South Valley University
Faculty of Commerce
Accounting Department
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Lectures in

Intermediate Accounting

Collection

Prepared by

Dr. Ali Abdelkarim Rawy

Ph.D. in Accounting
Hull University-England

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IN THE NAME OF ALLAH, THE MOST GRACIOUS, THE MOST MERCIFUL

THIS TEXTBOOK IS DEDICATED TO
THE MEMORY OF MY FATHER AND MY MOTHER
&
MY WIFE AND MY CHILDREN

CHAPTER ONE
ERRORS AND SUSPENSE ACCOUNTS

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ERRORS AND SUSPENSE ACCOUNTS

1.1 Introduction:

It is known that the basic information for the preparation and presentation of *Final Accounts* is supplied by the *Trial Balance*. Hence, the accuracy of the *Trial Balance* determines, to a great extent, the accuracy of the information provided by *Final Accounts*. Nevertheless, the *Trial Balance* provides only proof of the arithmetical accuracy of the books of accounts. Trial Balance simply guarantees that for every debit there is an equivalent credit entry. This means that despite an agreed *Trial Balance*, it is not necessary that there are no errors in the books of accounts. For instance, if a transaction is not at all recorded in the books of accounts, the trial balance will tally or equalise, but the books of accounts cannot be termed as accurate.

Anyway, if the two sides of the trial balance do not tally, it is a sharp proof of this fact that there are certain errors in the books of accounts. Thus, errors may be there in recording, classifying and summarising the financial transactions, whether the *Trial Balance* tallies or not.

1.2 Classification of Errors:

In practice, errors can broadly be classified into the following common categories:

1. Errors of Omission.

2. Errors of Commission.

3. Errors of Principle.

4. Compensating Errors.

1. Errors of Omission:

Errors of omission are incurred in those cases when a transaction is completely omitted or deleted from the books of accounts. In other words, this type of errors happens when a transaction is not recorded in the books of original entry. For example, if a purchase of goods or fixed assets on credit from Said Ramadan has not at all been recorded in the books of accounts, such an error will be termed as an error of omission.

As, there has been neither a debit entry nor a credit entry, therefore, the two sides of the *Trial Balance* will not be at all affected because of this error. Accordingly, such errors cannot be located out very easily. Such errors come to the attention when statement of accounts are received from or sent to creditors or debtors.

2. Errors of Commission:

Errors of commission include errors resulting from wrong balancing of an account, wrong posting, wrong carry forwards, wrong totalling, and so on. For example, if a sum of L.E.1,000 received from Ronaldo is credited to his account as L.E.10,000, this is an error of commission. Similarly, if the total of the debit side of an account is carried forward from one page to another and the mistake is committed in such carry forward (for example, total of L.E.886 is carried forward as L.E.688), such an error is an error of commission. Errors of commission affect the agreement of the *Trial Balance* and, therefore, their location is easier.

On the other hand, some types of errors of commission do not cause a trial balance to disagree. This refers to when a transaction has been entered on both sides of the ledger and in the correct class/type of account but one of the entries is in the wrong account. For example, stationery has been entered in the purchases account in error, or cheques posted to the wrong personal account.

3. Errors of Principle

Errors of principle are committed in those cases where a proper distinction between revenue and capital items is not made. A capital expenditure is taken as a revenue expenditure or *vice-versa*. Similarly, a capital receipt may have been taken as a revenue receipt. For example, a sale of old car of L.E.15,000 should be credited to the Car Account, but if it is credited to the Sales Account, it will be termed as an error of principle. Sale of old car is a capital receipt and if it is credited to Sales Account, it has been taken as a revenue receipt. Such errors by themselves do not affect the agreement of the *Trial Balance*. Therefore, they also are difficult to be located.

4. Compensating Errors:

Compensating errors, as the name indicates, are those errors which compensate each other. For instance, if a sale of L.E.10,000 to Mohamed is debited as only of L.E.1,000 to his account, while a sale of L.E.1,000 to Adel is debited as of L.E.10,000 to his account, it is a compensating errors. These errors also do not affect the agreement of the *Trial Balance* and, accordingly, their location is also difficult.

From the above presentation of errors, it is appeared that errors of omission, errors of principle and compensating errors by themselves alone do not affect the agreement of the *Trial Balance*. In case these errors get combined with errors of commission, they may affect the agreement of the *Trial Balance*. For example, if a sale of old car of L.E.15,000 is credited to the Sales Account only as of L.E.1,500, the error combines in itself both an error of principle as well as error of commission. Therefore, such error will cause the trial balance to disagree.

