covers a period of time?

    i. Balance sheet.

    ii. Statement of cash flows.

    iii. Income statement.

    iv. Both **(b)** and **(c)**.

CHAPTER THREE

The Accounting Process: Journalize Transactions

Learning Objectives

After studying this chapter, you should be able to:

1. Define debits and credits and explain how they are used to record business transactions.
2. Identify the basic steps in the recording process.
3. Explain what a journal is and how it helps in the recording process.

The Accounting Information System

The accounting information system is a system that

i. Collecting and processing transaction data, and

ii. Communicating financial information to decision makers.

Transactions

Business activity is all about transactions. ***A transaction*** is any event that has a financial impact on the business and can be measured reliably.

But not all events qualify as transactions. A transaction must occur before the company records anything. Transactions provide objective information about the financial impact on a company. Every transaction has two sides:

- You give something, and
- You receive something.

In accounting, we always record both sides of a transaction. And we must be able to measure the financial impact of the event on the business before recording it as a transaction.

So, ***accounting transactions*** are economic events that must be recorded in the financial statements because they affect

- Assets,
- Liabilities
- Shareholders' equity.

The Accounting Cycle

The Accounting Cycle is a step-by-step process of recording, classification and summarization of economic transactions of a business. It generates useful financial information in the form of financial statements including ***income statement, balance sheet, cash flow statement and statement of changes in equity***.

The time period principle requires that a business should prepare its financial statements on periodic basis. Therefore accounting cycle is followed once during each accounting period. Accounting Cycle starts from the recording of individual transactions and ends on the preparation of financial statements and closing entries.

Major Steps in the Accounting Cycle

Following are the major steps involved in the accounting cycle.

1. Analyzing and recording transactions in journals.
2. Posting journal entries to ledger accounts.
3. Preparing unadjusted trial balance.
4. Preparing adjusting entries at the end of the period.
5. Preparing adjusted trial balance.
6. Preparing financial statements.
7. Closing temporary accounts via closing entries.
8. Preparing post-closing trial balance.

The Journal Entries

The journal is an accounting record where the transactions are recorded in chronological order. Each accounting transaction has a double effect on the accounting equation. Transactions are recording using the double entry method.

Double-entry Accounting

All business transactions include 2 parts:

- You give something.
- You receive something.

Accounting is, therefore, based on a double-entry system, which records the dual effects on the entity. Each transaction affects at least two accounts.

Recording Transactions

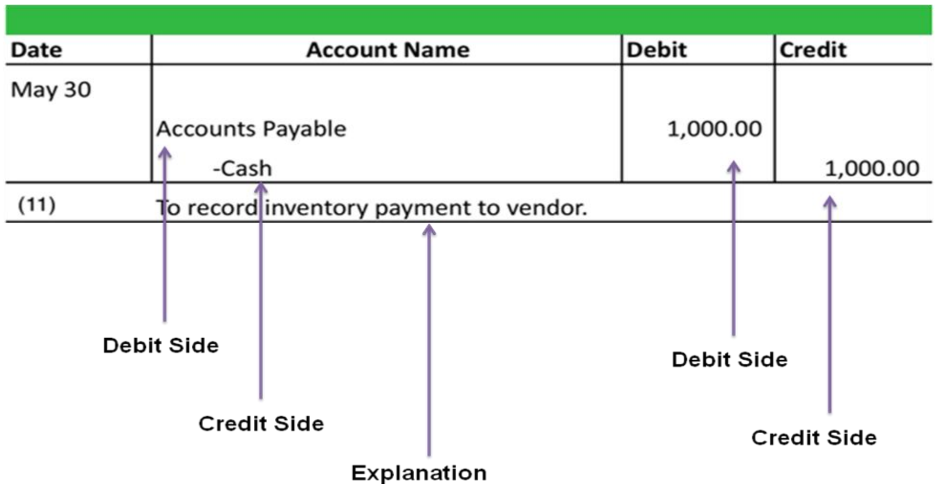
Accountants use a chronological record of transactions called a journal. The journalizing process follows three steps:

1. Specify each account affected by the transaction and classify each account by type (asset, liability, stockholders' equity, revenue, or expense).
2. Determine whether each account is increased or decreased by the transaction. Use the rules of debit and credit to increase or decrease each account.
3. Record the transaction in the journal, including a brief explanation. The debit side is entered on the left margin, and the credit side is indented to the right.

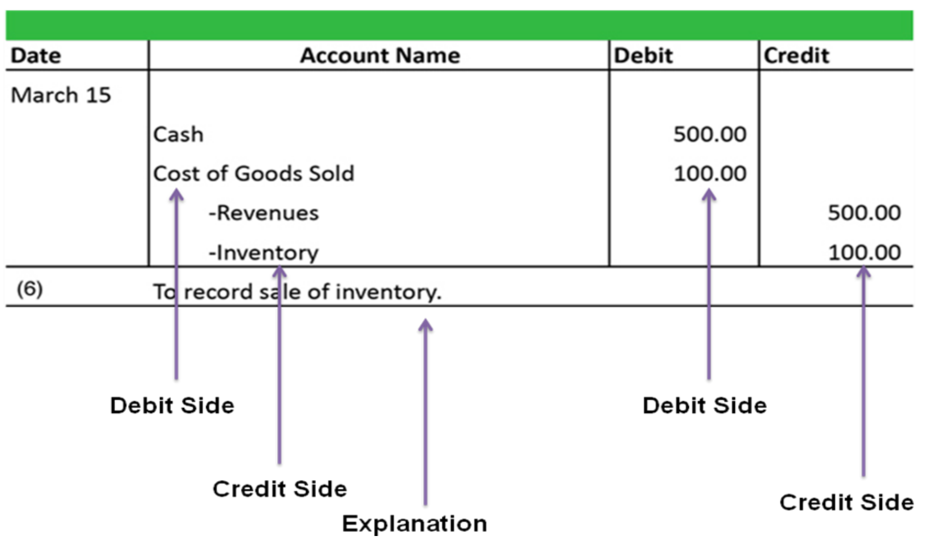
The Journal

The Journal is an accounting record; where the transactions are recorded in chronological order.

The journal takes the following format:



Date	Account Name	Debit	Credit
May 30			
	Accounts Payable	1,000.00	
	-Cash		1,000.00
(11)	To record inventory payment to vendor.		



Date	Account Name	Debit	Credit
March 15			
	Cash	500.00	
	Cost of Goods Sold	100.00	
	-Revenues		500.00
	-Inventory		100.00
(6)	To record sale of inventory.		

Increases and Decreases in the Accounts: The Rules of Debit and Credit:

The type of account determines how we record increases and decreases. The rules of debit and credit follow in the following table.

	Asset	Liability	Share Capital	Retained Earnings	Dividends	Revenues	Expenses
Normal Balance	**Dr**	**Cr**	**Cr**	**Cr**	**Dr**	**Cr**	**Dr**
+	**Dr**	**Cr**	**Cr**	**Cr**	**Dr**	**Cr**	**Dr**
-	**Cr**	**Dr**	**Dr**	**Dr**	**Cr**	**Dr**	**Cr**

- **The normal balance of assets is debit.**
  - Increases in assets are recorded on the left (debit) side of the account.
  - Decreases in assets are recorded on the right (credit) side.
  - You receive cash and debit the Cash account. You pay cash and credit the Cash account.
- **The normal balance of liabilities and shareholders' equity are credit.**
  - Increases in liabilities and shareholders' equity (share capital and retained earnings) are recorded on the right (credit) side.
  - Decreases in liabilities and shareholders' equity are recorded on the left (debit) side.
- **Dividends are decreases in shareholders' equity.**
  - Increases in dividends are recorded on the left (debit) side of the account.
  - Decreases in dividends are recorded on the right (credit) side.
- **Revenues are increases in shareholders' equity that result from delivering goods or services to customers.**
  - Increases in revenues are recorded on the right (credit) side.
  - Decreases in revenues are recorded on the left (debit) side.

- **Expenses are decreases in shareholders' equity due to the cost of operating the business.**
  - Increases in expenses are recorded on the left (debit) side of the account.
  - Decreases in expenses are recorded on the right (credit) side.

<u>Example 1:</u>

What is the normal balance for the following accounts?

Cash
Accounts Payable
Accounts Receivable
Service Revenue
Share Capital
Salaries Expense
Dividends
Building
Taxes Payable
Unearned Revenues
Prepaid Insurance
Rent Expense

<u>The Answer</u>

Account	Normal Balance
Cash	Debit
Accounts Payable	Credit
Accounts Receivable	Debit
Service Revenue	Credit
Share Capital	Credit
Salaries Expense	Debit
Dividends	Debit
Building	Debit
Taxes Payable	Credit
Unearned Revenues	Credit
Prepaid Insurance	Debit
Rent Expense	Debit

Example 2:

The following transactions occurred during the month of October, 2017 by El-Salam Advertising Inc.:

1. El-Salam invested LE 10,000 Cash in business.
2. El-Salam issued (signed) a 3-month, 12%, LE 5,000 Note Payable to Misr Bank in exchange for cash.
3. El-Salam acquired office equipment by paying LE 5,000 cash to Giza Co.
4. El-Salam received a LE 1,200 cash advance from Adel, (a customer).
5. El-Salam received LE 10,000 in cash from Al-Nasr Co. for advertising services performed.
6. El-Salam paid its office rent in cash, LE 900.
7. El-Salam paid LE 600 for a one-year insurance policy that will expire next year.
8. El-Salam purchases advertising supplies on account from Metro Supply for LE 2,500.
9. El-Salam hired four new employees.
10. El-Salam paid a LE 500 dividend.
11. El-Salam Paid LE 4,000 salaries.

Instructions:

Record the journal entries for the above mentioned transactions.

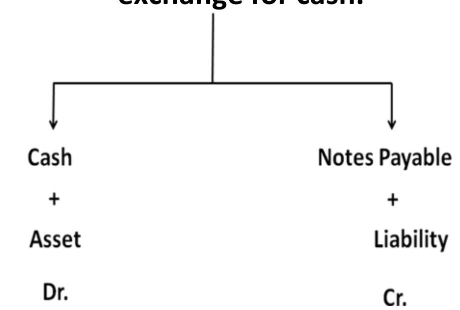
The Answer

1 - El-Salam invested LE 10,000 Cash in business.

Cash	Share Capital
+	+
Asset	Capital
Dr.	Cr.

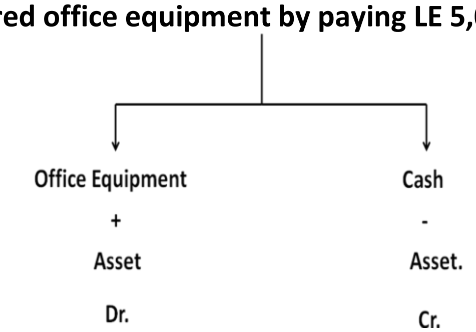
Date	Account Titles and Explanations	Dr.	Cr.
2017	Cash	10,000	
Oct.	Share Capital		10,000
1	(Invested cash in business)		

2– El-Salam issued (signed) a 3-month, 12%, LE 5,000 Note Payable to Misr Bank in exchange for cash.



Date	Account Titles and Explanations	Dr.	Cr.
2017	Cash	5,000	
Oct.	Notes Payable		5,000
2	(Issued note payable for cash)		

3– El-Salam acquired office equipment by paying LE 5,000 cash to Giza Co.



Date	Account Titles and Explanations	Dr.	Cr.
2017	Office Equipment	5,000	
Oct.	Cash		5,000
3	(Purchased office equipment for cash)		

4– El-Salam received a LE 1,200 cash advance from Adel, (a customer).

Cash	Unearned Revenue
+	+
Asset	Liability.
Dr.	Cr.

Date	Account Titles and Explanations	Dr.	Cr.
2017	Cash	1,200	
Oct.	Unearned Revenue		1,200
4	(unearned revenue in cash)		

5– El-Salam received LE 10,000 in cash from Al-Nasr Co. for advertising services performed.

Cash	Service Revenue
+	+
Asset	Revenue
Dr.	Cr.

Date	Account Titles and Explanations	Dr.	Cr.
2017	Cash	10,000	
Oct.	Service Revenue		10,000
5	(service revenue in cash)		

6– El-Salam paid its office rent in cash, LE 900.

Rent Expense	Cash
+	-
Expense	Asset
Dr.	Cr.

Date	Account Titles and Explanations	Dr.	Cr.
2017	Rent Expense	900	
Oct.	Cash		900
6	(Paid rent expense in cash)		

7– El-Salam paid LE 600 for a one-year insurance policy that will expire next year.

Prepaid Insurance	Cash
+	-
Asset	Asset
Dr.	Cr.

Date	Account Titles and Explanations	Dr.	Cr.
2017	Prepaid Insurance	600	
Oct.	Cash		600
7	(Paid prepaid insurance in cash)		

8– El-Salam purchases advertising supplies on account from Metro Supply for LE 2,500.

Supplies	Accounts Payable
+	+
Asset	Liability
Dr.	Cr.

Date	Account Titles and Explanations	Dr.	Cr.
2017	Supplies	2,500	
Oct.	Accounts Payable		2,500
8	(Purchased supplies on account)		

9– El-Salam hired four new employees.

Accounting transaction has *NOT* occurred!

10– El-Salam paid a LE 500 dividend.

Dividends	Cash
+	-
Dividends	Asset
Dr.	Cr.

Date	Account Titles and Explanations	Dr.	Cr.
2017	Dividends	500	
Oct.	Cash		500
10	(Paid Dividends in cash)		

11– Paid LE 4,000 salaries.

Salaries Expense	Cash
+	-
Expense	Asset
Dr.	Cr.

Date	Account Titles and Explanations	Dr.	Cr.
2017	**Salaries Expense**	**4,000**	
Oct.	**Cash**		**4,000**
11	**(Paid salaries expense in cash)**		

The entries for the previous transactions will appear in the journal of El-Salam Advertising Inc. as follows:

Date	Account Titles and Explanations	Dr.	Cr.
2017	Cash	10,000	
Oct.	Share Capital		10,000
1	(Invested cash in business)		
	Cash	5,000	
2	Notes Payable		5,000
	(Issued note payable for cash)		
	Office Equipment	5,000	
3	Cash		5,000
	(Purchased office equipment for cash)		
	Cash	1,200	
4	Unearned Revenue		1,200
	(unearned revenue in cash)		
	Cash	10,000	
5	Service Revenue		10,000
	(service revenue in cash)		

Date	Account Titles and Explanations	Dr.	Cr.
6	Rent Expense Cash (Paid rent expense in cash)	900	900
7	Prepaid Insurance Cash (Paid prepaid insurance in cash)	600	600
8	Supplies Accounts Payable (Purchased supplies on account)	2,500	2,500
10	Dividends Cash (Paid Dividends in cash)	500	500
11	Salaries Expense Cash (Paid salaries expense in cash)	4,000	4,000

Example 3:

On August 31, the balance sheet of Salem Corporation showed Cash LE 10,500, Accounts Receivable LE 2,500, Office Equipment LE 6,000, Accounts Payable LE 4,400, Share Capital LE 13,000, Supplies LE 600, and Retained Earnings LE 2,200, During September the following transactions occurred.

1. Paid LE 3,100 cash on accounts payable.
2. Collected LE 1,500 of accounts receivable.
3. Purchased additional office equipment for LE 3,500, paying LE 800 in cash and the balance on account.
4. Earned revenues of LE 7,800, of which LE 2,500 is in cash and the balance is due in October.
5. Paid dividends of LE 800.
6. Paid salaries LE 700, rent for September LE 900, and advertising expense LE 200.
7. Incurred utility expenses for the month on account, LE 350.

8. Received LE 6,000 from Alexandria Bank-money borrowed on a note payable.

Instructions: Prepare the journal entries for the above transactions.

The Answer

Date	Account Titles and Explanations	Dr.	Cr.
1	Accounts Payable	3,100	
	Cash		3,100
	(Paid accounts payable in cash)		
2	Cash	1,500	
	Accounts Receivable		1,500
	(Collected accounts receivable in cash)		
3	Office Equipment	3,500	
	Cash		800
	Accounts Payable		2,700
	(Purchased office equipment)		
4	Cash	2,500	
	Accounts Receivable	5,300	
	Service Revenue		7,800
	(Provided service)		
5	Dividends	800	
	Cash		800
	(Paid dividends in cash)		
6	Salaries Expense	700	
	Rent Expense	900	
	Advertising Expense	200	
	Cash		1,800
	(Paid expenses in cash)		

7	Utility Expense Accounts Payable (Incurred utility expense on account)	350	350
8	Cash Notes Payable (Borrowed cash on a note payable)	6,000	6,000

Example 4:

Cairo, Inc. completed the following transactions during its first month of operations:

a) Cairo, Inc opened a law firm by investing LE 15,000 cash
b) Paid monthly rent of LE 1,500.
c) Purchased office supplies on account, LE 800.
d) Paid employees' salaries of LE 1,800.
e) Paid LE 400 of the account payable created in transaction c.
f) Performed legal service on account, LE 8,300.
g) Declared and paid dividends of LE 2,000.

Instructions: Record the transactions in the journal of Cairo, Inc.

The Answer

Date	Account Titles and Explanations	Dr.	Cr.
a)	Cash Share Capital (Invested cash in the business)	15,000	15,000
b)	Rent Expense Cash (Paid monthly rent)	1,500	1,500
c)	Office Supplies Accounts Payable (Purchased supplies on account)	800	800
d)	Salary Expense Cash (Paid employees salaries)	1,800	1,800

e)	Accounts Payable Cash (Paid cash on accounts payable)	400	 400
f)	Accounts receivable Service Revenue (Performed services on account)	8,300	 8,300
g)	Dividends Cash (Paid dividends in cash)	2,000	 2,000

Example 5:

During October, Samy Co. completed the following transactions:

1. Samy Co. received LE 50,000 cash and issued ordinary shares to the shareholders.
2. Paid LE 10,000 cash and signed a LE 30,000 note payable to purchase land for an office site.
3. Purchased supplies on account, LE 2,000.
4. Borrowed LE 20,000 from the bank for business use. Samy Co. signed a note payable to the bank in the name of the business.
5. Service revenue earned during the month included LE 12,000 cash and LE 8,000 on account.
6. Paid LE 500 on account.
7. Paid employees' salaries LE 2,500, advertising expense LE 1,500 and utilities expense LE 500.
8. Declared and paid a cash dividend of LE 10,000.

Instructions:

Journalize each transaction of Samy Co. (Explanations are not required).