1.3 Location of Errors:

Logically, location of an error will depend upon the type of such error. For example, location of errors of principle, errors of compensating nature and errors of omission is slightly difficult. The reason is that such errors do not affect the balance or agreement of the *Trial Balance*. Accordingly, the location of such errors may be considerably delayed. On the other hand, location (discovery) of errors of commission is relatively easier because they affect the agreement of the *Trial Balance.* Therefore, the errors can be classified into two categories from the point of view of locating them:

- Errors which do not affect the agreement of the *Trial Balance.*
- Errors which affect the agreement of the *Trial Balance.*

1.3.1 Errors which do not affect the agreement of the Trial Balance:

Errors of omission, errors of commission and errors of compensating nature by themselves don't affect the agreement of the *Trial Balance.* Hence, their location is a difficult process. They are usually discovered or found out when statement of accounts are received by the business or sent to the customers or during the process of internal or external audit and sometimes by chance. For instance, if a credit purchase of L.E.5,000 from Ramsey has not been recorded in the accounting records, the error will not affect the agreement of the *Trial Balance*, and therefore, at the time of finalising the accounts it may not be found out.

Nevertheless, this will be traced out when a statement of account is sent to Ramsey showing the money due to him or when a statement of account is received from Ramsey showing the money recoverable by him. When these errors are found they have to be corrected. The entries have to be made in the double entry accounts. Furthermore, an entry should be made in the journal, to explain the correction.

In the following sections, an example will be given for each type of error.

1. Errors of Omission:

The sale of goods, L.E.2,000 to Sandra, has been completely omitted from the books. This error must be corrected by entering the sale in the books by the following Journal entry:

The Journal

	Dr L.E	Cr L.E.
Sandra	2,000	
Sales account		2,000

Correction of omission of Sales Invoice No.... from sales journal.

2. Errors of Commission:

A purchase of goods, L.E.1,500 from Samira, was entered in error in Samar's account. To correct this, it must be cancelled out of Samar's account, and then entered where it should be in Samira's account. The double entry will be:

The Journal

	Dr L.E.	Cr L.E.
Samar	1,500	
Samira account		1,500

Purchase Invoice No... entered in wrong personal account.

3. Errors of Principle:

The purchase of a machine, L.E.20,000, is debited to Purchase account instead of being debited to Machinery account. We therefore cancel the item out of the Purchase account by crediting that account. It is then entered where it should be by debiting the Machinery account.

The Journal

	Dr L.E.	Cr L.E.
Machinery account	20,000	
Purchases account		20,000

Correction of error: purchase of fixed asset debited to purchases account.

4. Compensating Errors:

The sales account is overcast by L.E.4,000, as also is the wages account. The trial balance therefore still "balances". This assumes that these are the only two errors found in the books.

The Journal

	Dr L.E.	Cr L.E.
Sales account	4,000	
Wages account		4,000

Correction of overcasts of L.E.4,000 each in the sales account and the wages account which compensating for each other.

5. Errors of Original Entry:

Where the original figure is incorrect, yet double entry is still observed using this incorrect figure. An example of this could be where there were sales of L.E.5,000 goods but an error is made in calculating the sales invoice. If it were calculated as L.E.3,500, and L.E.3,500 were credited as sales and L.E.3,500 were debited to the personal account of the customer Ahmed, the trial balance would still "balance".

The Journal

	Dr L.E.	Cr L.E.
Ahmed	1,500	
Sales account		1,500

Correction of error whereby sales were understated by L.E.1,500.

6. Complete Reversal of Entries:

Where the correct accounts are used but each item is shown on the wrong side of the account. Suppose we had paid a check to Walled for L.E.3,000, the double entry of which is Cr Bank L.E.3,000, Dr Walled L.E.3,000. In error it is entered as Cr Walled L.E.3,000, Dr Bank L.E.3,000. The trial balance totals will still agree. This is somewhat more difficult to adjust. First must come the amount needed to cancel the error, and then comes the actual entry itself. Because of this, the correcting entry is double the actual amount first recorded.

The Journal

	Dr L.E.	Cr L.E.
Walled	6,000	
Bank account		6,000

Payment of check L.E.3,000 debited to bank and credited to Walled in error.