The Answer

Date	Account and Explanation	Dr.	Cr.
1	Cash	50,000	
	Share Capital		50,000
2	Land	40,000	
	Cash		10,000
	Notes Payable		30,000
3	Supplies	2,000	
	Accounts Payable		2,000
4	Cash	20,000	
	Notes Payable		20,000
5	Cash	12,000	
	Accounts Receivable	8,000	
	Service Revenue		20,000
6	Accounts Payable	500	
	Cash		500
7	Salary Expense	2,500	
	Advertising Expense	1,500	
	Utilities Expense	500	
	Cash		4,500
8	Dividends	10,000	
	Cash		10,000

Key Terms:

- **Account (الحساب)** : The record of the changes that have occurred in a particular asset, liability, or stockholders’ equity during a period. The basic summary device of accounting.
- **Credit الجانب الدائن من الحساب** : The right side of an account.
- **Debit: الجانب المدين من الحساب** The left side of an account.
- **Journal دفتر اليومية**: The chronological accounting record of an entity’s transactions.
- **Transaction العملية المحاسبية** : Any event that has a financial impact on the business and can be measured reliably.

End of Chapter Questions

<u>Question (1):</u> Choose the best answer for each of the following questions.

1) The debt created by a business when it makes a purchase on account is a(n):

a) accounts receivable.

b) revenue.

c) prepaid expense.

d) accounts payable.

2) Transactions affecting Shareholders' Equity include:

a) sale of ordinary shares and payment of expenses.

b) revenues and purchase of supplies on account.

c) purchase of land and a sale on account.

d) payment of a liability and payment of expenses.

3) The owner of a business paid cash from his personal checking account to purchase an automobile for his personal use. This transaction:

a) increased a liability account and increased liabilities.

b) decreased cash and increased expenses.

c) increased assets and increased owners' equity.

d) is not a transaction recognized by the business.

4) What type of account is prepaid insurance?

a) A liability

b) An expense

c) Shareholders’ equity

d) An asset

5) Receiving a payment from a customer on account would:

a) increase shareholders’ equity.

b) have no effect on total assets.

c) increase shareholders’ equity.

d) decrease liabilities.

6) Which accounts are increased by debits?

a) Assets and owners’ equity

b) Expenses and owners’ equity

c) Assets, expenses and dividends

d) Assets, expenses and owners’ equity

Question (2):

1) Gamal and a few friends invest LE 50,000 to open Gold Star Car Wash, and the business issues ordinary share capital to the shareholders for cash.
2) Gold Star purchases land for a new location and pays cash of LE 40,000.
3) The business buys supplies on account, agreeing to pay LE 3,700 within 30 days.
4) Gold Star earns LE 7,000 of service revenue by providing services for customers. The business collects the cash.
5) Gold Star performs LE 3,000 service on account to YOUSSEF (a customer).
6) During the month, Gold Star pays LE 2,700 for the following expenses: equipment rent, LE 1,100; employee salaries, LE 1,200; and utilities, LE 400.
7) Gold Star pays LE 1,900 on account.
8) Gamal, the major shareholder of Gold Star paid LE 30,000 to remodel his home.

9) Gold Star collected LE 1,000 from YOUSSEF.

10) Gold Star sells some land for LE 22,000, which is the same amount that Gold Star paid for the land.

11) Gold Star declares a dividend and pays the shareholders LE 2,100 cash.

Instructions:

Prepare the journal entries for the above transactions.

Question (3):

Mohamed started his own delivery service, Cairo Deliveries, Inc. on June 1. The following transactions occurred during the month of June.

1) Invested LE 25,000 cash in the business.
2) Purchased used office equipment for LE 13,000. Cairo Deliveries paid LE 2,000 cash and signed a note payable for the remaining balance.
3) Paid LE 900 for office rent for the month.
4) Performed LE 3,000 of services on account.
5) Paid LE 200 in cash dividends.
6) Purchased supplies for LE 400 on account.
7) Received a cash payment of LE 750 for services provided in number 4 above.
8) Purchased gasoline (an expense) for LE 350 on account.
9) Received cash of LE 1,900 for services provided.
10) Made cash payment of LE 500 on the note payable.
11) Paid LE 450 for utilities.
12) Paid for the gasoline purchased on account in number 8 above.
13) Paid LE 600 for employee salaries

Instructions:

Prepare the journal entries to record the above mentioned transactions.

CHAPTER FOUR

The Accounting Process: Posting and Preparing the Trial Balance

Learning Objectives

After studying this chapter, you should be able to:

1. Explain what a ledger is and how it helps in the recording process.
2. Explain what posting is and how it helps in the recording process.
3. Explain the purposes of a trial balance.

The Posting Process

The next step after journalizing transactions in the journal is the posting.

The posting process describes transferring entries from the Journal to the Ledger accounts.

The journal is a chronological record of all company transactions listed by date. But the journal does not indicate how much cash or accounts receivable the business has. ***The ledger*** is a grouping of all the accounts, with their balances. For example, the balance of the Cash account shows how much cash the business has. The balance of Accounts Receivable shows the amount due from customers. Accounts Payable shows how much the business owes suppliers on open account, and so on. In the phrase "keeping the books," books refer to the accounts in the ledger. In most accounting systems, the ledger is computerized.

The Ledger:

The entries from the journal are posted to the ledger.

Posting:

Transferring information from the journals to the ledger accounts.

The Account:

An account is an individual accounting record of increases and decreases in a specific Asset, Liability, or Shareholders' Equity item. Each account has three parts:

1. The Title of the account
2. A left or Debit side
3. A right or Credit side

Debits and Credits:

- Debit means left. Thus, entry on left side is debiting.
- Credit means right. Thus, entry on right side is crediting.
- Normal balance is the side the increase happens on.

The Trial Balance:

A trial balance lists all accounts with their balances—assets first, then liabilities and shareholders' equity. The trial balance summarizes all the account balances for the financial statements and shows whether total debits equal total credits. A trial balance may be taken at any time, but the most common time is at the end of the period. It serves to prove the mathematical equality of debits and credits after posting. It helps in the preparation of financial statements.

The Flow of Accounting Data:

Let's continue the example of El-Salam Advertising Inc., and account for the same 11 transactions we illustrated earlier in chapter 3. Here we use the journal and the accounts. Each journal entry posted to the accounts is keyed by date or by transaction number. This linking allows you to locate any information you may need.

Example 1:

The following transactions occurred during the month of October, 2017 by El-Salam Advertising Inc.:

1. El-Salam invested LE 10,000 Cash in business.
2. El-Salam issued (signed) a 3-month, 12%, LE 5,000 Note Payable to Misr Bank in exchange for cash.
3. El-Salam acquired office equipment by paying LE 5,000 cash to Giza Co.
4. El-Salam received a LE 1,200 cash advance from Adel, (a customer).
5. El-Salam received LE 10,000 in cash from Al-Nasr Co. for advertising services performed.
6. El-Salam paid its office rent in cash, LE 900.
7. El-Salam paid LE 600 for a one-year insurance policy that will expire next year.

8. El-Salam purchases advertising supplies on account from Metro Supply for LE 2,500.
9. El-Salam hired four new employees.
10. El-Salam paid a LE 500 dividend.
11. El-Salam Paid LE 4,000 salaries.

Instructions:

1. Record the journal entries for the above mentioned transactions.
2. Post entries to the ledger accounts.
3. Prepare the trial balance
4. Prepare the income statement and the balance sheet.

The Answer

1. Record the journal entries for the above mentioned transactions:

Date	Account Titles and Explanations	Dr.	Cr.
2017	Cash	10,000	
Oct.	Share Capital		10,000
1	(Invested cash in business)		
	Cash	5,000	
2	Notes Payable		5,000
	(Issued note payable for cash)		
	Office Equipment	5,000	
3	Cash		5,000
	(Purchased office equipment for cash)		
	Cash	1,200	
4	Unearned Revenue		1,200
	(unearned revenue in cash)		
	Cash	10,000	
5	Service Revenue		10,000
	(service revenue in cash)		

6	Rent Expense Cash (Paid rent expense in cash)	900	900
7	Prepaid Insurance Cash (Paid prepaid insurance in cash)	600	600
8	Supplies Accounts Payable (Purchased supplies on account)	2,500	2,500
10	Dividends Cash (Paid Dividends in cash)	500	500
11	Salaries Expense Cash (Paid salaries expense in cash)	4,000	4,000

2. Post entries to the ledger accounts:

Cash

Dr.			Cr.
Transaction No. (1)	10,000	Transaction No. (3)	5,000
Transaction No. (2)	5,000	Transaction No. (6)	900
Transaction No. (4)	1,200	Transaction No. (7)	600
Transaction No. (5)	10,000	Transaction No. (10)	500
		Transaction No. (11)	4,000

Total Dr.	26,200
Total Cr.	11,000
Balance (Dr.)	**15,200**

Share Capital

Dr.			Cr.
		Transaction No. (1)	10000

Total Dr. 0

Total Cr. 10,000

Balance (Cr.) **10,000**

Notes Payable

Dr.			Cr.
		Transaction No. (2)	5,000

Total Dr. 0

Total Cr. 5,000

Balance (Cr.) **5,000**

Office Equipment

Dr.			Cr.
Transaction No. (3)	5,000		

Total Dr. 5000

Total Cr. 0

Balance (Dr.) **5000**

Unearned Revenue

Dr.			Cr.
		Transaction No. (4)	1,200

Total Dr. 0

Total Cr. 1,200

Balance (Cr.) **1,200**

Service Revenue

Dr.			Cr.
		Transaction No. (5)	10,000

Total Dr. 0

Total Cr. 10,000

Balance (Cr.) **10,000**

Rent Expense

Dr.			Cr.
Transaction No. (6)	900		

Total Dr. 900

Total Cr. 0

Balance (Dr.) **900**

Prepaid Insurance

Dr.			Cr.
Transaction No. (7)	600		

Total Dr. 600

Total Cr. 0

Balance (Dr.) **600**

Supplies

Dr.			Cr.
Transaction No. (8)	2,500		

Total Dr. 2500

Total Cr. 0

Balance (Dr.) **2500**

Acc. Payable

Dr.			Cr.
		Transaction No. (8)	2,500

Total Dr. 0
Total Cr. 2,500
Balance (Cr.) **2,500**

Dividends

Dr.			Cr.
Transaction No. (10)	500		

Total Dr. 500
Total Cr. 0
Balance (Dr.) **500**

Salaries Expense

Dr.			Cr.
Transaction No. (11)	4,000		

Total Dr. 4000
Total Cr. 0
Balance (Dr.) **4000**

3. Prepare the trial balance:

El-Salam Corporation
Trial Balance
October 31, 2017

Account	Dr.	Cr.
cash	15,200	
supplies	2,500	
prepaid insurance	600	
office equipment	5,000	
notes payable		5,000
accounts payable		2,500
unearned revenue		1,200
share capital		10,000
dividends	500	
service revenue		10,000
rent expense	900	
salaries expense	4,000	
total	28,700	28,700

4. Prepare the income statement and the balance sheet:

El-Salam Corporation
Income Statement
for the Month Ended Oct. 31, 2017

Revenues:		
Service Revenues	10,000	
Total Revenues		10,000
Expenses:		
salaries Expense	4,000	
Rent Expense	900	
Total Expenses		(4,900)
Net Income		5,100

Retained Earnings

Retained Earnings, 1/10/2017	0
Add: Net Income	5,100
Less: Dividends	(500)
Retained Earnings, 31/10/2017	4,600

El-Salam Corporation
Balance Sheet
Oct. 31, 2017

Assets		
Cash	15,200	
Supplies	2,500	
Prepaid Insurance	600	
Office Equipment	5,000	
Total Assets		23,300
Liabilities and Shareholders' Equity		
Liabilities:		
Notes payable	5,000	
accounts payable	2,500	
Unearned Revenue	1,200	
Total Liabilities		8,700
Shareholders' Equity:		
Share Capital	10,000	
Retained Earnings	4,600	
Total Shareholders' Equity		14,600
Total Liabilities and Shareholders' Equity		23,300

Example 2:

On August 31, the balance sheet of Salem Corporation showed Cash LE 10,500, Accounts Receivable LE 2,500, Office Equipment LE 6,000, Accounts Payable LE 4,400, Share Capital LE 13,000, Supplies LE 600, and Retained Earnings LE 2,200, During September the following transactions occurred.

1) Paid LE 3,100 cash on accounts payable.
2) Collected LE 1,500 of accounts receivable.

3) Purchased additional office equipment for LE 3,500, paying LE 800 in cash and the balance on account.
4) Earned revenues of LE 7,800, of which LE 2,500 is in cash and the balance is due in October.
5) Paid dividends of LE 800.
6) Paid salaries LE 700, rent for September LE 900, and advertising expense LE 200.
7) Incurred utility expenses for the month on account, LE 350.
8) Received LE 6,000 from Alexandria Bank-money borrowed on a note payable.

Instructions:

a) Prepare the journal entries for the above transactions.
b) Post to the Cash T-account and calculate the ending balance.
c) Post to the Accounts Payable T-account and calculate the ending balance.

The Answer

a) Prepare the journal entries for the above transactions.

Date	Account Titles and Explanations	Dr.	Cr.
1	Accounts Payable	3,100	
	Cash		3,100
	(Paid accounts payable in cash)		
2	Cash	1,500	
	Accounts Receivable		1,500
	(Collected accounts receivable in cash)		
3	Office Equipment	3,500	
	Cash		800
	Accounts Payable		2,700
	(Purchased office equipment)		

Date	Account Titles and Explanations	Dr.	Cr.
4	Cash	2,500	
	Accounts Receivable	5,300	
	Service Revenue		7,800
	(Provided service)		
5	Dividends	800	
	Cash		800
	(Paid dividends in cash)		
6	Salaries Expense	700	
	Rent Expense	900	
	Advertising Expense	200	
	Cash		1,800
	(Paid expenses in cash)		
7	Utility Expense	350	
	Accounts Payable		350
	(Incurred utility expense on account)		
8	Cash	6,000	
	Notes Payable		6,000
	(Borrowed cash on a note payable)		

b) Post to the Cash T-account and calculate the ending balance.

Cash

Dr.			Cr.
Beginning Balance	10,500		
Transaction No. (2)	1,500	Transaction No. (1)	3,100
Transaction No. (4)	2,500	Transaction No. (3)	800
Transaction No. (8)	6,000	Transaction No. (5)	800
		Transaction No. (6)	1,800

Total Dr.	20,500
Total Cr.	6,500
Balance (Dr.)	**14,000**

c) **Post to the Accounts Payable T-account and calculate the ending balance.**

Accounts Payable

Dr.			**Cr.**
		Beginning Balance	4,400
Transaction No. (1)	3,100	Transaction No. (3)	2,700
		Transaction No. (7)	350

Total Dr.	3,100
Total Cr.	7,450
Balance (Cr.)	**4,350**

Example 3:

Mohamed started his own delivery service, Cairo Deliveries, Inc. on June 1. The following transactions occurred during the month of June.

1) Invested LE 25,000 cash in the business.
2) Purchased used office equipment for LE 13,000. Cairo Deliveries paid LE 2,000 cash and signed a note payable for the remaining balance.
3) Paid LE 900 for office rent for the month.
4) Performed LE 3,000 of services on account.
5) Paid LE 200 in cash dividends.
6) Purchased supplies for LE 400 on account.
7) Received a cash payment of LE 750 for services provided in number 4 above.
8) Purchased gasoline (an expense) for LE 350 on account.
9) Received cash of LE 1,900 for services provided.
10) Made cash payment of LE 500 on the note payable.
11) Paid LE 450 for utilities.
12) Paid for the gasoline purchased on account in number 8 above.
13) Paid LE 600 for employee salaries

Instructions:

a) Prepare the journal entries for the above transactions.

b) Post to the Cash T-account and calculate the ending balance.

c) Post to the Accounts Payable T-account and calculate the ending balance.

The Answer

a) Prepare the journal entries for the above transactions.

Date	Account Titles and Explanations	Dr.	Cr.
1	Cash	25,000	
	Share Capital		25,000
	(Invested cash in business)		
2	Office Equipment	13,000	
	Cash		2,000
	Notes Payable		11,000
	(Purchased office equipment)		
3	Rent Expense	900	
	Cash		900
	(Paid rent expense in cash)		
4	Accounts Receivable	3,000	
	Service revenue		3,000
	(Performed service on account)		
5	Dividends	200	
	Cash		200
	(Paid dividends in cash)		
6	Supplies	400	
	Accounts payable		400
	(Purchased supplies on account)		
7	Cash	750	
	Accounts Receivable		750
	(Collected accounts receivable in cash)		
8	Gasoline expense	350	
	Accounts payable		350
	(Purchased gasoline on account)		
9	Cash	1,900	
	Service revenue		1,900
	(Provided service for cash)		

10	Notes Payable	500	
	Cash		500
	(Paid a note payable)		
11	Utilities Expense	450	
	Cash		450
	(Paid utilities expense in cash)		
12	Accounts payable	350	
	Cash		350
	(Paid accounts payable in cash)		
Date	Account Titles and Explanations	Dr.	Cr.
13	Salaries Expense	600	
	Cash		600
	(Paid salaries expense in cash)		

b) Post to the Cash T-account and calculate the ending balance.

Cash

Dr.			Cr.
Transaction No. (1)	25,000	Transaction No. (2)	2,000
Transaction No. (7)	750	Transaction No. (3)	900
Transaction No. (9)	1,900	Transaction No. (5)	200
		Transaction No. (10)	500
		Transaction No. (11)	450
		Transaction No. (12)	350
		Transaction No. (13)	600

Total Dr.	27,650
Total Cr.	5,000
Balance (Dr.)	**22,650**

c) Post to the Accounts Payable T-account and calculate the ending balance.

Accounts Payable

Dr.		Cr.	
Transaction No. (12)	350	Transaction No. (6)	400
		Transaction No. (8)	350

Total Dr.	350
Total Cr.	750
Balance (Cr.)	**400**

Example 4:

1) Gamal and a few friends invest LE 50,000 to open Gold Star Car Wash, and the business issues ordinary share capital to the shareholders for cash.
2) Gold Star purchases land for a new location and pays cash of LE 40,000.
3) The business buys supplies on account, agreeing to pay LE 3,700 within 30 days.
4) Gold Star earns LE 7,000 of service revenue by providing services for customers. The business collects the cash.
5) Gold Star performs LE 3,000 service on account to YOUSSEF (a customer).
6) During the month, Gold Star pays LE 2,700 for the following expenses: equipment rent, LE 1,100; employee salaries, LE 1,200; and utilities, LE 400.
7) Gold Star pays LE 1,900 on account.
8) Gamal, the major shareholder of Gold Star paid LE 30,000 to remodel his home.
9) Gold Star collected LE 1,000 from YOUSSEF.
10) Gold Star sells some land for LE 22,000, which is the same amount that Gold Star paid for the land.
11) Gold Star declares a dividend and pays the shareholders LE 2,100 cash.

Instructions:

a) Prepare the journal entries for the above transactions.

b) Post to the Cash T-account and calculate the ending balance.

c) Post to the Accounts Payable T-account and calculate the ending balance.

The Answer

a) Prepare the journal entries for the above transactions.

Date	Account Titles and Explanations	Dr.	Cr.
1	Cash	50,000	
	Share Capital		50,000
	(Invested cash in business)		
2	Land	40,000	
	Cash		40,000
	(Purchased land for cash)		
3	Supplies	3,700	
	Accounts Payable		3,700
	(Purchased supplies on account)		
4	Cash	7,000	
	Service Revenue		7,000
	(Provided services for cash)		
5	Accounts Receivable (Youssef)	3,000	
	Service Revenue		3,000
	(Provided services on account)		
6	Equipment Rent Expense	1,100	
	Salaries Expense	1,200	
	Utilities Expense	400	
	Cash		2,700
	(Paid expenses in cash)		
7	Accounts Payable	1,900	
	Cash		1,900
	(Paid accounts payable in cash)		
8	This is not a business transaction it is a personal transaction		
9	Cash	1,000	
	Accounts Receivable (Youssef)		1,000
	(Collected accounts receivable in cash)		

10	Cash	22,000	
	Land		22,000
	(Sold land in cash)		
11	Dividends	2,100	
	Cash		2,100
	(Paid dividends in cash)		

b) Post to the Cash T-account and calculate the ending balance.

Cash

Dr.			Cr.
Transaction No. (1)	50,000	Transaction No. (2)	40,000
Transaction No. (4)	7,000	Transaction No. (6)	2,700
Transaction No. (9)	1,000	Transaction No. (7)	1,900
Transaction No. (10)	22,000	Transaction No. (11)	2,100

Total Dr. 80,000
Total Cr. 46,700
Balance (Dr.) **33,300**

c) Post to the Accounts Payable T-account and calculate the ending balance.

Accounts payable

Dr.			Cr.
Transaction No. (7)	1,900	Transaction No. (3)	3,700

Total Dr. 1,900
Total Cr. 3,700
Balance (Cr.) **1,800**

Example 5:

The accounts of Deluxe Pool Service, Inc. follow with their normal balances at June 30, 2018. The accounts are listed in no particular order.

Account	Balance	Account	Balance
Dividends	LE 6,100	Share Capital	LE 8,400
Utilities expense	2,100	Accounts payable	4,400
Accounts receivable	15,900	Service revenue	22,400
Delivery expense	700	Land	29,800
Retained earnings	25,600	Note payable (Long-term)	10,500
Salary expense	8,200	Cash	8,500

Instructions

Prepare the company's trial balance at June 30, 2018, **listing accounts in proper sequence**.

The Answer

Deluxe Pool Service, Inc.
Trial Balance
As at June 30, 2018

ACCOUNT	DEBIT	CREDIT
Cash	8,500	
Accounts receivable	15,900	
Land	29,800	
Accounts payable		4,400
Note payable (Long-term)		10,500
Share capital		8,400
Retained earnings		25,600
Dividends	6,100	
Service revenue		22,400
Salary expense	8,200	
Utilities expense	2,100	
Delivery expense	700	
Total	71,300	71,300

Chart of Accounts

The ledger contains the accounts grouped under these headings:

1. Balance sheet accounts: Assets, Liabilities, and Stockholders' Equity

2. Income statement accounts: Revenues and Expenses

Organizations use a chart of accounts to list all their accounts and account numbers. Account numbers usually have 2 or more digits. Asset account numbers may begin with 1, liabilities with 2, stockholders' equity with 3, revenues with 4, and expenses with 5. The second, third, and higher digits in an account number indicate the position of the individual account within the category. For example, Cash may be account number 101, which is the first asset account. Accounts Payable may be number 201, the first liability. All accounts are numbered by using this system.

Organizations with many accounts use lengthy account numbers. For example, the chart of accounts of Apple Computer may use 5-digit account numbers.

Key Terms

- **Chart of accounts** دليل الحسابات: List of a company's accounts and their account numbers.
- **Ledger دفتر الأستاذ:** The book of accounts and their balances.
- **Posting الترحيل:** Copying amounts from the journal to the ledger.
- **Trial balance ميزان المراجعة**: A list of all the ledger accounts with their balances.

End of Chapter Exercises

Exercise (1):

Choose the best answer for each of the following questions.

1) Dalia Company showed the following balances at the end of its first year:

Cash	**LE 7,000**
Prepaid insurance	**700**
Accounts receivable	**3,500**
Accounts payable	**2,800**
Notes payable	**4,200**
Capital	**1,400**
Dividends	**700**
Revenues	**21,000**
Expenses	**17,500**

What did Dalia Company show as total Debit on its trial balance?

a) LE 30,100
b) LE 29,400
c) LE 28,700
d) LE 30,800

2) The normal balance of the Share Capital account is a ________ because it increases ________

a) debit, shareholders' equity
b) debit, expenses
c) credit, shareholders' equity
d) debit, assets

3) Which of the following statements regarding accounts is TRUE?

a) Dividends are decreased by debits and increased by credits.
b) A liability is increased by a debit and decreased by a credit.
c) Revenue is increased by a debit; an expense is increased by a credit.
d) An asset is increased by a debit and decreased by a credit.

4) The trial balance is used to determine whether:

a) total increases in accounts equal total decreases in accounts
b) total assets equal total liabilities.
c) total debits equal total credits.
d) total revenues plus gains equal total expenses plus losses.

Exercise 2:

Green Tree Cellular, Inc. completed the following transactions during April 2018, its first month of operations:

Apr.	1	Invested LE 19,100 cash in the business.
	2	Purchased LE 300 of office supplies on account.
	4	Paid LE 14,700 cash for land to use as a building site.
	6	Performed service for customers and received cash of LE 2,700.
	9	Paid LE 200 on accounts payable.
	17	Performed service for **Fady** on account totaling LE 1,000.
	23	Collected LE 200 from **Fady**.
	30	Paid the following expenses: salary, LE 1,300; rent, LE 500.

Required

1. Record the transactions in the journal of Green Tree Cellular, Inc.
2. Post the entries to the ledger.
3. Prepare the trial balance of Green Tree Cellular, Inc., at April 30, 2018, **listing accounts in proper sequence**

Exercise 3:

During October, Samy Co. completed the following transactions:

1. Samy Co. received LE 75,000 cash and issued ordinary shares to the shareholders.
2. Purchased supplies on account, LE 3,000.
3. Borrowed LE 30,000 from the bank for business use. Samy Co. signed a note payable to the bank in the name of the business.

4. Paid LE 15,000 cash and signed a LE 45,000 note payable to purchase land for an office site.
5. Service revenue earned during the month included LE 18,000 cash and LE 12,000 on account.
6. Paid LE 750 on account payable.
7. Paid employees' salaries LE 3,750, advertising expense LE 2,250 and utilities expense LE 750.
8. Declared and paid a cash dividend of LE 15,000.

Required

1) Journalize each transaction of Samy Co. (**Explanations are not required**).
2) Post to the Cash T-account and calculate the ending balance.

CHAPTER FIVE

Financial Accounting and Adjusting Entries

Learning Objectives

After studying this chapter, you should be able to:

1. Explain the time period assumption.
2. Explain the accrual basis of accounting.
3. Explain the reasons for adjusting entries and identify major types of adjusting entries
4. Prepare adjusting entries for deferrals
5. Prepare adjusting entries for accruals
6. Describe nature and purpose of adjusted trial balance
7. Prepare an adjusted trial balance

5.1 Why are adjusting entries prepared within the accounting cycle of most business entities?

Adjusting entries rise as a result of applying the cash/accrual basis of accounting.

Definition of Cash Accounting

The basis of accounting in which the recognition of revenues and expenses are done only when there is actual receipt or disbursement of cash takes place. In this method, the revenue or expense is recognized when the inflow or outflow of cash exists in reality.

The method is mostly used by sole traders, contractors and other professionals who recognize their income when there is an inflow of cash and report expenses when cash goes out of the entity.

Definition of Accrual Accounting

Accrual Accounting is the base of present accounting. It is also known as the mercantile system of accounting wherein the transactions are recognized as and when they take place. Under this method, the revenue is recorded when it is earned, and the expenses are reported when they are incurred.

As per matching concept, the expenses of a particular accounting period are matched with its revenue. The accrual basis of accounting fulfills this criterion; that is why it is regarded as an effective tool for recording receipts and payments. Although, some items are necessary to be adjusted at the end of the financial year like:

- Unearned Income
- Accrued Income
- Prepaid Expenses
- Outstanding Expenses

This method is preferred by most of the entities as the system not only informs about the past transactions regarding the revenue and expense, but it also predicts the cash receipts and disbursements expected to arise in the future. Besides this, one of the major drawbacks of accrual accounting is that the company has to pay tax on the income which is not yet received.

Comparions Chart

BASIS FOR COMPARISON	CASH ACCOUNTING	ACCRUAL ACCOUNTING
Meaning	The accounting method in which the income or expense is recognized only when there is actual inflow or outflow of cash.	The accounting method in which the income or expense is recognized on mercantile basis.
Nature	Simple	Complex
Method	Not recognized method as per companies act.	Recognized method as per companies act.
Income statement	Income statement shows lower income.	Income statement will show a comparatively higher income.
Applicability of matching concept	No	Yes
Recognition of revenue	Cash is received	Revenue is earned
Recognition of expense	Cash is paid	Expense is incurred
Degree of Accuracy	Low	Comparatively high

5.2 What are adjusting entries?

Adjusting entries are usually made on the last day of an accounting period (year, quarter, month) so that the financial statements reflect the revenues that have been earned and the expenses that were incurred during the accounting period.

Sometimes an adjusting entry is needed because:

- revenue has been earned, but it has not yet been recorded.
- an expense may have been incurred, but it hasn't yet been recorded.
- a company may have paid for six-months of insurance coverage, but the accounting period is only one month. (This means that five months of insurance expense is prepaid and should not be reported as an expense on the current income statement.)
- a customer paid a company in advance of receiving goods or services. Until the goods or services are delivered, the amount is reported as a liability. After the goods or services are delivered, an entry is needed to reduce the liability and to report the revenues.

A common characteristic of an adjusting entry is that it will involve one income statement account and one balance sheet account. (The purpose of each adjusting entry is to get both the income statement and the balance sheet to be accurate.)

5.3 Recognition of Revenue and Expenses

Determining the amount of revenue and expenses, shown in the financial statements of a particular accounting period, is a Very complicated task. For that reason the accountants follow two generally accepted accounting principles – revenue recognition principles and matching principles.

According to ***revenue recognition principle*** the revenue, earned in a particular accounting period, is revenue of that period. For example, sale price realized or receivable on account of a particular accounting period is the revenue of that period.

Whether sale or service rendered in an accounting period is treated as income on occurrence or on cash received depends on accounting principle. Generally merchandise or service is treated as income when it is transferred.

5.4 Time of Preparation of Adjusting Entries

While preparing financial statements necessary adjusting entries are to be passed. Therefore if the financial statements are prepared at the end of six months period in that case also necessary adjusting entries are to be passed.

As per convention and some laws, business organizations report the results and financial position of the business to the owners at least once in a year. That is why adjusting entries are required at least once in a year for preparing financial statement correctly.

5.5 Types of Adjusting Entries

Types of adjusting entries are discussed below:

1. Advances, and
2. Accruals.

Each of them is again of two types as stated below:

1. Advances
    1. Advance payment of expenses: Cash payment of expenses and recording them property until used or expiry of period.
    2. Unearned Income: Unearned income received for cash and recorded as cash received and liability till income accrued.
2. Accruals
    1. Accrued Income: Revenue accrued but not yet received for cash or accounted for.
    2. Outstanding Expenses: Expenses incurred but not yet paid or accounted for.

Accrued Revenues

If you perform a service for a customer in one month but don't bill the customer until the next month, you would make an adjusting entry showing the revenue in the month you performed the service. You would debit accounts receivable and credit service revenue.

Accrued Expenses

A good example of accrued expenses is wages paid to employees. When a business firm owes wages to employees at the end of an accounting period, they make an adjusting journal entry by debiting wages expense and crediting wages payable.

Unearned Revenues

Unearned revenues refer to payments for goods to be delivered in the future or services to be performed. If you place an order for an item from a company on the Internet in February and that item does not arrive (and you don't pay for it) until March, the company from which you placed the order would record the cost of that item as unearned revenue. During the month which you made the purchase, the company would make an adjusting entry debiting unearned revenue and crediting revenue.

Prepaid Expenses

Prepaid expenses are a very descriptive title. Prepaid expenses are assets that are paid for and gradually get used up during the accounting period. A common example of prepaid expenses is office supplies. A company buys and pays for office supplies. Gradually, during the accounting period, the office supplies are used up. As they are used up, they become an expense. During the month when the office supplies are used, an adjusting entry is made to debit office supply expense and credit prepaid office supplies.

Depreciation

Depreciation is the process of allocating the cost of an asset, such as a building or a piece of equipment, over the serviceable or economic life of the asset. Adjusting entries are a little different for depreciation. Business owners have to take accumulated depreciation into account. Accumulated depreciation is just what it says - the accumulated depreciation of a company's assets over the life of the company.

The accumulated depreciation account on the balance sheet is called a contra-asset account, and it is used to record depreciation expense. Increases are recorded as credits in contra-asset accounts. When an asset is purchased, it depreciates by some amount every month. For that month, an adjusting entry is made to debit depreciation expense - equipment and credit accumulated depreciation by the same amount.

After you make your adjusted entries, you post your adjusted entries to your general ledger accounts and prepare the adjusted trial balance. The process is just like preparing the trial balance except the adjusted entries are used. You correct any errors that you found.

6.6 Examples and Exercises

This example is a continuation of the accounting cycle problem we have been working on. In the previous step we prepared an unadjusted trial balance. Here we will pass adjusting entries.

Relevant information for the preparation of adjusting entries of Company A
Office supplies having original cost L.E4, 320 were unused till the end of the period. Office supplies having original cost of L.E22, 800 are shown on unadjusted trial balance.

Prepaid rent of L.E36,000 was paid for the months January, February and March.
The equipment costing L.E80,000 has useful life of 5 years and its estimated salvage value is L.E14,000. Depreciation is provided using the straight line depreciation method.
The interest rate on L.E20,000 note payable is 9%. Accrue the interest for one month.
L.E3,000 worth of service has been provided to the customer who paid advance amount of L.E4,000.

The adjusting entries of Company A are:

Date	Account	Debit	Credit
Jan 31	Supplies Expense	18,480	
	Office Supplies		18,480
	Supplies Expense = L.E22,800 − L.E4,320 = L.E18,480		
Jan 31	Rent Expense	12,000	
	Prepaid Rent		12,000
	Rent Expense = L.E36,000 ÷ 3 = L.E12,000		
Jan 31	Depreciation Expense	1,100	
	Accumulated Depreciation		1,100

	Depreciation Expense = (L.E80,000 – L.E14,000) ÷ (5 × 12) = L.E1,100		
Jan 31	Interest Expense	150	
	Interest Payable		150
	Interest Expense = L.E20,000 × (9% ÷ 12) = L.E150		
Jan 31	Unearned Revenue	3,000	
	Service Revenue		3,000

An adjusted trial balance is prepared in the next step of the **accounting cycle.**

Adjusting Entries for Rent Expense

Exercise 1

On September 1, 20x1, Entity A entered into an agreement to rent office space for a year and paid L.E36,000 for a six-month rent. Prepare journal entries on the following dates:

September 1, 20x1

Paid L.E36,000 rent for a six-month period from September 1, 20x1 to February 28, 20x2

Dr.Prepaid rent	**36,000**	
Cr.Cash		**36,000**

December 31, 20x1

Record the rent expense for the period from September 1, 20x1 to December 31, 20x1

Dr.Rent expense	**24,000**	
Cr.Prepaid rent		**24,000**

[Note]Monthly rent expense = L.E36,000 / 6 months = L.E6,000

Rent expense for the period from September 1 to December 31 = L.E6,000 x 4 = L.E24,000

Adjusting Entries for Supplies Expense

Exercise 2

On December 1, 20x1, Entity B purchased L.E4,500 supplies and recorded as an asset. On December 31, 20x1, Entity B checked supplies and found L.E1,200 in the inventory. Prepare journal entries on the following dates:

December 1, 20x1

Dr.Supplies	**4,500**	
Cr.Cash		**4,500**

December 31, 20x1

Dr.Supplies expense	**3,300**	
Cr.Supplies		**3,300**

[Note]

Supplies consumed during December = L.E4,500 - L.E1,200 = L.E3,300

Exercise 3

On December 1, 20x1, Entity C purchased L.E3,000 supplies and recorded as supplies expense.

On December 31, 20x1, Entity C checked supplies and found L.E1,000 in inventory. Prepare journal entries on the following dates:

December 1, 20x1

Dr.Supplies expense	**4,500**	
Cr.Cash		**4,500**

December 31, 20x1

Dr.Supplies	**1,200**	
Cr.Supplies expense		**1,200**

[Note]
Supplies left in the inventory at December 31, 20x1 = L.E1,200

Adjusting Entries for Insurance Expense

Exercise 4

On December 1, 20x1, Entity D signed a new insurance contract and paid L.E6,300 insurance premium for a three-month period from December 1 20x1 to February 20x2. Prepare journal entries on the following dates:

December 1, 20x1

Prepaid insurance	**6,300**	
Cash		**6,300**

December 31, 20x1

Insurance expense	**2,100**	
Prepaid insurance		**2,100**

[Note]
Insurance expense for December 20x1 = L.E6,300 / 3 months = L.E2,100
The balances of prepaid insurance account are as follows:

Balance at December 1, 20x1 = L.E6,300
Balance at December 31, 20x1 = L.E6,300 - L.E2,100 = L.E4,200

Adjusting Entries for Salaries Expense

Exercise 5

On December 16, 20x1, Entity E hired a new staff with a monthly salary of L.E4,600. Monthly salary is paid on the 15th of each month. Prepare journal entries on the following dates:

December 16, 20x1

No journal entry is prepared when a new staff is hired.

December 31, 20x1

Salaries expense	**2,300**	
Salaries payable		**2,300**

[Note]

Salaries expense = L.E4,600 / 2 = L.E2,300

Adjusting Entries for Unearned Revenue

Exercise 6

On November 9, 20x1, Entity G received L.E1,200 from a subscriber to a magazine issued by the entity. Each issue of the magazine is published and sent to subscribers on the first day of each month. Prepare journal entries on the following dates:

November 9, 20x1

Cash	**12,000**	
Unearned subscription revenue		**12,000**

December 1, 20x1

Unearned subscription revenue	**1,000**	
Subscription revenue		**1,000**

5.7 Adjusted Trial Balance

Adjusted trial balance is the fifth step of accounting cycle that is prepared after the preparation and posting of adjusting entries to the relevant ledger accounts. Adjusted trial balance provides enough information for the preparation of a number of financial statements such as income statement, balance sheet and statement of changes in equity.