1.3.2 Errors which affect the agreement of the Trial Balance:

Normally, such errors are easy to be discovered because they are caught at an early stage. Once the *Trial Balance* does not tally, the accountant can start to find out these errors. These errors could be as a result of the following:

- Incorrect additions in any account.
- Making an entry on only one side of the accounts, a debit but no credit; a credit but no debit.
- Entering a different amount on the debit side from the amount on the credit side.

The procedures which will be followed for locating of such errors may be as below:

1- The difference of the two sides of the *Trial Balance* should be found out. The amount should then be divided by two. The two sides of the *Trial Balance* should then be checked to find out if there is an amount equal to that figure. It is possible that the amount may have been placed to a wrong side resulting in difference in the totals of the *Trial Balance*. For instance, if the total of the debit side of the *Trial Balance* is L.E.9,000 more than the credit side of the *Trial Balance*, L.E.9,000 should be divided by 2, thus giving a figure of L.E.4,500. The debit side should then be checked to find out if there is an amount of L.E.4,500 appearing on that side. If it is so, it should be seen whether the amount has been correctly put to that side or it should have gone to the credit side.

2- If the mistake is not found out by taking step No. 1-, the difference should be divided by 9. If the difference is completely divisible, it can be an error of transposition of figures. For example, if the figure of 698 is written as 896, the difference is of L.E.198. this figure is completely divisible by 9. Thus it can be concluded that in such cases where the difference is divisible by 9, there can be a probability of this type of error.

3- In case, the difference is still not traceable, the following further possibilities should be checked:

(a) If the difference is in a round figure, there is a possibility of wrong summing or wrong carry forwards of the totals of a subsidiary book or there is an error in balancing the accounts.

(b) In case, the difference is not in a round figure, there is a possibility of error being committed in posting the transactions from the Journal to the Ledger.

(c) If the difference is of a substantial amount, it will be appropriate to compare the *Trial Balance* of the current year with the *Trial Balance* of the last year and see whether there is any abnormal difference between the balances of important accounts of the two *Trial Balances.*

4- Since cash and bank accounts are not maintained usually in the Ledger, it will be also advisable to check whether the balances of the cash and bank accounts have been taken in the Trial Balance or not.

5- The schedules of sundry debtors and sundry creditors should be checked to find out whether all balances of debtors and creditors have been included in these schedules or not.

6- The totals of the subsidiary books such as the Sales Book, Purchases Book should be checked and it should be seen whether posting has been done from these two books correctly to Sales, Purchases or other accounts as the case might be.

7- If the error is still not traceable, check thoroughly the books of original entry and their posting into the Ledger and finally the balancing of different accounts.

8- An organization may keep ledgers on sectional/self balancing system. In such a case, there are three ledgers: *(1)* Sales Ledger containing personal accounts of all trade debtors, *(2)* Purchases Ledger containing personal accounts of all trade creditors, and *(3)* General Ledger containing all other real, nominal and personal accounts except those of trade debtors and trade creditors. Nevertheless, there will be two total accounts in this ledger: *(a)* Total Debtors Account, and *(b)* Total Creditors Account. The balance of the Total Debtors Account should agree with the total of the Schedule of Debtors as prepared from the Sales Ledger. Similarly, the balance of the Total Creditors Account should agree with the total of the Schedule of Creditors as prepared from the Purchases Ledger. To this point, in case the balance of Total Debtors Account does not tally with the total of Schedule of Debtors, the personal accounts in the Sales Ledger should be checked and the other Ledger may not be touched. Regarding the Total

Creditors Account and the Schedule of Total Creditors, same is true.

1.4 Suspense Accounts and Errors:

The accountant should take the above mentioned steps one after the other to locate the difference in the totals of the Trial Balance. However, many errors will mean that Trial Balance totals will not be equal. In case the accountant is not in a position to determine the difference and he/she is in a hurry to close the books of accounts, he/she may transfer the difference to an account known as ***"Suspense Account"***. Accordingly, Suspense Account is an Account to which the difference in the trial balance has been put temporarily.

When the errors are located in the beginning or during the operations of the following year, appropriate accounting entries are done and the Suspense Account is closed. On the other hand, it should be considered that Suspense account should be opened by the accountant only when failing to find out the errors in spite of doing the best efforts.

♂**Note:** you will often notice the use of the expression 'to cast', which means 'to add up'. ***Overcasting*** means incorrectly adding up a column of figures to give an answer which is greater than it should be. ***Undercasting*** means incorrectly adding up a column of figures to give an answer which is less than it should be.