Format and methods of preparing adjusted trial balance

The format of adjusted trial balance is similar to that of unadjusted trial balance. It has three columns. The first column is used to write account names or titles, the second column is used to write debit amounts and the third column is used to write credit amounts. Adjusted trial balance is prepared using one of the two methods explained below:

First method:

The first method is similar to the preparation of an unadjusted trial balance. The ledger accounts are adjusted for the end of period adjusting entries and the account balances are listed to prepare adjusted trial balance. This method is time consuming but is considered more systematic and is usually used by large companies where a lot of adjusting entries are prepared at the end of each accounting period.

Second method:

The second method is simple and fast but less systematic and is usually used by small companies where only a few adjusting entries are found at the end of accounting period. In this method, the adjusting entries are directly added to the unadjusted trial balance to convert it to adjusted trial balance.

Both the methods are in practice and produce the same result. To simplify the procedure, we shall use the second method in the next example.

Example:

Marketing Consulting Service Inc. adjusts its accounts at the end of each month. The unadjusted trial balance on December 31, 2015 and adjusting entries for the month of December are given below. The adjusting entries for the first 11 months of the year 2015 have already been made.

Marketing Consulting Service, Inc Unadjusted Trail balance December 31, 2015		
Account name	Debit	Credit
Cash	24550	
Consulting fees receivable	11700	
Prepaid office rent	3150	
Prepaid dues and subscriptions	150	
Supplies	300	
Equipment	18000	
Accumulated Depreciation – equipment		5100
Note payable		2500
Income tax payable		6000
Unearned consulting fees revenue		2975
Capital stock		15000
Retained earnings		16350
Dividends	30,000	
Consulting fees earned		128590
Salaries expense	44,410	
Telephone expense	1275	
Rent expense	11000	
Income tax expense	25500	
Dues and subscription expense	280	
Supplies expense	800	
Depreciation expense – equipment	3300	

Miscellaneous expense	2100	
Total	**176515**	**176515**

Marketing Consulting Service, Inc

General journal

December 31, 2015

Date	Account Title and explanation	Debit	Credit
1	Rent Expense	1050	
	Prepaid office rent		1050
2	Dues and subscription expense	50	
	Prepaid Dues and subscription		50
3	Supplies expense	75	
	Supplies		75
4	Depreciation expense – equipment	300	
	Accumulated depreciation– equipment		300
5	Interest expense	50	
	Interest payable		50
6	Unearned consulting fees	1425	
	Consulting fees earned		1425
7	Consulting fees receivables	5500	
	Consulting fees earned		5500
8	Salaries expense	850	
	Salaries payable		850
9	Income tax expense	2500	
	Income tax payable		2500

Required: Prepare an adjusted trial balance of Marketing Consulting Service Inc. on December 31, 2015.

Solution

Marketing Consulting Service, Inc adjusted Trail balance, December 31, 2015		
Account name	Debit	Credit
Cash	24550	
Consulting fees receivable	17200	
Prepaid office rent	2100	
Prepaid dues and subscriptions	100	
Supplies	225	
Equipment	18000	
Accumulated Depreciation – equipment		5400
Note payable		2500
Income tax payable		8500
Unearned consulting fees revenue		1550
Salaries payable		850
Interest payable		50
Capital stock		15000
Retained earnings		16350
Dividends	30,000	
Consulting fees earned		135515
Salaries expense	45,260	
Telephone expense	1275	
Rent expense	12050	
Interest expense	50	
Income tax expense	28000	
Dues and subscription expense	330	
Supplies expense	875	
Depreciation expense – equipment	3600	
Miscellaneous expense	2100	
Total	**185715**	**185715**

The accounts that have been affected as a result of making adjusting entries for the month of December are shown in red color in the adjusted trial balance.

Key Terms:

1. **Cash basis**—an accounting method in which an expense is recorded when cash is paid and revenue is recorded when cash is received. Cash-basis accounting is NOT in accordance with GAAP.
2. **Accrual basis**—an accounting method in which an expense is recorded when it is incurred and revenue is recorded when it is earned. It is the basis of accounting in which transactions that change a company's financial statements are recorded in the periods in which the events occur.
3. **Matching principle**—the accounting principle that states that revenue earned during an accounting period should be offset by the expenses that were incurred in earning that revenue.
4. **Fiscal year**—an accounting period that is one year in length. A fiscal year usually begins on the first day of a month and ends twelve months later on the last day of a month.
5. **Calendar year**—an accounting period that extends from January 1 to December 31.
6. **Accruals**—Expenses incurred and revenue earned in the current accounting period but not recorded as of the end of the period. To accrue means to build up or to accumulate.
7. **Deferrals**—Expenses and revenues that have been recorded in the current accounting period but are not incurred or earned until a future period. To defer means to put off or to postpone.
8. **Prepaid Expenses**—expenses paid in cash and recorded as assets (or expenses as shown in the chapter appendix—alternative treatment of prepaid expenses) before they are used or consumed. Depreciation of plant assets falls into this category.

9. **Unearned Revenues**—cash received and recorded as liabilities (or revenues as shown in the chapter appendix—alternative treatment of unearned revenues) before revenue is earned.

10. **Accrued Revenues**—revenues earned but not yet received in cash or recorded.

11. **Accrued Expenses**—expenses incurred but not yet paid in cash or recorded.

End of chapter questions and problems

I . Matching Question

1. Unearned Revenue	A. Liability created when customers pay in advance for products or services
2. Accrued Expenses	B. Revenues earned but not received in cash or recorded
3. Accrued Revenues	C. Expense created by allocating the cost of an asset to expense over its useful life.
4. Depreciation	D. Expenses incurred but not yet paid in cash or recorded
5. Prepaid Expenses	E. E. Expenses such as cash that benefit more than one accounting period and are recorded as assets

True/False questions

1. Entries made at the end of an accounting period to bring an asset or liability account to its proper amount and update the related expense → adjusting entries
2. An assumption that accountants can divide the economic life of a business into artificial time periods → Accounting period
3. 12 month period that ends when a company's sales activities are at their lowest point → natural business year
4. Financial statements covering periods of less than one year → interim financial statements
5. The principle that requires that companies match efforts with accomplishments → unearned revenue

III Multiple choice questions

1. **An accounting period that is one year in length chosen as the organization's annual accounting period**

   a) fiscal year
   b) plant assets
   c) contra account
   d) cash-basis accounting

2. **Accounting system that that recognizes revenues when cash is received and records expenses when cash is paid**
   a) cash-basis accounting
   b) accrual-basis accounting
   c) contra account
   d) fiscal year

3. **List of accounts and balances prepared before accounting adjustments are recorded**
   a) adjusted trial balance
   b) accrual-basis accounting
   c) unearned revenue
   d) unadjusted trial balance

4. **Accounting system that recognizes revenues when earned and expenses when incurred**
   a) unadjusted trial balance
   b) accrual-basis accounting
   c) cash-basis accounting
   d) adjusted trial balance

5. **Tangible, long-lived assets used to produce or sell products or services**
   a) depreciation
   b) unearned revenue
   c) plant assets
   d) profit margin

IV Practice Problem 1

The trial balance of ABC co at October 31, 2006, the end of the current year, is shown below.

ABC Co
Trial Balance
October 31, 2006

Cash	3950	
Supplies	6295	
Prepaid Insurance	2735	
Equipment	50650	
Accumulated Depreciation – Equipment		11209
Trucks	36300	
Accumulated Depreciation – Trucks		7400
Accounts Payable		4015
Mohamed Salah, Capital		37426
Mohamed Salah, Drawing	6000	
Service Revenue		89950
Wages Expense	26925	
Rent Expense	9600	
Truck Expense	5350	
Miscellaneous Expense	2195	
Total	**150000**	**150000**

The data needed to determine year-end adjustments are as follows:
a**.** Supplies on hand at October 31 are L.E1,150.

b. Insurance premiums expired during year are L.E1,800. c. Depreciation of equipment during year is L.E3,380.
d. Depreciation of trucks during year is L.E4,400.
e. Wages accrued but not paid at October 31 are L.E1,075.

Instructions

1. Journalize the required adjusting entries,
2. Prepare an Adjusted Trial Balance

CHAPTER SIX

Financial Statements

Learning Objectives

After studying this chapter, you should be able to:

- Explain the need for financial statements preparation
- Identify different types of financial statements
- Identify and describe each financial statement, its contents and objective
- Prepare financial statements

6.1 What are Financial Statements?

Financial statements are reports prepared and issued by company management to give investors and creditors additional information about a company’s performance and financial standings. The four general purpose financial statements include:

- Income Statement
- Balance Sheet
- Statement of Stockholders Equity
- Statement of Cash Flows

These reports are prepared in this order and are issued to the public as a full set of statements. This means they are not only published together, but they are also designed and intended to be read and used together.

The purpose of these reports is to provide useful financial information to users outside of the company. In essence, these reports complete the fundamental purpose of financial accounting by providing information that is helpful in the financial decision-making process.

6.2 What are the different types of Financial Statements?

Interim Statements

Financial sheets that are issued for time periods smaller than one year are called interim statements because they are used as temporary statements to judge a company’s financial position until the full annual statements are issued.

Interim financial statements are most commonly issued quarterly or semi-annually. In Egypt, all listed companies on the Egyptian Stock Exchange (EGX) are required to prepare quarterly financial statements.

Annual Statements

The annual financial statement is prepared once a year and covers a 12-month period of financial performance. Generally, these statements are issued at the end of a company's fiscal year instead of a calendar year. Public companies are required to issue both interim and annual statements. A CPA firm must always audit annual statements, but some interim statements can simply be reviewed by a qualified firm.

6.3 What are the main financial sheets prepared by most companies?

The following are the most popular financial statements prepared by most companies and will be discussed in the following sections:

- Income Statement
- Statement of Stockholders Equity
- Balance Sheet
- Statement of Cash Flow

6.3.1 The Income Statement

What is an Income Statement?

The income statement is a report that shows the income, expenses, and resulting profits or losses of a company during a specific time period.

The income statement calculates the net income of a company by subtracting total expenses from total income. This calculation shows investors and creditors the overall profitability of the company as well as how efficiently the company is at generating profits from total revenues.

Income Statement Format

There are two income statement formats that are generally prepared.

- ***The Single-step income statement*** –Only shows one category of income and one category of expenses. This format is less useful of external users because they can't calculate many efficiency and profitability ratios with this limited data.
- ***The Multi-step income statement*** –Separates expense accounts into more relevant and usable accounts based on their function. Cost of goods sold, operating and non-operating expenses are separated out and used to calculate gross profit, operating income, and net income.

Income Statement Example

Here is an example of a Single Step Income Statement format

Paul's Gitar Shop, Inc. **Income Statement** **For the Year Ended December 31, 2105**		
Revenues:		
Merchandise sales	24800	
Music Lesson Income	3000	
Total Revenues		27800
Expenses:		
Cost of goods sold	10200	
Depreciation Expense	2000	
Wages Expense	750	
Rent Expense	500	
Interest Expense	500	
Supplies expense	500	
Utilities expense	400	
Total Expenses		14850
Net Income		12950

As you can see, this example income statement is a single-step statement because it only lists expenses in one main category. Although this statement might not be extremely useful for investors looking for detailed information, it does accurately calculate the net income for the year.

This net income calculation can be transferred to Paul's statement of owner's equity for preparation.

Multi Step Income Statement

A simple multiple step income statement separates income, expenses, gains, and losses into two meaningful sub-categories called operating and non-operating. Unlike the single step income statement format where all revenues are combined in one main income listing and all expenses are totaled together, the multiple step statement lists these activities in separate sections, so users can better understand of the core business operations.

To do this, all income and expenses cannot be listed together. They must be separated into meaningful categories.

Format

The multistep income statement format is broken down into two main sections: operating and non-operating.

Operating Section

The operating section is subdivided into two main sections that list the primary business income and expenses. The first section computes the gross profit of the business by subtracting the cost of goods sold from the total sales. This is a key figure for investors, creditors, and internal management because it shows how profitable the company is at selling its goods or making its products.

Jazz Music Shop, Inc. Income Statement For the Year Ended December 31, 2105		
Sales	6400	
Cost of Goods Sold	1400	
Gross Profit		**5000**

The total sales figure in the above statement include all merchandise sales made during the period and the cost of goods sold would include all expenses paid to purchase, ship, and get the merchandise ready for sale. The gross margin computes the amount of money the company profits from the sales of its merchandise. Keep in mind; no other expenses are taken into account yet. This is simply the cash flow in from the sales of merchandise and the cash flow out from the purchase of that merchandise. This section not only helps measure the profitability of the core business activities, it also helps measure the health of the business.

The second part of the operating section lists all of the operating expenses in two separate categories: selling and administrative. Selling expenses are exactly what they sound like: costs incurred to sell products. These expenditures typically include advertising, salesmen salaries, commissions, and freight. The administrative expenses include expenditures that aren't directly related to selling product like rent, office staff salaries, and supplies.

The selling and administrative expense sections are added together to compute the total operating expenses. This total expense line is subtracted from the gross profit computed in the first section to arrive at the company's operating income.

Operating Expenses:		
Selling Expenses:		
Advertising Expense	100	
Sales Commission	234	334
Administrative Expense:		
Rent Expense	950	
Supplies Expense	31	981
Total Operating Expenses		1315
Income from operations		**3685**

Non-Operating and Other

The non-operating and other section lists all business revenues and expenses that don't relate to the business' principle activities. For example, our retailer isn't in the business of receiving insurance proceeds. If a tree hit the building and the insurance company paid out a small settlement, the income would not be reported with total sales. It would be reported in the non-operating and other section because it doesn't have anything to do with sales.

Non-Operating Income and Expenses		
Insurance Proceeds	1000	
Interest Expense	250	
Total Operating		**750**
Net Income		**4435**

Other income and expenses like interest, lawsuit settlements, extraordinary items, and gains or losses from investments are also listed in this section. Unlike the operating section, the non-operating section is not split into subcategories. It simply lists all of the activities and totals them at the bottom.

Once the non-operating section is totaled, it is subtracted from or added to the income from operations to compute the net income for the period.

Example
Let's take a look at a multi-step income statement example.

Jazz Music Shop, Inc. Income Statement For the Year Ended December 31, 2105		
Sales	6400	
Cost of Goods Sold	1400	
Gross Profit		**5000**
Operating Expenses:		
Selling Expenses:		
Advertising Expense	100	
Sales Commission	234	334
Administrative Expense:		
Rent Expense	950	
Supplies Expense	31	981
Total Operating Expenses		**1315**
Income from operations		**3685**
Non-Operating Income and Expenses	1000	
Insurance Proceeds	250	
Interest Expense		**750**
Total Operating Net Income		**4435**

As clear, this multi-step income statement template computes net income in three steps.

Step 1: Compute Gross Profit (Total sales – Cost of goods sold)

Step 2: Compute Income From Operations (Gross profit – operating expenses)

Step 3: Compute Net Income (Income from operations – non-operating and other)

The cost of goods sold is separated from the operating expenses and listed in the gross margin section. This is particularly important because it gives investors, creditors, and management the ability to analyze the financial statement sales and purchasing efficiency.

The operating section clearly lists the operating income of the company. This is the amount of money the company made from selling its products after all operating expenses have been paid. This is a key figure because it shows the health of the business. If a company's operations are strong, it will almost always show a profit at the bottom line, but not all companies with a profitable bottom line have strong operations.

Lastly, you can see the non-operating and other section being subtracted to compute the net income.

The multistep income statement gives far more detail than the single step statement, but it can also be more misleading if not prepared correctly. For instance, management might shift expenses out of cost of goods sold and into operations to artificially improve their margins. It's always important to view comparative financial statements over time, so you can see trends and possibly catch misleading placement of expenses.

6.6.2 The Statement of Stockholders Equity

The statement of owner's equity, sometimes referred to as owner's equity statement, represents the value of a business after all its obligations have been met over a specified period of time. This statement shows the movement of capital through a business and generally reflects the amount of capital the owner(s) has invested plus any profits the business generates that is in turn reinvested into the business. This reinvested income is called retained earnings.

It is usually prepared after the income statement because the net income or net loss for the period must be reported on this statement. Similarly, it is prepared before the balance sheet, since the owner's equity at the end of the period must be reported on the balance sheet. Because of this, the statement of owner's equity is often viewed as the connecting link between the income statement and balance sheet.

The statement of owner's equity is commonly calculated by referring to the balance sheet and income statement during a specific period of time. The income statement provides information about the net income or losses of the business, while the balance sheet will provide the information regarding owner contributions and draws.

To calculate the statement, the beginning balance is needed to start and is obtained from the previous periods ending equity balance. Income and owner contributions are added to the beginning balance total, while business losses and owner draws are subtracted. This sum is the ending equity balance.

Beginning equity balance

+ Income earned

+ Owner contributions

– Losses incurred

– Owner draws

= Ending equity balance

What is the Statement of Owner's Equity Used For?

This statement can show the financial health of a business and whether that business has sufficient cash flow to fund its own operations without the aid of outside investment. In the exception of a business that is quickly growing and the owners have to invest capital to fund additional inventory, accounts receivable, wages, etc., if a business is unable to show it could financially support itself without capital infusions from the owner, creditors would be unlikely to loan the business money.

Example of a Statement of Owner's Equity

For this example, XYZ Inc. has L.E5,000 of capital at the beginning of the period. The owner, Jane Smith, added L.E1,000 of cash to paid-in capital and the business earned L.E2,000 from sales. The owner also withdrew L.E2,000 to pay for personal expenses. The resulting statement of owner's equity shows an ending capital balance of L.E6,000. The ending equity balance will be carried forward to the following period and become the beginning balance.

XYZ, Inc. **Statement of Owner's Equity** **For the Year Ended December 31, 2105**	
Jane Smith, Capital, October, 1, 2017	5,000
Investment During The month	1000
Net Income	2000
Subtotal	**8000**
Withdrawals during the month	(2000)
Net loss for periods	0
Jane Smith, Capital, October, 31, 2017	**6000**

6.6.3 The Balance Sheet

The balance sheet, also called the statement of financial position, is the third General purpose Financial Statement prepared during the accounting cycle. It reports a company's assets, liabilities, and equity at a single moment in time. You can think of it like a snapshot of what the business looked like on that day in time.

Unlike the income statement, the balance sheet does not report activities over a period of time.