It should be tried very hard to find errors immediately when the trial balance totals are not equal. When they cannot be found, the trial balance totals should be made to agree with each other by inserting the amount of the difference between the two sides in a *suspense account*. This could be shown as below, where there is a L.E.500 difference.

Trial Balance as on 31 December 2021

	Dr	Cr
	L.E.	*L.E.*
Totals after all the accounts have been listed	200,000	199,500
Suspense account		500

To make the two totals the same, a figure of L.E.500 for the suspense account has been shown on the credit side. A suspense account is opened and the L.E.500 difference is also shown there on the credit side.

Suspense Account

	L.E.
	Dec 31 Difference per trial balance 500

1.4.1 Suspense Account and the Balance Sheet:

If the errors are not located before the final accounts are prepared, the suspense account balance will be included in the balance sheet. Where the balance is a credit balance, it should be included on the capital and liabilities side of the balance sheet. When the balance is a debit balance it should be shown on the assets side of the balance sheet.

1.4.2 Correction of Errors:

When the errors are found they must be corrected, using double entry. Each correction must also have an entry in the journal describing it.

Examples relating to one error only:

Example 1:

Assume that the error of L.E.500 as shown above is found in the following year on 31 March 2022. The error was that the sales account was undercasted by L.E.500. The action taken to correct this is:

Debit suspense account to close it: L.E.500.

Credit sales account to show item where it should have been: L.E.500.

The accounts now appear as below.

Suspense Account

2022	L.E.	2021	L.E.
		Dec 31 Difference per	
Mar 31 Sales	500	trial balance	500
	===		===

Sales Account

		2022	L.E.
		Mar 31 Suspense	500

This can be presented in journal entry form as:

The Journal

	Dr	Cr
2022	L.E.	L.E.
Mar 31 Suspense	500	
Sales		500

Correction of undercast of sales by L.E.500 in last year's accounts.

Example 2:

The trial balance on 31 December 2021 had a difference of L.E.1,000. It was a shortage on the debit side.

A suspense account is opened, the difference of L.E.1,000 is entered on the debit side. On May 2022 the error was found. We had made a payment of L.E.1,000 to Mahmud to close his account. It was correctly entered in the cash book, but it was not entered in Mahmud's account.

First of all, ***(a)*** the account of Mahmud is debited with L.E.1,000, as it should have been in 2013. Second ***(b)*** the suspense account is credited with L.E.1,000 so that the account can be closed.

Suspense Account

2021	L.E.	2022	L.E.
May 31 Difference per trial balance	1,000	May 31 Mahmud	1,000
	===		===

Mahmud Account

2022	L.E.	2022	L.E.
May 31 Suspense	1,000	Jan 1 Balance b/d	1,000

This can be shown in journal entry form as:

The Journal

	Dr	Cr
2022	L.E.	L.E.
May 31 Mahmud	1,000	
Suspense		1,000

Correction of non-entry of payment last year in Mahmud's account.

Examples relating to more than one error:

Example 3:

In this example, the suspense account was caused by more than one error. The trial balance at 31 December 2021 showed a difference of L.E.7,700, being a shortage on the debit side. A suspense account is opened, and the difference of L.E.7,700 is entered on the debit side of the account.

On 31 March 2022 all the errors from the previous year were found.

1 A check of L.E.15,000 paid to Kamal had been correctly entered in the cash book, but had not been entered in Kamal's account.

2 The purchases account had been undercast by L.E.2,000.

3 A check of L.E.9,300 received from Sabry had been correctly entered in the cash book, but had not been entered in Sabry's account.

These three errors resulted in a net error of L.E.7,700, shown by a debit of L.E.7,700 on the debit side of the suspense account. These are corrected as follows:

(a) Make correcting entries in accounts for 1, 2 and 3.

(b) Record double entry for these items in the suspense account.

Kamal Account

2022	L.E.		
Marc 31 Suspense 1	15,000		

Purchases Account

2022	L.E.		
March 31 Suspense 2	2,000		

Sabry Account

		2022	L.E.
		Mar 31 Suspense 3	9,300

Suspense Account

2022	L.E.	2022	L.E.
Jan 1 Balance b/d	7,700	Mar 31 Kamal 1	15,000
Mar 31 Sabry 3	9,300	Mar 31 Purchases 2	2,000
	17,000		17,000
	=====		=====

These can be shown in journal entry form as:

The Journal

	Dr	Cr
2022	L.E.	L.E.
Mar 31 Kamal	15,000	
Suspense		15,000
Check paid omitted from Kamal's account.		

Mar 31 Purchases	2,000	
Suspense		2,000

Undercasting of purchases by L.E.2,000 in last year's accounts.

Mar 31 Suspense	9,300	
Sabry		9,300

Check received omitted from Sabry's account.

Only those errors which make the trial balance totals different from each other have to be corrected via the suspense account.

Example 4:

A sale of L.E.500 to Karim was entered in the sales book as of L.E.5,000, from where he was debited by L.E.50,000.

This is a multiple type of error. It affects more than two accounts. The accounts involved are *(a)* Karim, *(b)* Sales Account, and *(c)* Suspense Account.

The total of the Sales Book is posted to the Sales Account. The sale has been recorded as of L.E.5,000 in the sales book; from where the posting must have been done to the sales account. Thus, the sales Account has been credited by L.E.5,000 instead of

L.E.500. It has been credited more by L.E.4,500. In order to rectify the error, it should, therefore, be debited by L.E.4,500. The account of Karim should have been debited by L.E.500 only but it has been debited by L.E.50,000. It has, therefore, been debited more by L.E.49,500. In order to rectify the matters, it should be credited by L.E.49,500. These two errors must have created difference in the trial balance which should have gone to the Suspense Account.

Sales Account comes on the credit side of the trial balance. It has been credited by L.E.4,500 more and, therefore, the credit side of the trial balance will be more by this amount on account of this error. On the other hand, Karim is a debtor, his account has been excess debited by L.E.49,500. The debit side of the trial balance should, therefore, be more by this amount.

The net effect is that the debit side of the trial balance must have been more by L.E.45,000 which must have been put to the Suspense Account by giving credit to it. The rectifying entry will therefore be as follows:

The Journal

	Dr L.E.	Cr L.E.
Suspense A/c	45,000	
Sales A/c	4,500	
Karim A/c		49,500

Thus, on the basis of the above examples, the following rules can be formed out:

a. Find out the accounts affected by the error.

b. Find out what should have been done and what has been done.

c. Credit or debit the respective account in order to set the matters right.

d. Put the differences to Suspense account.

Example 5:

A sale of L.E.10,000 to Sarah was entered in the purchases book from where the account of Sarah was debited by L.E.1,000.

The preceding error affects the following accounts: *(a)* Sales Account, *(b)* Purchases Account, and *(c)* Account of Sarah.

Sales account should have been credited by a sum of L.E.10,000. It has not been done since it has been recorded in the Purchases Book. Accordingly, sales account should be credited- what should have been done.

Purchases account has been debited since the transaction has been entered in the purchases book from where it must have been posted to the purchases account. It has been debited by a sum of L.E.10,000 unnecessarily. It should, therefore, be credited to remedy what has been done wrongly.

Account of Sarah should have been debited by L.E.10,000. In the normal course, since the transaction has been recorded in the purchase book, his account should have been credited.

However, the accountant has debited her account by L.E.1,000 instead of L.E.10,000. Her account should therefore be debited by L.E.9,000 more in order to give full debit to her account.

The difference, if any, should be transferred to the Suspense Account as given in rule *d*. presented above. The rectifying journal entry will be as follows:

The Journal

	Dr L.E.	Cr L.E.
Suspense A/c	11,000	
Sarah A/c	9,000	
Purchases A/c		10,000
Sales A/c		10,000

Comprehensive illustration 1.1:

The trial balance of XYZ on 31st December 2021 showed a difference of L.E.5,800 (excess debit). It was put to a suspense account and the books were closed. Ongoing through the books in January 2022, following errors were located. You are required to pass appropriate correcting journal entries and prepare the Suspense Account.

1. L.E.5,400 received from Maher was posted to the debit side of his account.

2. L.E.1,000 being Purchases Returns was posted to the debit side of Purchases Account.

3. L.E.2,000 discount received, entered in the cash book was not posted to the ledger.

4. L.E.5,740 paid for repairs to motor-car was debited to the motor-car account as L.E.1,740.

5. A sale of L.E.3,500 to Suzy was entered in the Sales Book as of L.E.5,300.

6. While carrying forward total of one page in Sami's Account, the amount of L.E.2,500 was written on the credit side instead of debit side.