The balance sheet is basically a report version of the accounting equation also called the balance sheet equation where assets always equation liabilities plus shareholder's equity.

In this way, the balance sheet shows how the resources controlled by the business (assets) are financed by debt (liabilities) or shareholder investments (equity). Investors and creditors generally look at the statement of financial position for insight as to how efficiently a company can use its resources and how effectively it can finance them.

Format

This statement can be reported in two different formats: account form and report form. The account form consists of two columns displaying assets on the left column of the report and liabilities and equity on the right column. You can think of this like debits and credits. The debit accounts are displayed on the left and credit accounts are on the right. The report form, on the other hand, only has one column. This form is more of a traditional report that is issued by companies. Assets are always present first followed by liabilities and equity.

In both formats, assets are categorized into current and long-term assets. Current assets consist of resources that will be used in the current year, while long-term assets are resources lasting longer than one year. Liabilities are also separated into current and long-term categories.

Reporting Balance sheet accounts

Assets Section

Similar to the accounting equation, assets are always listed first. The asset section is organized from current to non-current and broken down into two or three subcategories. This structure helps investors and creditors see what assets the company is investing in, being sold, and remain unchanged. It also helps with financial ratio analysis. Ratios like the current ratio are used to identify how leveraged a company is based on its current resources and current obligations.

The first subcategory lists ***the current assets*** in order of their liquidity. Here's a list of the most common accounts in the current section:

- Cash
- Accounts Receivable
- Prepaid Expenses
- Inventory
- Due from Affiliates

The second subcategory lists ***the long-term assets***. This section is slightly different than the current section because many long-term assets are depreciated over time. Thus, the assets are typically listed with a total accumulated depreciation amount subtracted from them. Here's a list of the most common long-term accounts in this section:

- Long-term
- Equipment
- Leasehold Improvements
- Buildings
- Vehicles
- Long-term Notes Receivable

Many times there will be a third subcategory for investments, ***intangible assets***, and or property that doesn't fit into the first two. Here are some examples of these balance sheet items:

- Other
- Investments
- Goodwill
- Trademarks
- Mineral Rights

According to the historical cost principle, all assets, with the exception of some intangible assets, are reported on the balance sheet at their purchase price. In other words, they are listed on the report for the same amount of money the company paid for them. This typically creates a discrepancy between what is listed on the report and the true fair market value of the resources. For instance, a building that was purchased in 1975 for L.E20,000 could be worth L.E1,000,000 today, but it will only be listed for L.E20,000. This is consistent with the balance sheet definition that states the report should record actual events rather than speculative numbers.

Liabilities Section

Liabilities are also reported in multiple subcategories. There are typically two or three different liability subcategories in the liabilities section: ***current, long-term, and owner debt.***

The current liabilities section is always reported first and includes debt and other obligations that will become due in the current period. This usually includes trade debt and short-term loans, but it can also include the portion of long-term loans that are due in the current period. The current debts are always listed by due dates starting with accounts payable. Here's a list of the most common current liabilities in order of how they appear:

- Current Liabilities
- Accounts Payable
- Accrued Expenses
- Unearned Revenue
- Lines of Credit
- Current Portion of Long-term Debt

The second liabilities section lists the obligations that will become due in more than one year. Often times all of the long-term debt is simply grouped into one general listing, but it can be listed in detail. Here are some examples:

- Long-term Liabilities
- Mortgage Payable
- Notes Payable
- Loans Payable

A lot of times owners loan money to their companies instead of taking out a traditional bank loan. Investors and creditors want to see this type of debt differentiated from traditional debt that's owed to third parties, so a third section is often added for owner's debt. This simply lists the amount due to shareholders or officers of the company.

Equity Section

Unlike the asset and liability sections, the equity section changes depending on the type of entity. For example, corporations list the common stock, preferred stock, retained earnings, and treasury stock. Partnerships list the members' capital and sole proprietorships list the owner's capital.

Like all financial statements, the balance sheet has a heading that display's the company name, title of the statement and the time period of the report. For example, an annual income statement issued by Farah Shop, Inc. would have the following heading:

- Farah Shop, Inc.
- Balance Sheet
- December 31, 2015

Example

Here is an example of how to prepare the balance sheet in its two forms:

1. **T-shape form**

Farah Shop, Inc. Balance Sheet December 31, 2015			
Assets		**Liabilities**	
Current Assets		**Current Liabilities**	
Cash	32800	Account payable	49000
Account Receivable	300	Accrued Expenses	450
Prepaid Rent	1000	Unearned Revenue	1000
Inventory	39800	**Total Current Liabilities**	**50450**
Total Current Assets	**73900**	**Long term Liabilities**	**99500**
Long term Assets		**Total Liabilities**	**149950**
Leasehold Improvements	100,000	**Owner's Equity**	
Accumulated Depreciation	(2000)	**Owner's Equity:**	
Total Long term Assets	98000	Retained earnings	11950
	98000	Common Stock	10,000
Total Assets	**171900**	**Total Owner's Equity**	**21950**
		Total Liabilities & Owner's Equity	**171900**

2. **Report Format Balance Sheet**

Farah Shop, Inc. Balance Sheet December 31, 2015		
Cash		32800
Account Receivable		300
Prepaid Rent		1000
Inventory		39800

Total Current Assets		**73900**
Long term Assets	100,000	
Leasehold Improvements	(2000)	
Accumulated Depreciation		98000
Total Long term Assets		**98000**
Total Assets		**171900**
Current Liabilities		
Account payable	49000	
Accrued Expenses	450	
Unearned Revenue	1000	
Total Current Liabilities	**50450**	
Long term Liabilities	**99500**	
Total Liabilities		**149950**
Owner's Equity		
Owner's Equity:		
Retained earnings	11950	
Common Stock	10,000	
Total Owner's Equity		**21950**
Total Liabilities & Owner's Equity		**171900**

6.6.4 The Cash Flow Statement

The statement of cash flows, also called the cash flow statement, is the fourth general-purpose financial statement and summarizes how changes in balance sheet accounts affect the cash account during the accounting period. It also reconciles beginning and ending cash and cash equivalents account balances.

This statement shows investors and creditors what transactions affected the cash accounts and how effectively and efficiently a company can use its cash to finance its operations and expansions. This is particularly important because investors want to know the company is financially sound while creditors want to know the company is liquid enough to pay its bills as they come due. In other words, does the company have good cash flow?

The term cash flow generally refers to a company's ability to collect and maintain adequate amounts of cash to pay its upcoming bills. In other words, a company with good cash flow can collect enough cash to pay for its operations and fund its debt service without making late payments.

Format and Template

The cash flow statement format is divided into three main sections: cash flows from operating activities, investing activities, and financing activities.

Operating Activities

Cash flows from operating activities include transactions from the operations of the business. In other words, the operating section represents the cash collected from the primary revenue generating activities of the business like sales and service income. Operating activities are short-term and only affect the current period. For example, payment of supplies is an operating activity because it relates to the company operations and is expected to be used in the current period.

Operating cash flows are calculated by adjusting net income by the changes in current asset and liability accounts.

Investing Activities

Cash flows from investing activities consist of cash inflows and outflows from sales and purchases of long-term assets. In other words, the investing section of the statement represents the cash that the company either collected from the sale of a long-term asset or the amount of money spent on purchasing a new long-term asset. You can think of this section as the company investing in itself. The investments are long-term in nature and expected to last more than one accounting period.

Investing cash flows are calculated by adding up the changes in long-term asset accounts.

Financing Activities

Cash flows from financing consists of cash transactions that affect the long-term liabilities and equity accounts. In other words, the financing section on the statement represents the amount of cash collected from issuing stock or taking out loans and the amount of cash disbursed to pay dividends and long-term debt. You can think of financing activities as the ways a company finances its operations either through long-term debt or equity financing.

Financing cash flows are calculated by adding up the changes in all the long-term liability and equity accounts.

How to Prepare a Cash Flow Statement?

The statement of cash flows is generally prepared using two different methods:

- the direct method, and
- the indirect method.

Both results in the same financial statement showing how financial transactions affected would have affected the bank account of the company. Each method is used for a slightly different reason and typically used for different sized companies.

The Statement of Cash Flows: Direct Method

The cash flow statement presented using the direct method is easy to read because it lists all of the major operating cash receipts and payments during the period by source. In other words, it lists where the cash inflows came from, usually customers, and where the cash outflows went, typically employees, vendors, etc.

After all of the sources are listed, the total cash payments are then subtracted from the cash receipts to compute the net cash flow from operating activities. Then the investing and financing activities added to arrive at the net cash increase or decrease. Let’s take a look at how this report is formatted and structured.

Format

Here’s a list of the most common types of receipts and payments used in the direct method format:

- Receipts received from Customers
- Payments paid to Suppliers
- Payments paid to Employees
- Interest Payments
- Income Tax Payments

The FASB recommends that all companies issue their statement of cash flows in the direct method. The problem with this method is it’s difficult and time consuming to create. Most companies don’t record and store accounting and transactional information by customer, supplier, or vendor. Business events are recorded with income statement and balance sheet accounts like sales, materials, and inventory. It’s laborious for most companies to compile the information with this method.

For example, in order to figure out the receipts and payments from each source, you have to use a unique formula. The receipts from customers equals net sales for the period plus the beginning accounts receivable less the ending accounts receivable. Similarly the payments made to suppliers is calculated by adding the purchases, ending inventory, and beginning accounts payable then subtracting the beginning inventory and ending accounts payable.

The investing and financing activities are reported exactly the same on both direct and indirect methods.

Example

Here's an example of a cash flow statement prepared using the direct method.

Farah Shop, Inc. **Statement of Cash Flows** **For the Year Ended December 31, 2015**		
Cash Flows from Operating Activities:		
Cash received from customers	51300	
Cash paid for merchandise	(15000)	
Cash paid for employees	(10000)	
Cash paid for Interest	(500)	
Cash paid for Income tax	(1500)	
Net cash flow provided by operating activities		**24300**
Cash Flows from Investing Activities:		
Purchase of property and equipment	(101,000)	
Net cash flow used by Investing activities		**(101,000)**
Cash Flows from Financing Activities:		
Proceeds from line of credit	0	
Payment on line of credit	10,000	
Proceeds from long term debt	99500	
Payment on long term debt	0	
Net cash flow used by Financing activities		**109500**
Net Increase (decrease) in cash		**32800**
Beginning cash balance		**0**
Ending cash balance		**32800**

As you can see, all of the operating activities are clearly listed by their sources. This categorization does make it useful to read, but the costs of producing it for outweigh the benefits to the external users. This is why FASB has never made it a requirement to issue statements using this method.

The Statement of Cash Flows: Indirect Method

The statement of cash flows prepared using the indirect method adjusts net income for the changes in balance sheet accounts to calculate the cash from operating activities. In other words, changes in asset and liability accounts that affect cash balances throughout the year are added to or subtracted from net income at the end of the period to arrive at the operating cash flow.

The operating activities section is the only difference between the direct and indirect methods. The direct method lists all receipts and payments of cash from individual sources to compute operating cash flows. This is not only difficult to create; it also requires a completely separate reconciliation that looks very similar to the indirect method to prove the operating activities section is accurate.

Format

The indirect operating activities section always starts out with the net income for the period followed by non-cash expenses, gains, and losses that need to be added back to or subtracted from net income. These non-cash activities typically include:

- Depreciation expense
- Amortization expense
- Depletion expense
- Gains or Losses from sale of assets
- Losses from accounts receivable

The non-cash expenses and losses must be added back in and the gains must be subtracted.

The next section of the operating activities adjusts net income for the changes in asset accounts that affected cash. These accounts typically include:

- Accounts receivable
- Inventory
- Prepaid expenses

- Receivables from employees and owners

This is where preparing the indirect method can get a little confusing. You need to think about how changes in these accounts affect cash in order to identify what way income needs to be adjusted. When an asset increases during the year, cash must have been used to purchase the new asset. Thus, a net increase in an asset account actually decreased cash, so we need to subtract this increase from the net income. The opposite is true about decreases. If an asset account decreases, we will need to add this amount back into the income. Here’s a general rule of thumb when preparing an indirect cash flow statement:

Asset account increases: subtract amount from income

Asset account decreases: add amount to income

The last section of the operating activities adjusts net income for changes in liability accounts affected by cash during the year. Here are some of the accounts that usually are used:

- Accounts payable
- Accrued expenses

Since liabilities have a credit balance instead of a debit balance like asset accounts, the liabilities section works the opposite of the assets section. In other words, an increase in a liability needs to be added back into income. This makes sense. Take accounts payable for example. If accounts payable increased during the year, it means we purchased something without using cash. Thus, this amount should be added back. Here’s a basic tip that you can use for all liability accounts:

Liability account increases: add amount from income

Liability account decreases: subtract amount to income

All of these adjustments are totaled to adjust the net income for the period to match the cash provided by operating activities.

Example

It might be helpful to look at an example of what the indirect method actually looks like.

Farah Shop, Inc. Statement of Cash Flows For the Year Ended December 31, 2015		
Cash Flows from Operating Activities:		
Net Income		
Adjustments to reconcile net income to net cash flow provided by operating activities		
Depreciation Expense	2000	
Decrease (Increase) in current Assets:		
Account Receivable	(300)	
Inventory	(39,800)	
Prepaid Expenses	(1000)	
Increase (Decrease) in current Assets:		
Account payable	49000	
Accrued Expenses and Unearned Revenue	1450	
Net cash flow provided by operating activities		**24300**
Cash Flows from Investing Activities:		
Purchase of property and equipment	(101,000)	
Net cash flow used by Investing activities		**(101,000)**
Cash Flows from Financing Activities:		
Proceeds from line of credit	0	
Payment on line of credit	10,000	
Proceeds from long term debt	99500	
Payment on long term debt	0	
Net cash flow used by Financing activities		**109500**
Net Increase (decrease) in cash		**32800**
Beginning cash balance		**0**
Ending cash balance		**32800**

As shown above, the operating section always lists net income first followed by the adjustments for expenses, gains, losses, asset accounts, and liability accounts respectively.

Although most standard setting bodies prefer the direct method, companies use the indirect method almost exclusively. It's easier to prepare, less costly to report, and less time consuming to create than the direct method. Standard setting bodies prefer the direct because it provides more information for the external users, but companies don't like it because it requires an additional reconciliation be included in the report. Since the indirect method acts as a reconciliation itself, it's far less work for companies to simply prepare this report instead.

Key Terms

- **Assets**: Economic resources owned by a business.
- **Liabilities:** This includes any debt accrued by a business in the course of starting, growing and maintaining its operations. Liabilities can be divided into two major types: current, which refers to immediate debts (e.g. money owed to suppliers), and long-term debt, which refers to liabilities (e.g. loans and accounts payable).
- **Expenses:** Business expenses are the costs the company incurs each month in order to operate.
- **Cash Flow**: Shows the overall movement of funds through the business each month, including income and expenses.
- **Cash Flow Statement**: shows the money that entered and exited a business during a specific period of time.
- **Income Statement**: Also known as a "profit and loss statement," an income statement shows the profitability of a business during a period of time. The income statement looks at a business' revenues and expenses through all of its activities.
- **Balance Sheet**: A business' balance sheet gives a snapshot of the company's financial situation at a given moment. This includes the cash it has on hand, the notes payable it has outstanding and owner(s) equity in the business.

End of chapter practice exercises and problems

Practice Exercise 1

Mark each of the following with an (A) to indicate it is an asset, an (L) to indicate it is a liability, an (R) to indicate it is revenue, or an (E) to indicate it is an expense.

_____ Cash
_____ Building
_____ Loan due to the bank
_____ Inventory
_____ Salary expense
_____ Rent expense
_____ Amounts owed to employees for work done
_____ Equipment
_____ Amounts owed to suppliers
_____ Sales

Practice Problem 1

ABC Repair Services

Adjusted Trial Balance

December 31, 2017

Account Title	Debit	Credit
Cash	L.E7,480.00	
Accounts Receivable	3,700.00	
Service Supplies	600.00	
Furniture and Fixtures	3,000.00	
Service Equipment	16,000.00	
Accumulated Depreciation		L.E720.00
Accounts Payable		9,000.00
Utilities Payable		1,800.00

Loans Payable		12,000.00
Mr. Hani, Capital		13,200.00
Mr. Hani, Drawing	7,000.00	
Service Revenue		9,850.00
Rent Expense	1,500.00	
Salaries Expense	3,500.00	
Taxes and Licenses	370.00	
Utilities Expense	1,800.00	
Service Supplies Expense	900.00	
Depreciation Expense	720.00	
Totals	L.E46,570.00	L.E46,570.00

Required:

1. Prepare an Income Statement for the year ended 2017
2. Prepare a Statement of Owner's Equity for year 2017
3. Prepare a Balance Sheet for year 2017

CHAPTER SEVEN

Accounting for Long -Term Assets

Learning Objectives

After studying this chapter, you should be able to:

1. Understand the different types of long- term (fixed) assets
2. Measure the cost of acquiring fixed assets
3. Understanding the differences between capital expenditures and revenue expenses
4. Identify the different Depreciation methods
5. Compute the annual depreciation expense and accumulated depreciation
6. Record the disposal of an asset by sale or trade

7.1 Long term (Fixed) Assets

Long term-assets are acquired by business to start its operations which are intended to perform. Long term assets are the cornerstone for a business and they represent the most expensive items on the balance sheet. Long term assets may include land, buildings, property, plant and equipment **(PPE)** and vehicles. Long term assets are also known as **Plant assets** or **Fixed assets.** Plant assets are necessarily for new business to start with to carry out its day to day activities. For example, a business needs to get offices for their executive managers and employees to do their jobs on daily basis. It may also need a storage house to keep its goods safe. It also needs a place to keep its computers and servers safe. A business may also need cars or vans to transport their employees to their working places. Equipments are also important to produce the required products to provide the intended services to the business clients.

7.2 Characteristics of Long-term assets

Long-term assets are much durable and are expected to last for a longer period of time, normally for more than one year. For example, you are not expected to buy a new car for L.E100,000 every year or to buy a new home every month. Accordingly, this type of assets is considerably expensive than current assets (e.g. cash, inventory and supplies). There are several special characteristics of long-term assets that distinguish them from other assets.

- They are relatively expensive
- They are not acquired to be resold to business clients as inventory.
- It is relatively hard to fairly identify the entire cost of acquiring a long -term asset.