7. The purchase of machinery on 1st January 2021 for L.E.60,000 was entered in the Purchase Account.

Solution

No.	Explanation	Dr L.E.	Cr. L.E.
1	Suspense A/c....	10,800	
	Maher A/c....		10,800
	....		
2	Suspense A/c....	2,000	
	Purchases A/c....		1,000
	Purchases Returns A/c....		1,000
	....		
3	Suspense A/c....	2,000	
	Discount Received A/c....		2,000
	....		
4	Repairs A/c....	5,740	
	Motor Car A/c....		1,740
	Suspense A/c....		4,000
	....		
5	Sales A/c....	1,800	
	Suzy A/c....		1,800
	....		
6	Sami A/c....	5,000	
	Suspense A/c....		5,000

7	.... Machinery A/c.... Purchases A/c....	60,000	60,000

Dr. Suspense Account Cr.

	L.E.		L.E.
Maher A/c	10,800	Balance b/d	5,800
Purchases A/c	1,000	Repairs A/c	4,000
Purchases Returns	1,000	Sami A/c	5,000
Discount A/c	2,000		
Total	14,800	*Total*	14,800

•Note: While passing the rectifying journal entries, you should put the difference to the Suspense Account, in case it has been opened and no other account is available.

1.5 The Effect of Errors on Profits:

Some of the errors will have meant that original profits calculated will be wrong. Other errors will have no effect upon profits. Errors committed in a year may affect the profit of that year. This happens when the error relates to such accounts which are taken into account while computing gross or net profit of the business.

In other words, if the errors relate to such accounts which find their place in the Trading Account or the Profit and Loss Account, the errors will affect the profit of the business. For instance,, errors involving Purchases Account, Sales Account, Expense Account, and Income Account will all affect the profit of the business.

In case on account of errors such accounts are either not debited or unnecessarily credited, this will result in increase in profit of the business. For example, if repairs of machinery amounting to L.E.5,000 has been debited to Machinery Account by mistake, the net profit will increase by L.E.5,000.

Similarly, if on account of such errors such accounts are unnecessarily debited or are not unnecessarily credited, the errors will decrease the net profit of the firm. For instance, if a sale of L.E.1,000 is recorded in the books as only a sale of L.E.100, it will result in reducing the net profit of the business by L.E.900. The following illustration will clear and explain the matters.

Comprehensive illustration 1.2:

Using the information presented in illustration 1.1, compute the effects:

(1) On profit for the year 2021 of the errors committed, and

(2) On profit of 2022 of the errors being corrected.

Solution

Effect of Errors on Profit of 2021

	Increase (+) L.E.	Decrease (−) L.E.
1- No effect on profit since no account relates to Trading or Profit & Loss Account.		
2- The net profit will decrease by L.E.2,000 because both the Purchases and Sales accounts relate to Trading Account.		2,000
3- The net profit will decrease by L.E.2,000, since the account not credited relates to Profit & Loss Account.		2,000
4- The net profit will increase by L.E.5,740, since the account not debited relates to Profit & Loss Account.	5,740	
5- The net profit will increase by L.E.1,800, since excess credit has been given to an account which relates to Trading Account.	1,800	
6- No effect on profit since no account relates to Trading or Profit & Loss Account.		
7- The net profit will decrease by L.E.60,000; since the account given unnecessarily debit relates to Trading Account.		60,000
	7,540	64,000

Accordingly, on the whole, the net profit of the business for the year would decrease by L.E.56,460.

Effect of Errors on Profit of 2022

	Increase (+) L.E.	Decrease (−) L.E.
1- No effect on profit since no account relates to Trading or Profit & Loss Account.		
2- The net profit would increase by L.E.2,000 since both the accounts credited relate to Trading Account.	2,000	
3- The net profit will increase by L.E.2,000, since the account credited relates to Profit & Loss Account.	2,000	
4- The net profit will decrease by L.E.5,740, since the account debited relates to Profit & Loss Account.		5,740
5- The net profit will decrease by L.E.1,800, since the account debited relates to Trading Account.		1,800
6- No effect on profit since neither account relates to Trading or Profit & Loss Account.		
7- The net profit will increase by L.E.60,000; since the account credited relates to Trading Account.	60,000	
	64,000	7,540

Accordingly, on account of correction of errors, the net profit of 2013 will increase by L.E.56,460.

Important note:

According to the preceding illustration, it is clear that if the net profit has decreased because of committing of errors, it will increase because of correcting those errors or *vice-versa*. Thus, the effect on net profit can be found out simply by preparing one statement either showing the effect of errors on net profit or showing the effect of correction of errors on net profit. If one effect is found out, the other will be just reverse of it.

Comprehensive illustration 1.3:

The different kinds of errors will be illustrated as bellow:

Trading and Profit and Loss Account for the year Ended 31 December 2021

	L.E.		L.E.
Stock of goods	5,000	Sales	80,000
Add Purchases	61,000		
	66,000		
Less Closing stock	7,000		
Cost of goods sold	59,000		
Gross profit c/d	21,000		
	80,000		80,000
	=====		=====
Rent	2,000	Gross profit b/d	21,000
Insurance	1,200	Discount received	2,500
Lighting	1,800		
Depreciation	2,500		
Net profit	16,000		
	23,500		23,500
	=====		=====

Balance Sheet as at 31 December 2021

	L.E.	L.E.		L.E.	L.E.
Fixed assets			Capital		
Fixtures at cost	22,000		Balance as at		
Less Depreciation	8,000		1.1.2021	18,000	
		14,000	*Add* Net profit	16,000	
Current assets				34,000	
Stock	7,000		*Less* Drawing	9,000	
Debtors	6,000				25,000
Bank	3,400		*Current liabilities*		
		16,400	Creditors		6,000
Suspense account		600			
		31,000			31,000
		=====			=====

1 Errors which do not affect profit calculations:

If an error affects items only in the balance sheet, then the original calculated profit will not need altering. Assume that in Illustration 1.3 the L.E.600 debit balance on the suspense account was because of the following error:

1 November 2021 was paid L.E.600 to a creditor Mustafa. It was correctly entered in the cash book. It was not entered anywhere else. The error was found on 1 January 2022. The journal entries to correct it will be:

The Journal

		Dr	Cr
2022		L.E.	L.E.
January1	Mustafa	600	
	Suspense account		600

Payment to Mustafa on 1/11/2021 not entered in his account. Correction now made.

Both of these accounts appeared in the balance sheet only with Mustafa as part of creditors. The net profit of L.E.16,000 does not have to be changed.

2 Errors which do affect profit calculations:

If the error is in one of the figures shown in the trading and profit and loss account, then the original profit will need altering.

Assume that in Illustration 1.3 the L.E.600 debit balance was because the rent account was added up incorrectly. It should be shown as L.E.2,600 instead of L.E.2,000. The error was found on 1 January 2022. The journal entries to correct it are:

The Journal

		Dr	Cr
2022		L.E.	L.E.
January1	Rent	600	
	Suspense account		600
Correction of rent undercast last year.			

Rent last year should have been increased by L.E.600. This would have reduced net profit by L.E.600. A statement of corrected profit for the year is now shown.

Statement of Corrected Net Profit for the year ended 31 December 2021

	L.E.
Net profit per the accounts	16,000
Less Rent understated	600
	15,400
	======

3 Where there have been several errors:

If in Illustration 1.3 there had been four errors in the accounts found on 31 March 2022, their correction can now be seen. Assume that the net difference had also been L.E.600.

1 Sale overcast by	L.E.700
2 Insurance undercast by	L.E.400
3 Cash received from a debtor entered in the cash book only	L.E.500

4 A purchase of L.E.590 is entered in the books, debit and credit entries as	L.E.950

The entries in the suspense account and the journal entries will be as follows:

The Journal

No.	Explanation	Dr L.E.	Cr. L.E.
2022	Sales A/c....	700	
1Mar	Suspense A/c....		700
31	Sales overcast of L.E.700 in 2021.		
	....		
	Insurance A/c....	400	
2Mar	Suspense A/c....		400
31	Insurance expense undercast by L.E.400 in 2021.		
	....		
3Mar	Suspense A/c....	500	
31	Debtor's A/c....		500
	Cash received omitted from debtor's account in 2021.		
	....		
4Mar	Creditor's A/c....	360	
31	Purchases A/c....		360
	Credit purchase of L.E.590 entered both as debit and credit as L.E.950 in 2021.		

Dr. Suspense Account Cr.

2022	L.E.	2022	L.E.
Jan 1 Balance b/d	600	Mar 31 Sales	700
Mar 31 Debtor	500	,, 31 Insurance	400
Total	1,100	*Total*	1,100

***Note*: in 4, the correction of the understatement of purchases does not pass through the suspense account.**

Accordingly, we can calculate the corrected net profit for the year 2021. Only items **1, 2** and **4** affect figures in the trading and profit and loss account. These are the only adjustments to be made to profit.