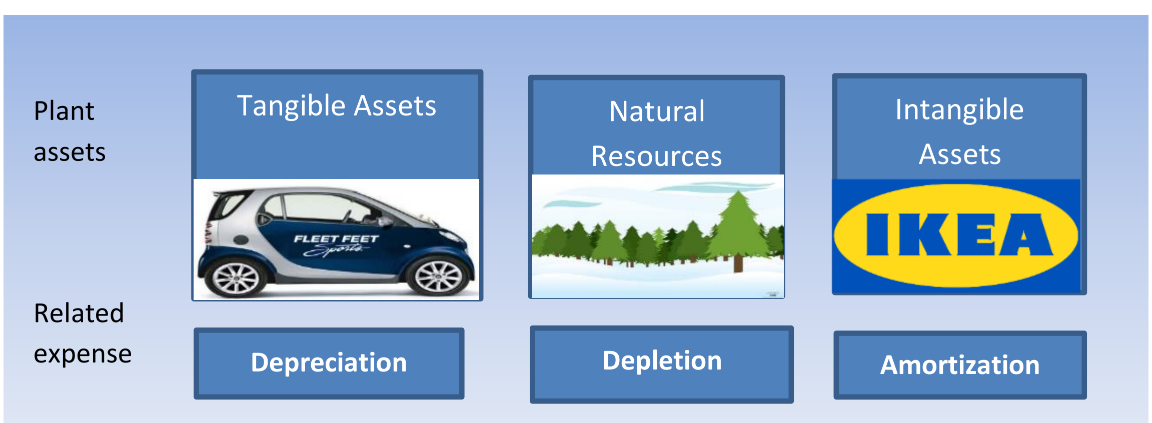
- They normally last for more than one year; as a result its cost should be allocated over the years of useful life.
- They may be sold or traded in at the end of its useful life. Therefore, disposal of an asset is important because it may ends up with gain or loss that should be reported in the income statement.

7.3 Classification of Long-term assets

As explained earlier, long-term assets are necessary for a business to carry out its daily operations. These assets are various as each of which performs specific task or job. However, these assets are normally classified into three main groups as follow:

1. **Tangible (or physical) assets.** This group includes assets whose physical characteristics define their utility or usefulness such as buildings, machines, vans and furniture. These assets can be recognized by bare eyes and hence can be evaluated objectively.
2. **Natural resources.** This group includes assets that come from the ground and can ultimately be used up such as diamond, iron, oil and coal.
3. **Intangible assets:** This group includes assets which value is not derived from their physical features but rather subjectively identified such as application software, brands and trademarks.

Exhibit 7-1 Long term assets groups



Exhibition 7-1 demonstrates each group of the long- term assets (i.e. plant assets) and the expense applied to each group. The depreciation, depletion and amortization are proportion of the asset value that is used up during the fiscal year. Accordingly, this amount is treated as expenses and hence should be recorded in the income statement. The treatment of this type of expenses will be discussed in the last section of this chapter.

7.4 Measuring the cost of a fixed asset

According to the cost principle, a fixed asset should be recorded at its historical cost. The historical cost is the cost of the asset on the day of purchasing. This cost does not include the purchasing price of an asset; it also includes all other costs incurred to make the asset ready for use.

Therefore, the cost of a plant asset includes its purchase price in addition to the amount of tax paid, commissions paid, insurance fees, and installation costs. All these costs together construct the historical value of the asset that will be allocated on each subsequent year. In the following paragraphs, such costs will be discussed in detail for specific types of fixed assets.

Land and land improvements

The cost of land is not depreciable, unless in special case as when it has precious minerals or metals. In this case it will be treated as natural resources. However, in normal cases land is not depreciated as it does not prone to consumption and deterioration like other types of fixed assets. The cost of land includes the following costs paid by the purchaser:

a. **Cost of land acquisition**

- ❑ Purchase price (i.e. invoice price)
- ❑ Brokerage commission
- ❑ Survey and legal fees
- ❑ Property taxes in arrears
- ❑ Costs of clearing the land and removing unwanted buildings

b. Costs of land improvements

- ❑ Fencing
- ❑ Paving
- ❑ Sprinkler systems
- ❑ Lighting
- ❑ Signs

The costs of land improvements are not added to the original cost of the land and hence subject to depreciation.

Example 1:

Suppose a company purchases land that costs LE 150,000 with a note payable for LE50,000. The company has also paid cash as follows: LE30,000 for property taxes in arrears, LE 12,000 for cleaning the land and making ready for use and LE 8000 survey fees. Moreover, the company paid LE 25,000 for fencing, LE15,000 for paving and LE10,000 for lighting.

<u>Required:</u>

a. Measure the cost of the purchased land.
b. Record the land purchase and land improvement transactions in the general journal.

Exhibit 7-2 . Calculating the cost of land

MEASURING THE COSTS OF LAND	
PURCHASE PRICE OF LAND	LE 150,000
ADD:	
PROPERTY TAXES IN AREARS	…………………… LE 30,000
LAND CLEANING	………………………… 12,000
SURVEY FEES	…………………………. 8,000 50,000
TOTAL COST OF LAND	……………………………………………… LE200,000

According to the table above, the cost of the land that will appear on the company's balance sheet should be LE 200,000 not LE 150,000. Notice that the costs of land improvement have not been added up to the original price. This will be treated separately. The entry to record the purchase of the land on 1st January 2018, will be as follows:

Exhibit 7-3 Recording the entry of land purchase transaction

2018			
JAN 1ST	Land (Asset +)	200,000	
	Notes payable (Liability +)		150,000
	Cash (Asset -)		50,000

The entry above shows that the company has ***capitalized*** the cost of the land at LE 200,000. **Capitalization** means that as asset was debited (increased) because the company acquired an asset. Therefore, the land has been debited for LE 200,000.

Exhibit 7-4 Recording the land account on the balance sheet

Balance sheet At December 31, 2018	
Long term assets	
Land …………………………….	200,000

To record the land improvement costs, you need to add them up first and record them at land improvement account as follows:

Exhibit 7-5 Measuring the land improvement costs

MEASURING LAND IMPROVEMENT COSTS		
FENCING COSTS	……………………. LE 25,000	
PAVING COSTS	………………………..15,000	
LIGTHING COSTS	………………………..10,000	
LAND IMPROVEMENTS	………………………………….	LE50,000

Exhibit 7-6 Recording the land improvement transactions in the general journal:

2018			
JAN 1ST	Land improvements (Assets+)	50,000	
	Cash (Asset -)		50,000

The amount of land improvements for LE 50,000 will be depreciated annually, meanwhile the land account will not be depreciated since land and land improvements are two entirely separate assets.

Buildings

The cost of a building depends on whether the company is constructing the building itself or is buying an existing one. These costs include the following:

The costs of constructing a building:

- Architectural fees
- Building permits
- Contractor charges
- Payments for material, labor and overhead costs

The costs of purchasing an existing building

- Purchase price

- Costs of renovating the building and making it ready for use.

Machinery and Equipment

- The cost of machinery and building includes:
- Purchase price
- Transportation charges
- Insurance coverage while in transit
- Sales tax
- Purchase commission
- Installation costs
- The cost of testing the asset before putting it into operation

Note that after the asset is installed and put into operation, the company no longer debits the cost of insurance, ordinary repairs and maintenance to the Equipment account but rather will be recorded as expenses and recorded in the income statement.

Furniture and fixtures

Furniture and fixtures are other types of assets that are required to facilitate the business day to day activities. The cost includes the basic purchasing cost (less any granted discounts), in addition to other costs to make it ready for intended use. For example, the costs of the administrative desks should include along with the cost of purchasing the desk, the shipment and assembling costs. However, the costs of desk maintenance for the subsequent years will be recorded as expenses and will not be added to the original cost of the desk.

7.5 Capital Expenditures and Revenue Expenses

Accountants divide spending on fixed assets into two categories based on several criteria.

- The magnitude of the expenditure
- The purpose of the expenditure
- The number of periods expected to benefit from the expenditure.

Capital expenditure

The capital expenditures are spent on fixed assets to make it ready for use. Such costs are debited (added) to the original price of the asset because:

- They increase the assets' capacity or efficiency, or
- They help extend the assets' useful life.

As explained in Exhibit 7-2, the land costs and associated costs are considered as capital expenditure. Also, an ***extraordinary repair*** is a capital expenditure because it extends the asset's capacity or useful life. For example, a company may spend extraordinary repair for LE 4000 to rebuild the engine on a five -year old truck. The extraordinary repair would extend the assets' life past the normal expected life. For example, a company has spent LE 4000 to rebuild the engine on five-year-old truck. follows:

Exhibit 7-7 Recording the cost of rebuilding the engine

	RECORDING THE COST OF REBUILDING THE TRUCK ENGINE		
	Truck (Assets+)	4,000	
	Cash (Asset -)		4000

Revenue expenses

Expenses incurred to maintain the asset in working order, such as repair or maintenance expense, are not added up to the original purchase price of the fixed assets. This type of expenses is mostly paid on a regular basis to keep the asset operating efficiently. There are many types of revenue expenses such as:

- Repairing the air conditioner
- Repairing a truck
- Cost of maintain an equipment
- Repairing the tires of a car

All the above **ordinary repair** expenses are debited to a separate account called repair and maintenance expense.

Example 2:

A company purchased a used truck on the 24th January 2018 for LE 120,000 in cash. The company has also paid extra LE 5000 for engine repair and LE 1000 for cleaning and painting.

Required:

Record the entries on 24th of Jan.2018. First, we need to record the capital expenditure to obtain the truck as follows:

Exhibit 7-8 Recording the Truck acquisition

2018			
24TH, JAN	Truck (Assets+)	125,000	
	Cash (Asset -)		125,000

The entry above show that the truck value is composed of the original price LE 120,000 plus the capital expenditure of LE 5000. The costs of cleaning and painting are not part of the truck cost. Thus, it is treated as regular repair and maintenance expense.

Exhibit 7-9 Recording the Truck acquisition

2018			
24, JAN	Repairs and maintenance expense (Assets+)	1,000	
	Cash (Asset -)		1,000

Treating a normal expense as capital expenditure, or vice versa, creates an accounting error. For instance, allocating the cost of painting the truck would overstate the truck account and hence, overstating the owner's equity. This would also understate the repair and maintenance account.

On the other hand, if engine repair cost has been treated as normal expense, this would overstate the repair and maintenance expense and it would understate the truck account. Hence the owner's equity would be understated as well.

7.6 Depreciation

Depreciation can be defined as the regular allocation of a proportion of the fixed asset's cost to its corresponding expense account over its useful life. Depreciation is the mechanism by which the expense is matched against the revenue generated from using the asset in order to measure the net income.

IAS 16 defines depreciation as "*the systematic allocation of the depreciable amount of an asset over its life. The depreciable amount is the cost of an asset or other amount substituted for cost in the financial statements, less its residual value*". Note that this definition places an emphasis on the consumption in a particular accounting period rather than an average over the asset's life. The American Institute of Certified Public Accountants (AICPA) employed the definition as:

"Depreciation Accounting is a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage value (if any) over the estimated useful life of unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not of valuation. Depreciation for the year is the portion of the total charge under such a system that is allocated to the year."

Reasons for deprecation

There are different terms related to the process of depreciating a long-term asset that you should have good grasp of. However, these terms differ based on the nature of the asset it describes.

Depletion: This term is mostly applied on the natural resources and describes the process of removing an available but irreplaceable resource such as extracting coal from a coal miner or oil out of an oil well. Depletion differs from depreciation in that the former implies removal of a natural resource, while the latter implies a reduction in the service capacity of an asset.

Amortization: This term is mostly applied to intangible assets (i.e. nonphysical assets) and describes the process of writing off intangible assets. The intangible assets cannot be recognized by bare eyes such as patents, copyrights, leaseholds and goodwill are recorded at their cost. Many of these assets have a limited useful life and are, therefore, written off.

Obsolescence: it happens not due to the excessive usage of an asset but rather because the technology used by this asset has become out of date. Therefore, this term refers to the decline in the useful life of an asset because of factors such as (i) technological advancements, (ii) changes in the market demand of the product, (iii) legal or other restrictions, or (iv) improvement in production process.

Why it is important to account for depreciation?

The depreciation occurs because of the several reasons such as:

1. **To Ascertain the Profits or Losses**: The true profits or losses could be ascertained when all costs of earning revenues have been properly charged against them. Fixed assets like building, plant and machinery, furniture, motor vehicles etc. are important tool in earning business income. But the cost of the fixed asset is not charged to profit and loss of the accounting period in which the asset is purchased.

2. **To show the Asset as its Reasonable Value**: The assets get decrease in their value over a period of time on account of various such as passage of time, constant use, accidents, etc. Therefore, if the depreciation is not charged then the asset will appear in the balance sheet at the over stated value. This practice is unfair as the balance sheet fail to present the true financial position.

3. **Replacement of assets**: Business assets become useless at the expiry of their life and, therefore, need replacement. The cash resources of the concern are saved from being distributed by way of dividend by providing for depreciation. The resources so saved, if set aside in each year, may be adequate to replace it at the end of life of the asset.

4. **To Reduce Income Tax**: If tax is paid on the business income without providing for depreciation then it will be in excess to the actual income tax.

7.7 Measuring Depreciation

In order to calculate depreciation, it is necessary to determine three main factors:

1. Cost (or revalued amount if the company is following a revaluation policy.
2. Economic (useful) life;
3. Residual value.

- **The asset cost**: is the price of the asset on the purchasing date or the revaluation value of the asset.
- **The useful economic life:** is determined based on some factors such as repair costs, the cost and availability of replacements, and the comparative cash flows of existing and alternative assets.
- **Residual value:** is defied by IAS 16 as the net amount which an entity expects to obtain for an asset at the end of its useful life after deducting the expected costs of disposal. Where PPE is carried at cost, the residual value is initially estimated at the date of acquisition.

Example 3:
A company purchased a truck on 21st January for LE 200,000. It is expected that the truck will be used for 5 years. The residual value is expected to be LE 50,000.
Required:

a. Calculate the annual depreciation of the truck.

$$Depreciation = \frac{cost - estimated\ residual\ value}{economic\ useful\ life}$$

$$Depreciation = \frac{200{,}000 - 50{,}000}{5} = LE\ 30{,}000$$

b. Record the depreciation transaction in the general journal.

The annual deprecation is treated as expense to match the revenue generated using the purchased truck. The expense is accumulated annually till the last year of the economic useful life in order to replace the consumed truck by totally brand new one. Therefore, another account is generated to record the total amount of the annual depreciation which is known as "accumulated depreciation as follows:

2018			
21, JAN	Depreciation expense (Expenses+)	30,000	
	Accumulated depreciation		30,000

7.8 Depreciation Methods

There are several depreciation methods which use different techniques to measure the depreciation expense, but they can be categorized into three main categories:

- **Straight line method**: it charges the same amount of depreciation to expense in every reporting period. This method approximates the average usage pattern of most assets, and so is an easy and a reasonable way to match revenues to expenses.
- **Accelerated method**: it charges the largest amount of the depreciable fixed asset to expense as soon as possible and rapidly declines the amount being charged to expense in later periods. There are two ways to apply this method either by using the ***double-declining balance method*** and the sum of the years' digits method.

- **Usage based method**: A usage-based depreciation method is designed to have a variable periodic depreciation expense that is based on the amount that a fixed asset is actually used. An example of this method is the ***Units of Production method*** **(UOP)**. This is the most accurate of the depreciation methods in matching actual usage to the related depreciation expense but suffers from an inordinate amount of record keeping track usage levels. Given this problem, it is usually restricted to the more expensive fixed assets whose usage levels vary considerably over time.

7.8.1 The straight-line method

According to this method, an equal amount of depreciation is allocated to each year. To calculate the depreciation expense according to this method the following equation should me used:

Straight-line depreciation$= \frac{(\text{asset cost – Residual value}}{useful\ life}$ X $\frac{No.of\ months}{12}$

Example 4:

A company bought a new truck for LE 185,000 on 1st of January, 2017. The truck is expected to last for 6 years. The salvage value is LE 6,000. Calculate the depreciation expense for this truck at 31st December, 2017.

Straight-line depreciation $\frac{(185{,}000 - 5000)}{6}$ X $\frac{10}{12}$ = LE 25,000

Since the truck is purchased on the first of March, then the depreciation expense is calculated for 10 months only starting from March till the end of December.

The entry to record the depreciation expense is as follows:

2017			
1ST ,MARCH	Depreciation expense (Expenses+)	25,000	
	Accumulated depreciation - Truck		25,000

The following schedule shows the depreciation expense for the truck over its useful life.

Date	Asset cost	Depreciation for the year				
		Depreciable cost	Depreciation rate	Depreciation expense (1)	Accumulated Depreciation (2)	Book value (3)
1-1-2017	LE 185,000					185,000
31-12-2017		(185,000-5000)	1/6 X 12/12	= 30,000	30,000	155,000
31-12-2018		(185,000-5000)	1/6 X 12/12	= 30,000	60,000	125,000
31-12-2019		(185,000-5000)	1/6 X 12/12	= 30,000	90,000	95,000
31-12-2020		(185,000-5000)	1/6 X 12/12	= 30,000	120,000	65,000
31-12-2021		(185,000-5000)	1/6 X 12/12	= 30,000	150,000	35,000
31-12-2022		(185,000-5000)	1/6 X 2/12	= 30,000	180,000	$\boxed{5000}$ Residual Value

In the schedule above, column No (1) shows the annual depreciation expense that will be recorded in the income statement among the other expenses. Meanwhile, column No (2) shows the accumulated depreciation account which will appear, at the end of the year, subtracted from the asset account. Finally, Column No (3) shows the asset's book value or the net asset value, which is calculated by subtracting the accumulated depreciation amount from the original cost of the truck (LE185,000). Over the years, the asset will be consistently used. Therefore, the accumulated depreciation account will increase but the asset book value will decrease.

7.8.2 Units- of Production

Units of production is another method of depreciation which basically counts on allocating a fixed amount of depreciation to each individual unit of production. The depreciation is calculated by units instead of by years as in the straight-line method. The unit of output can be miles, units, or hours. Each asset can have different unit of output based on how it is used in the production or the nature of this asset. For example, the more miles are cut, the more the depreciated amount will be.

Example 5:

Assume that the truck in Example 3 has cut 100,000 miles over its entire useful life. These miles have been drives as follows: 10,000 miles, 15,000 miles, 20,000 miles, 25,000 miles, 20,000 miles and 10,000 miles in each consecutive year.

In this case, the depreciation expense will be calculated not based on the number of years of the truck useful life, but rather based on the number of miles driven in each year. Therefore, the depreciation expense will be calculated as follows:

Step 1: Calculate the depreciation rate as follows:

Units of production depreciation per unit of output = (Cost – Residual value)X 1/ life (units)

= (185,000 -5000) X 1/100,000

= 1.8 per mile

Step 2: Prepare the depreciation schedule that shows the depreciation expense, accumulated depreciation and the book value of the truck throughout its useful life.

Date	Asset cost	Depreciation for the year				
		Depreciable per unit (mile)	Number of units	Depreciation expense (1)	Accumulated Depreciation (2)	Book value (3)
1-1-2017	LE 185,000					185,000
31-12-2017		1.8	10,000	= 18,000	18,000	167,000
31-12-2018		1.8	15,000	= 27,000	45,000	140,000
31-12-2019		1.8	20,000	= 36,000	81,000	104,000
31-12-2020		1.8	25,000	= 45,000	126,000	59,000
31-12-2021		1.8	20,000	= 36,000	162,000	23,000
31-12-2022		1.8	10,000	= 18,000	180,000	5000 Residual value

Look at the last row in column 3, you can see that the residual value LE 5000 still the same in Example 3.

7.8.3 Double Declining Balance Method

This is an accelerated depreciation method which writes off more depreciation near the start of an asset's life. This not followed in the straight-line method. The main accelerated method of depreciation is double declining -balance (DDB) method. The depreciation expense is calculated using the following equation:

Double declining depreciation = (Cost – Accumulated depreciation) X 2/useful life X months/12

In the first year after the truck acquisition, the deprecation is calculated as following:

Depreciation expense for the first year = (185,000 – 0) X 2/6 X 12/12 = LE 61,667

Depreciation expense, for the second year= (185,000 - 61,667) X 2/6 X 12/12= LE 41,111

Note that residual value is not included in the formula. Residual value is ignored until the last year. Final -year depreciation is calculated as the amount needed to bring the asset to its residual value as shown in the following schedule.

Date	Asset cost	Depreciation for the year				
		Depreciable cost	Depreciation rate	Depreciation expense (1)	Accumulated Depreciation (2)	Book value (3)
1-1-2017	LE 185,000					185,000
31-12-2017		185,000	2/6 X 12/12	= 61,667	61,667	123,333
31-12-2018		123,333	2/6 X 12/12	= 41,111	102,778	82,222
31-12-2019		82,222	2/6 X 12/12	= 27,407	130,185	54,815
31-12-2020		54,815	2/6 X 12/12	= 18,272	148,457	36,543
31-12-2021		36,543	2/6 X 12/12	= 12,181	160,638	24,362
31-12-2022				= **19,362***	180,000	$\boxed{5000}$

In the last row, notice that the depreciation expense equals LE19,362*. This time the depreciation expanse has been calculated differently by subtracting the residual value LE 5000 from the remaining book value of the truck LE 24,362.

7.9 Disposal of fixed asset

An enterprise may dispose an asset by either selling or trading that an asset for many reasons such as obsolescence or inadequacy or for even inefficiency. To record the disposal of an asset by selling it, several steps need to be taken to write off the asset account in the company's books.

First, the amount realized should be credited to the Asset Account.

Second, the amount of depreciation for the period of which the asset has been used should be written off as usual. Eventually, any balance in the Asset Account will represent profit or loss on disposal of the asset. This balance in the Asset Account should be transferred to the profit and loss account. The disposal of an asset could be either through the direct selling of this asset and collecting its value in cash or by trading it for another asset or to be traded partially in cash. In the following paragraphs, these methods will be further explained.

7.9.1 Selling the asset for cash

In most cases, the company may prefer to dispose the asset by selling it especially if it is in a good condition.

Example 6:

A company purchased a machinery costing LE 206,000 at 1st Jan 2011. The accounting year of the company ends on 31st December every year. The expected residual value for the machine at the end of five years is LE 6000. The accumulated depreciation for the machinery until December 31st 2013 was LE120,000O. In 1st March 2014, one-third of the machinery which was installed in 2011, has become obsolete and should be disposed.

Required:

1. Record the proper entries to dispose the machinery on 1st Jan 2014 assuming that the company the machines were sold in cash for:
    a. LE 70,000
    b. LE 90,000
    c. LE 60,000
2. Draw the machinery account on the date on Jan 1st 2014 for a,b, and c

Case (a) selling the machinery for no profit/ no loss:

Step 1: Bring the depreciation up to date. This entails calculating the depreciation expense on the date of sale and add this amount to the accumulated depreciation for previous years.

The Accumulated depreciation as in Dec,31st 2013 …………………………………… LE 120,000
Add: depreciation expense on March,1st , 2014=($(206000-6000)X\ \frac{1}{5}X\ \frac{2}{12}$)……… <u>16,000</u>
The updated accumulated depreciation …………………………………………………… LE 136,000

The journal entry to record the depreciation expense on 1st of March 2014:

2014			
1ST , MARCH	Depreciation expense (Expenses+)	16,000	
	Accumulated depreciation (CA +)		16,000

Step 2: Removed the disposed assets from the company' books. To do so, we to take the following actions:

1. Cancel off the accumulated depreciation for the disposed assets only.

2. Record the cash collected from selling the asset in the asset account. In the example above, the cash collected in case (a) LE 70,000.
3. Calculate the profit/loss of the selling process and record this amount in the asset account.

The cash received LE 40,000 should be compared with the book value of the sold machinery which is [LE 206,000 – 136,000= LE 70,000]

The profit/loss = Cash received – book value of the asset

The profit (loss) = 70,000 - 70,000 = LE 0 . It is realized that in case (a) there is no profit or loss as the cash received from selling the disposed machinery has only coved the book value of that machine. If cash received was greater than the book value, then profit will be realized. On contrary, if cash received was less than the book value, then losses will be incurred. The journal entry to record the selling of machinery on 1st of March 2014:

2014			
1ST , MARCH	Cash (Asset +)	70,000	
	Accumulated depreciation (CA -)	136,000	
	Machinery (Asset -)		206,000

To solve the problem for case (b) and (c) , step one will be the same. However, step two will be slightly different as a new account will appear on the machinery account which is the profit and loss account which will be charged with either profit or loss. This will be explained in detail in the following paragraphs.

Case (b) Selling machinery with profit:

As cash received is LE 90,000 exceeds the machinery book value LE 70,000, then the profit/loss account will be charged with gains of (LE 90,000 – 70,000 = LE 20,000). The journal entry to record the selling of machinery and the realized profit will be as follows:

2014			
1ST , MARCH	Cash (Asset +)	90,000	
	Accumulated depreciation (CA -)	136,000	
	Machinery (Asset -)		206,000
	Gain on sale of machinery)		20,000

Case (c) Selling machinery with loss

As cash received equals LE 60,000 which in its turn exceeds the machinery book value LE 70,000, then the profit (loss) account will be charged with loss of LE 60,000 – 70,000 = LE (10,000).

The journal entry to record the selling of machinery and the realized profit will be as follows:

2014			
1ST, MARCH	Cash (Asset +)	60,000	
	Accumulated depreciation (CA -)	136,000	
	Profit/loss account (loss on sale of machinery)	10,000	
	Machinery (Asset -)		206,000

7.9.2 Trading the asset for another asset

In this case, the asset will be replaced by another asset whether used or a totally brand new one. The following steps will be as following:

Step 1: Bring the depreciation up to date. This entails calculating the depreciation expense on the date of sale (or trading) and then add this amount to the accumulated depreciation for previous years.

Step 2: Remove the disposed assets from the company' books. To do so, the following actions will be taken:

1. Cancel off the accumulated depreciation for the disposed assets only.
2. In this case, the asset will be replaced by another asset instead of collecting cash. Therefore, the fair price of the newly received asset should be recorded.
3. Measuring the outcome by calculating the profit (loss) of the trading process.

Step 3: This step may end up with generating profit (loss) from trading the asset. This will be calculated using this formula:

Gain (loss) on trading = Fair price of the new asset – Book value of the old asset

For example, if the company traded a truck which originally costs LE 120,000 and accumulated depreciation LE 22,000 with a brand new one which costs E150,000. In this case, the profit gained on trading will equal LE 150,000 – (120,000-20,000) = LE 50,000]

Example 7:

A company traded machinery originally costs LE 156,000 for a brand new one that costs LE136,000 at 1st of July 2017. The accounting year ends on 31st December. The machinery is depreciated at EL16,000 annually and the accumulated depreciation for the machinery equals LE 42,000 at December 31st 2017.

Required: Journalize the entries to record the trading of machinery.

Step 1. Calculate and record the depreciation expense for the last six months

Depreciation expense = 16,000 X 6/12 = LE 8000

2017			
1ST , JULY	Depreciation expense (Expenses+)	8,000	
	Accumulated depreciation (CA +)		8,000

Step 2. Remove the old disposed machinery from the books by closing the accounts of both machinery and accumulated depreciation. In the same time, the new machinery will be recorded at its fair price and the difference between the fair value and the book value of the old machinery should be computed in order to record the trading entry as shown below.

2017			
1ST , JULY	Accumulated depreciation (22,000+8000)	30,000	
	Machinery (New) (A+)	136,000	
	Machinery (Old) (A-)		156,000
	Gain on trading (136,000 -126,000)		10,000

If a new machinery has been partially traded by paying LE 10,000 in cash in addition to the old machinery in this case the following steps should be followed instead:

Step 1 : will be the same as in the example above.

Step 2: will start with recording the trading entry which will be slightly different from the previous case as the trading process is partially in cash. The recorded entry will be as following:

2017			
1ST , JULY	Accumulated depreciation (22,000+8000)	30,000	
	Machinery (New) (A+)	136,000	
	Machinery (Old) (A-)		156,000
	Cash (136,000 -126,000)		10,000

Realize that in the case above, the asset has been traded for a new asset and the remaining amount of the purchase price has been paid in cash. If the purchase price has been entirely covered by the value of the traded machinery, then no cash will be paid. As a result, in such situation normally there will be no profit or loss realized.

Key-Terms:

- **Accelerated depreciation method is the method** that writes off more of the asset's cost towards the early years of its useful life.
- **Amortization:** systematic reduction in the assets carrying value. It represents the expense that applies to intangible assets.
- **Capitalization:** is the process of adding the capital expenditure to the original cost of a log-term asset.
- **Capital expenditure:** Expenditures that increase the capacity or efficiency of an asset or the expense that help expand its useful life.
- **Depreciation expense** is a proportion of the fixed asset that is annually written off to count for the consumption of the asset in production.
- **Estimated residual value:** Expected cash value of an asset at the end of its useful life. It is also called salvage or scrap value.
- **Estimated useful life**: the anticipated time period that the asset will serve. It can be expressed either in Years, Miles, Units of outputs or other measures.
- **Intangible assets:** assets with no physical form such as goodwill, trade name and trade mark.
- **Impairment:** a decline in an intangible asset (e.g. copyrights, goodwill, trademarks, and brand name) value which is outside normal depreciation. It is recorded as a loss in the period that the decline is identified.
- **Land improvements:** depreciable improvements to land such as fencing, sprinklers, paving and lighting.
- **Net book value:** the original cost of an asset less to total accumulated depreciation of that asset.

- **Tangible assets:** Assets with physical form such as buildings, trucks and machinery.
- **Units - of-production method**: depreciation method by which a fixed amount of depreciation is assigned to each amount of depreciation is assigned to each unit of production by an asset.

End of Chapter Questions

Q1. Test yourself: Choose the correct answer from a, b, c and d:

1. **Which cost is not recorded as part of the cost of a building**:
   a. Construction material
   b. Concrete for the building's foundation
   c. Workers help with construction
   d. Annual building maintenance.
2. **Which of the following assets has no depreciable value**?
   a. Buildings
   b. Land
   c. Machinery
   d. Vehicles
3. **Which of the following depreciation methods used for intangible assets?**
   a. Units - of - production
   b. Straight line method
   c. Depletion method
   d. impairment
4. **Which of the following statements is <u>TRUE</u>:**
   a. Double declining depreciation method could be used for tax return preparation as it allows for more depreciation in the earlier years of the asset useful life.
   b. Straight line method can be used for goodwill
   c. Estimated useful life is the length of the service period expected from the asset in use.
5. **Which of the followings is <u>NOT</u> a capital expenditure of a building?**
   a. Building permits

b. Contractor changes
c. Annual painting of the building
d. Architecture fees

Q2. Solve the following comprehensive problems:

On 1st of March 2016, company ABC has purchased a new equipment costing LE23,000. The company paid insurance on the transportation process for LE 2,500 and installation fees LE 4.500 in cash. The equipment is expected to be used for five years.

Required

1. Record the entry on the date of equipment purchase.
2. Calculate the annual depreciation expense of the equipment for the first three years under each of the following assumptions:
   a. The company uses straight line method with Zero residual value.
   b. The company uses straight line method with a residual value of LE 6,000.
   c. The company uses double declining method with zero residual
3. If the company follows the straight-line method and decides to replace this equipment with a new one, record the entries of the disposal process at the end of year three based on the following assumptions:
   a. The equipment will be sold for LE 15,000.
   b. The company will trade the old equipment with a new one that costs LE 23,000 pay the difference in cash.
4. Journalize the entries of the disposal process at the end of third year under each assumption (3a & 3b).

Solution:

Requirement No (1): The cost of equipment = 23,000 + 2,500 + 4,500 = LE 30,000

2016			
MARCH 1ST	Equipment (Assets+)	30,000	
	Cash (Asset -)		30,000
	Recording the purchase of equipment		

Requirement (2): Calculating the annual depreciation expense of the equipment under each of the following assumptions:

Assumption (a) the company uses the straight-line method with no residual value:

Depreciation expense for Y1 $= \frac{(30,000 - 0)}{5} \times \frac{10}{12}$ = LE 5,000

Depreciation expense for Y2 $= \frac{(30,000 - 0)}{5} \times \frac{12}{12}$ = LE 6,000

As the company follows the straight line method then the depreciation expense for Y3 will be exactly the same of Y2 = LE 6000

Assumption (b) the company uses the straight-line method with a residual value of LE 6,000:

Depreciation expense for Y1 $= \frac{(30,000 - 6000)}{5} \times \frac{10}{12}$ = LE 4,000

Depreciation expense for Y2 $= \frac{(30,000 - 6000)}{5} \times \frac{12}{12}$ = LE 4,800

As the company follows the straight line method then the depreciation expense for Y3 will be exactly the same of Y2 = LE 4,800

Assumption (C) the company uses double declining method with zero residual value:

Depreciation expense for Y1 = (30,000– 0) X 2/5 X 10/12 = LE 10,000

Depreciation expense for Y2 = (30,000 – 10,000) X 2/5 X 12/12 = LE 8000

Depreciation expense for Y3 = (30,000 – 18,000) X 2/5 X 12/12 = LE 4800

2018			
31ST, DEC.	Cash (Asset +)	15, ,000	
	Accumulated depreciation (CA -)	17,000	
	Equipment (Old Asset -)		30,000
	Gain on sale of equipment (15000-13,000)		2000

Requirement (3&4) If the company follows the straight-line method and decides to replace this equipment with a new one, record the entries of the disposal process at the end of year three:

First of all, we need to calculate the book value of the equipment at the end of Y3

The equipment (book value) = cost 30,000 - Accumulated depreciation 17,000

= LE 13,000

Assumption (a) the equipment will be sold for LE 15,000.

Then the journal entry to record the depreciation expense for Y3:

2018			
31ST ,DEC	Depreciation expense (Expenses+)	6,000	
	Accumulated depreciation (CA +)		6,000

Then we need to record the equipment disposal entry at the end of Y3:

Assumption (b) The company will partially trade the old equipment with a new one that costs LE 23,000. The difference will be paid in cash.

The first entry related to record the depreciation expense for Y3 will be the same as in the assumption (a) above. However, the journal entry regarding the disposal of the equipment will be slightly different as shown below:

2018			
31ST, DEC	Machine (new Asset +)	23, ,000	
	Accumulated depreciation (CA -)	17,000	
	Equipment (Asset -)		30,000
	Cash (23000-13,000)		10,000

CHAPTER EIGHT

Completing the Accounting Cycle: The Closing Process

Learning Objectives

After studying this chapter, you should be able to:

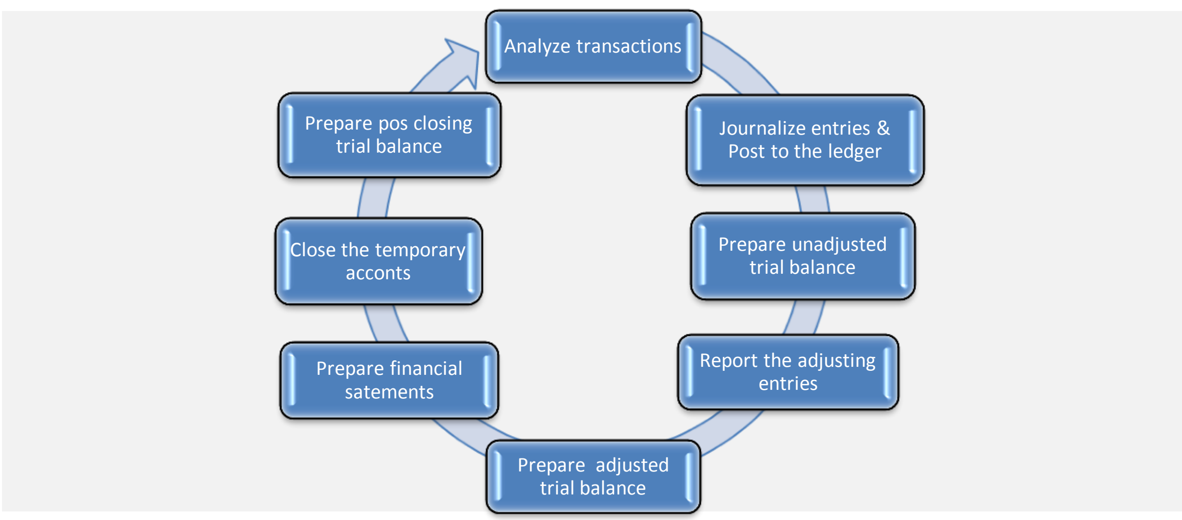
1. Understand the difference between temporary and permanent accounts.
2. Learn how to record the closing entries at the end of the accounting period.
3. Prepare the post-closing trial balance.
4. Understand the operating cycle term.

8.1 Accounting Cycle

A**ccounting cycle** refers to a group of steps that enable to prepare the whole set of financial statements. These steps are cyclical in nature as they are repeated in each accounting period (e.g. every year or every quarter). The implemented steps are also related to each other and organized is a sequential order as shown below.

Exhibit 8-1 Accounting Cycle

First of all, accounting cycle starts with analyzing the economic transactions (event) such purchasing a new asset or paying due expenses. These transactions will subsequently be recorded in a proper journal. Once the entries have been recorded manually or electronically, as in modern computerized systems, each entry will be automatically posted to a corresponding account in the general ledger. Once all the ledger accounts



are balanced, an unadjusted trial balance is prepared to match the debit and credit accounts together. According to the accrual basis, adjusted entries will be recorded at the end of accounting period. Journalizing the adjusted entries and updating the related accounts in the general ledger enable to match incurred expenses with revenues generated during the same period of time. Eventually, the adjusted trial balance is prepared in order to prepare the required financial statements to be submitted later to end uses.

8.2 Completing the Accounting Cycle

The last step in the accounting cycle is closing temporary accounts to prepare the company to start a new cycle for next accounting period. Accordingly, the closing process normally takes place at the end of each accounting period and aims at journalizing and posting the closing entries to the proper accounts.

The closing process ends up with closing the temporary accounts that have been opened during the accounting period. Such accounts are opened to calculate the net income (net loss) or to measure the drawings of the owner throughout the year. This would enable the company to measure its net income for each year individually by comparing the revenues generated with the expenses paid during the same period. The closing process also updates the capital account with the drawing account.

8.3 Closing Temporary Accounts

During the closing process all temporary accounts are closed (zeroed out) in the income summary. The **temporary accounts** are those accounts which are temporary opened during the year to show all the revenue and expense accounts separately. The temporary accounts are closed in on the other unlike the temporary accounts, permanent accounts used to serve the company's operations for more than a year and hence their accounts are not closed. These permanent accounts are commonly known as the balance sheet accounts which are Assets, liabilities and Owner' equity. The following diagram shows the main steps of the closing process. There are four steps in closing the company' books and they are:

Step 1: Close the revenue accounts in the Income Summary account. This closing entry transfers the total revenues to the credit side of the Income Summary account.

Step 2: Close the expense accounts in the Income Summary account. This closing entry transfers total expenses to the debit side of the Income summary account. The ending results of the income Summary account can be either net income or net loss of the period. If the closed revenues exceed the closed expenses, then the results will be net income which will be transferred to the capital account credit side. However, if the expenses exceed the revenues then the results will be net loss and hence will be closed in the debit side of the capital account.

Step 3: Close the net income/net loss in the capital account.

Step 4: Transfer the ending results of the drawing account in the Capital account. This will transfer the total balance of drawings in the debit side of the capital account.

The following example illustrates the journal entries of the closing process at the end of the accounting period.

Example 1:

Ali has a car repair shop opened on January 1st, 2017. The following accounts are extracted from Ali's book at December 31st,2017 in (LE).

Service revenues …………….	100,000	Salaries expense ……………	35,000
Rent Expense ……………………	20,000	Ali, Capital (1st Jan.2017)	74,000
Utilities expense………………..	15,000	Ali, Drawings …….……………	24,000

Required:

Record the journal entries to close the temporary accounts in Ali's book at December 31st, 2017.

Step 1: Close the revenue account in the Income Summary

2017	ACCOUNT	Debit	Credit
31ST, JAN	Service Revenue (revenue -)	100,000	
	Income Summary		100,000

Step 2: Close the expense accounts in the Income Summary

2017	ACCOUNT	Debit	Credit
31ST, JAN	Income Summary	70,000	
	Rent expense		20,000
	Utility expense		15,000
	Salaries expense		35,000

Step 3: Close the net income in Ali's Capital

2017	ACCOUNT	Debit	Credit
31ST, JAN	Income Summary (100,000-70,000)	30,000	
	Ali. Capital		30,000

Step 4: Close the drawings in Ali's Capital

2017	ACCOUNT	Debit	Credit
31ST, JAN	Ali. Capital	24,000	
	Ali, Drawings		24,000

Post-closing Trial balance

The accounting cycle can end with a post- closing trial balance. This optional step lists the accounts and their adjusted balances after closing. The following trial balance represents Ali's accounts after closing the temporary accounts as in Example 1.

Ali Car Repair Shop		
Post-Closing Trial Balance		
December 31, 2017		
	Debit	Credit
Cash	LE 30,000	
Accounts Receivable	35,000	
Supplies	25,000	
Furniture	57,000	
Building	33,000	
Accumulated depreciation- Furniture		17000
Accumulated depreciation- Building		13000
Accounts payable		65,000
Interest payable		5,000
Ali's capital		80,000
Total	**LE 180,000**	**LE 180,000**

8.4 Classified Balance Sheet

This section describes a classified balance sheet which organizes assets and liabilities into important subgroups that serve managers and other financial statement users to take proper decisions. The classified balance sheet is composed of the main groups of accounts; Assets, Liabilities and Equity.

The assets are further classified into two sub-groups based on the nature of the asset. These sub-groups are **Current assets and non-current assets or fixed assets. The current assets** represent the assets which are expected to be used or last for a year or less such as cash, inventory, accounts receivables and office supplies. **Non-current assets** are more expensive and durable than current assets. They are normally used for more than a year. Therefore, depreciation is normally calculated for non-current assets but not for current assets. Both types of assets help company keep its **operating cycle** working smoothly. Operating cycle refers to the time elapses from paying cash to acquire good/services to be used in operations till receiving cash from selling the produced goods/services. Therefore, they are called **operating assets** to differentiate them from other non-operating assets which are used for other purposes. The word “operating” refers to conventional operations that the company is intended to perform (e.g. producing cars, selling groceries, and fixing cars….etc.). Meanwhile, the word “cycle” refers to the circular flow of cash used for company inputs and cash received from its outputs. In some cases, operating cycle can be less than a year or could take slightly more time. In the balance sheet, current assets are listed before non-current assets and current liabilities are listed before non-current liabilities. This classification considers how easily the account can be converted into cash.

As learned in the previous chapters, at the end of the accounting period, the company prepares a set of financial statements; income statement, balance sheet, Owner’s Equity statement, and cash flow statement. These statements are provided to either internal or external users to take different types of decisions. In this chapter, we will be focusing on one of these statements which is the balance sheet. Exhibit 8-2 below provides an example for a classified balance sheet for a ABC company. Notice how the balance sheet accounts have been presented and organized.

Exhibit 8-2. Classified Balance Sheet

ABC MINIMART Balance Sheet December 31,2017		
Assets	LE	LE
Current Assets		
Cash …………………………………………..	35,000	
Accounts receivables………………………….	10,000	
Prepaid expense ………………………………	5000	
Total current assets……………………………		50,000
Long-term investments ………………………...…		
Notes Receivable ……………………………		
Plant assets		
Equipment ……………………...……………	216,000	
less: accumulated depreciation …………………….	16,000	200,000
Buildings………………………………………	315,000	
Less: Accumulated depreciation…………………	15,000	300,000
Total plants Assets …………………………..		500,000
Total assets		550,000
Liabilities & Equity		
Current liabilities		
Accounts payable …………………………………	25,000	
Wages payable ……………………………………..	33,000	
Notes payable ……………………………………...	17,000	
Total current liabilities		75,000
Long-term liabilities ……………………………..		125,000
Total liabilities …………………………………		200,000
Equity		
Ali's capital ……………………………………		350,000
Total liabilities and Equity ……………………….		550,000

Realize that the balance sheet accounts namely; Assets, Liabilities and Owner's Equity are those remained opened at the end of the year to show the company's financial position and the balances of these accounts will represent the opening balance for next year.

Example 2:

The following table represents the company ABC adjusted trial balance.

ABC Company Adjusted Trial Balance December 31, 2016		
	Debit	Credit
Cash	LE 34,000	
Rent receivable	11,000	
Accounts Receivable	20,000	
Supplies	54,000	
Furniture & fixtures	116,000	
Building	195,000	
Accumulated depreciation- Furniture		56000
Accumulated depreciation- Building		85000
Accounts payable		42,000
Interest payable		54,000
Salaries payable		20,000
ABC, capital		150,000
ABC, drawings	10,000	
Service revenue		118,000
Salary expense	34,000	
Supplies expense	30,000	
Advertising expense	21,000	
Total	LE 525,000	LE525,000

Required

a. Prepare the closing entries at December, 31st 2016.

b. Prepare Post- Closing Trial balance

c. Prepare classified balance sheet at December,31st 2016.

a. Closing the temporary accounts:

The revenue and expenses accounts related to the current accounting period will be closed in the summary account. Then the ending results of the income summary account will be closed in the capital account by (debiting) crediting it based on whether the results are profit or loss. Eventually, the drawing account will be closed by debiting the capital account.

Step 1: Close the revenue account in the Income Summary

2017	ACCOUNT	Debit	Credit
31ST, JAN	Service Revenue (revenue -)	118,000	
	Income Summary		118,000

Step 2: Close the expense accounts in the Income Summary

2017	ACCOUNT	Debit	Credit
31ST, JAN	Income Summary	85,000	
	Salaries expense		34,000
	Supplies expense		30,000
	Advertising expense		21,000

Step 3: Close the net income in Ali's Capital

2017	ACCOUNT	Debit	Credit
31ST, JAN	Income Summary (100,000-70,000)	33,000	
	Ali. Capital		33,000

Step 4: Close the drawings in Ali's Capital

2017	ACCOUNT	Debit	Credit
31ST, JAN	Ali. Capital	10,000	
	Ali, Drawings		10,000

b. Prepare Post- Closing Trial balance:

Notice that the following trial balance shows only the balance sheet items.

ABC Company		
Post-Closing Trial Balance		
December 31, 2016		
	Debit (LE)	Credit (LE)
Cash	LE 34,000	
Rent receivable	11,000	
Accounts Receivable	20,000	
Supplies	54,000	
Furniture & fixtures	116,000	
Building	195,000	
Accumulated depreciation- Furniture		56,000
Accumulated depreciation- Building		85,000
Accounts payable		42,000
Interest payable		54,000
Salaries payable		20,000
ABC, capital *		173,000
Total	LE 430,000	LE430,000

*The ABC, capital account = 150,000 – 10,000 + 33,000 = LE 173,000

C. Prepare classified balance sheet at December ,31st 2016:

ABC MINI-MART Balance Sheet December 31,2016		
Assets	LE	LE
Current Assets		
Cash ………………………………………..	34,000	
Accounts receivables………………………….	20,000	
Rent receivable …………………………….	11,000	
Supplies…………………………………..	54,000	
Total current assets………………………….		119,000
Plant assets		
Furniture and fixtures ………………..………	116,000	
less: accumulated depreciation …………………….	(56,000)	60,000
Buildings……………………………………	195,000	
Less: Accumulated depreciation………………….	(85,000)	
Total plants Assets …………………………..		110,000
Total assets		289,000

Liabilities & Equity		
Current liabilities		
Accounts payable …………………………………	42,000	
Interest payable ……………………………………..	54,000	
Salaries payable ……………………………………..	20,000	
Total current liabilities		116,000
Equity		
ABC, capital ………………………………………		173,000
Total liabilities and Equity ……………………….		289,000

Notice that the prepaid expenses such as rent receivable is part of assets, accordingly it has not been closed like other expense accounts. Similarly, the Interest payable and Salaries payable accounts are treated as part of liabilities and hence they have not been closed either.

Key Terms

- ***Accounting cycle:*** A process on sequential steps that enable companies to record, organize, summarize and prepare their financial statements to be provided to end users.
- ***Classified balance sheet:*** *A balance sheet that organizes and classifies the asset and* liabilities accounts into current and non-current (long term) items.
- ***Closing entries:*** Entries that transfer the revenue, expense, and drawing balances to the Capital account.
- ***Operating cycle:*** Time span during which cash is paid for goods and services, which are eventually sold to customers from whom the business collect cash.
- ***Income summary:*** Temporary account where revenue and expense accounts are transferred prior to their final transfer to the capital account.
- ***Post-closing trial balance:*** A statement that lists all the assets and liabilities accounts in addition to the capital account at the end of the period after journalizing and posting the closing entries.

End of Chapter Questions

Question (1). Test yourself: Choose the correct answer from a, b, c and d:

6. **Which part of the accounting cycle considers modifying the ending balances of the expenses, revenue and other accounts towards the end of the year**:

a. Post-closing trial balance
b. Ledge accounts
c. Closing entries
d. Adjusting entries

7. **Which of the following indicates a net loss within the income summary**?

a. Credit side is greater than debit side
b. **Credit side is less than debit side**
c. Credit side equals than debit side
d. None of the above.

3. **Which of the accounts is not closed at the end of the year?**

a. **Accumulated depreciation**
b. Depreciation expense
c. Utilities expense
d. Service revenue

4. **Which of the following accounts is not transferred to the income summary?**

a. Interest expense
b. Rent revenue
c. **Interest payable**
d. Salary expense

5. **Which of the following items will be recorded under current assets?**

a. Interest expense
b. land
c. Interest payable
d. **Interest receivable**

6. **Which of the following accounts is a contra account?**

a. Depreciation expense
b. Accumulated depreciation
c. Accounts receivable
d. Interest receivable

Question (2). Solve the following comprehensive problems:

1. The following is the trial balance of Ramzy Cars Repair workshop. It demonstrates the accounts recorded until December 31st, 2017 before making the required adjustments:

Ramzy Cars Repair Unadjusted Trial Balance December 31, 2017		
	Debit	**Credit**
Cash	LE 14,4,00	
Rent receivable	2,600	
Accounts Receivable	3,000	
Prepaid insurance	14,000	
Supplies	12,000	
Furniture & fixtures	118,000	
Building	100,000	
Land	120,000	
Accumulated depreciation- Furniture		18,000
Accumulated depreciation- Building		20,000
Accounts payable		16,000
Interest payable		17,000
Salaries payable		5,000
Ramzy, capital		316,000
Ramzy, drawings	6,000	
Service, revenue		60,000
Salary expense	14,000	
Supplies expense	12,000	
Advertising expense	21,000	
depreciation- expense Furniture	5000	
Depreciation expense building	10,000	
Total	LE 452,000	LE 452,000

The following adjustments have been taken place at December 31st, 2017:

1. Prepaid insurance expired, LE 2,500
2. Building- Depreciation for the year LE 10,000
3. Supplies in hand LE 10,000
4. Salaries payable paid in total

Required:

1. Journalize the adjusting entries that Ramzy has not recorded yet.
2. Prepare the adjusting trial balance after considering the transactions above.
3. Journalize the closing entries at the end of the year.
4. Compute the ending balance of Ramzy's capital account at the end of the year. Explain why should this account be debited or credited in the income summary?
5. Prepare the post -closing trial balance.
6. Prepare the classified balance sheet in a report format

Solution:

Requirement (1) Journalize the adjusting entries that Ramzy has not recorded yet:

1. To record the insurance expense for the year:

2017	**ACCOUNT**	Debit	Credit
31ST, DEC.	Insurance expense	2,500	
	Prepaid insurance		2,500

2. To record the depreciation expense of the building**:**

2017	**ACCOUNT**	Debit	Credit
31ST, DEC.	Depreciation expense-Building	10,000	
	Prepaid insurance		10,000

3. To record the supplies expense for the year

2017	**ACCOUNT**	Debit	Credit
31ST, DEC.	supplies expense	2,000	
	Supplies		2,000

4. To record the payment of total salaries in due:

2017	ACCOUNT	Debit	Credit
31ST, DEC.	Salaries payable	5,000	
	Cash		5,000

Requirement 2: Preparation of the adjusted trial balance

Ramzy Cars Repair		
Adjusted Trial Balance		
December 31, 2017		
	Debit	**Credit**
Cash	LE 9,4,00	
Rent receivable	2,600	
Accounts Receivable	3,000	
Prepaid insurance	11,500	
Supplies	10,000	
Furniture & fixtures	118,000	
Building	100,000	
Land	120,000	
Accumulated depreciation- Furniture		18,000
Accumulated depreciation- Building		30,000
Accounts payable		16,000
Interest payable		17,000
Ramzy, capital		316,000
Ramzy, drawings	6,000	
Service, revenue		60,000
Salary expense	14,000	
Supplies expense	14,000	
Advertising expense	21,000	
depreciation- expense Furniture	5000	
Depreciation expense building	20,000	
Insurance expense	2,500	
Total	LE 457,000	LE457,000

Requirement 3: Journalize the closing entries at the end of the year:

Step 1: close the expense accounts in the income summary

2017	ACCOUNT	Debit	Credit
31^{ST}, DEC	Income Summary	76,500	
	Salary expense		14,000
	Supplies expense		14,000
	Advertising expense		21,000
	depreciation- expense Furniture		5,000
	Depreciation expense building		20,000
	Insurance expense		2,500

Step 2: Close the revenue account in the income summary

2017	ACCOUNT	Debit	Credit
31^{ST}, DEC	Service revenue	60,000	
	Income summary		60,000

Step 3: Close the results of income summary in Ramzy's capital account.

The ending balance of income summary = total revenue 60,000- total expenses 60,500

loss = LE (500)

2017	ACCOUNT	Debit	Credit
31^{ST}, DEC	Ramzy, capital	16,500	
	Income summary (loss)		16,500

Step 4: Close Ramzy's drawing account

2017	ACCOUNT	Debit	Credit
31^{ST}, DEC	Ramzy, capital	6,000	
	Ramzy, drawings		6,000

Re quirement 4: Compute the ending balance of Ramzy's capital account at the end of the year.

Ramzy, capital ………………………… LE 316,000
Less: drawings ……………………………….(6000)
Less: Income summary (loss) …………(16,500)
Ramzy, capital at Dec 31,2017……….293,500

Explain why should this account be debited or credited in the income summary?

As the total amount of expenses exceeds the total revenue generated during the year, the company incurred loss and hence Ramzy capital account has been (debited) reduced by this loss.

Requirement 5: Prepare the post -closing trial balance

Ramzy Cars Repair Post-closing Trial Balance December 31, 2017		
	Debit	**Credit**
Cash	LE 9,4,00	
Rent receivable	2,600	
Accounts Receivable	3,000	
Prepaid insurance	11,500	
Supplies	10,000	
Furniture & fixtures	118,000	
Building	100,000	
Land	120,000	
Accumulated depreciation- Furniture		18,000
Accumulated depreciation- Building		30,000
Accounts payable		16,000
Interest payable		17,000
Ramzy, capital		**293,500**
Total	LE 374,500	LE374,500

Requirement 6: Prepare the classified balance sheet

Ramzy Cars Repairs Balance Sheet December 31,2017		
Assets	LE	LE
Current Assets		
Cash ………………………………………..	9,400	
Accounts receivables………………………….	3,000	
Rent receivable ……………………………	2,600	
Prepaid insurance ………	11,500	
Supplies ………………...	10,000	
Total current assets …………………		36,500
Plant assets		
land ……………………………………………..	120,000	
Building……………………...……………	100,000	
less: accumulated depreciation……….	(30,000)	
	70,000	
Furniture & fixtures ………………………….	118,000	
Less: Accumulated depreciation………………….	(18,000)	
	100,000	
Total plants Assets …………………………..		290,000
Total assets		
Liabilities & Equity		326,500
Current liabilities		
Accounts payable …………………………………	16,000	
Interest payable …………………………………...	17,000	
Total current liabilities		33,000
Equity		
Ali's capital ………………………………………		293,500
Total liabilities and Equity ……………………….		326,500