Statement of Corrected Net Profit for the year ended 31 December 2021

		L.E.
Net profit per the accounts		16,000
Add Purchases overstated **4**		360
		16,360
Less Sales overcast **1**	700	
Rent undercast **2**	400	1,100
Corrected net profit for the year		15,260
		======

Error **3**, the cash not posted to a debtor's account, did not affect profit calculations.

1.6 Questions and Practical Problems:

1. Write out the journal entries to correct the following errors using a Suspense Account:

(1) The total of "Discount Allowed" from the Cash Book for the month of December 2021 amounting to L.E.3,500 was not posted.

(2) An amount of L.E.1,750 entered in the Sales Returns Book has been posted to the debit of Mr. Ronaldo who returned the goods.

(3) Bad debts aggregating L.E.2,500 were written off during the year in the sales ledger but were not adjusted in the general ledger.

(4) Goods of the value of L.E.5,000 returned by Mr. Sameh were entered in the Sales Day Book and posted therefrom to the credit of his account.

(5) A sales of L.E.8,000 made to Mr. Peter was correctly entered in the Sales Day Book but wrongly posted to the debit of Mr. Armando as L.E.800.

[Answer Key: Opening Balance of Suspense Account (Dr L.E.17,200)].

2. In 2022, Mr. Baraka found that his books for the year 2021 contained some errors in spite of an agreed trial balance. The errors were.

(1) An invoice for L.E.500 for goods purchased from Mr. Balkawi was entered in Sales Returns Book; in the ledger, this was debited to the account of Mr. Balkawi.

(2) Goods bought on credit from Mr. Kishk for L.E.1,500 were entered in the Sales Book as L.E.1,050. Mr. Kishk's account was credited with this amount of L.E.1,050.

(3) The Sales Book for the month of April, 2020 was overcast by L.E.1,500.

(4) A sale of L.E.2,570 to Mr. Duff was entered in the Sales Book as L.E.5,270. Mr. Duff was debited with L.E.7,520.

(5) L.E.790 paid for freight on machinery was debited to Freight Account as L.E.970.

Instructions

Give journal entries to correct the errors using a Suspense Account where is necessary.

[Answer Key: Suspense Account shows a closing credit balance of L.E.170, showing that some errors are still to be traced].

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3. Pass journal entries to correct the following errors:

(1) A check of L.E.7,500 received for loss of stock by fire had been deposited in the proprietor's Private Bank Account.

(2) An item of purchase of L.E.1,510 was entered in the Purchases Book as L.E.150 and posted to the Supplier's Account as L.E.510.

(3) A sale return of L.E.500 was not entered in the financial account although it was duly taken in the stock book.

(4) An amount of L.E.3,000 was received in full settlement from a customer after he was allowed a discount of L.E.500, but while writing the books, the amount received was entered in the Discount Column and the Discount Allowed was entered in the Cash Column.

(5) Bill Receivable from Mr. ***A*** of L.E.10,000, was posted to the credit of Bill Payable Account and also Credited to the account of Mr. ***A.***

[Answer Key: Opening balance in Suspense Account L.E.20,360 (Dr)].

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4. An accountant could not tally the Trial Balance. The difference was temporarily placed to Suspense Account for preparing the final accounts. The following errors were later discovered.

(a) The Sales Book was undercast by L.E.500.

(b) Entertainment expenses of L.E.950, although entered in the Cash Book were omitted to be posted in the Ledger.

(c) Discount column of the receipt side of the Cash Book was wrongly added as L.E.1,400 instead of L.E.1,200.

(d) Commission L.,E.250 paid, was posted twice, once to discount account and once to commission account.

(e) A sale of L.E.1,390 to Radwan though correctly entered in the sales book, was posted wrongly to his account as L.E.1,930.

(f) A purchase from Nor Alden of L.E.920 although correctly entered in purchase book, was wrongly debited to his personal account.

Instructions

(1) Pass the necessary rectifying journal entries.

(2) Prepare Suspense Account.

(3) State the effect of each of the rectification on the profit. What would be the correct profit if the profit originally arrived at was L.E.100,000?

[Answer Key: Suspense Account, opening balance L.E.2,380 (Cr). Correct profit L.E.100,000].

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5. Show the journal entries necessary to correct the following errors:

(a) A sale of goods of L.E.6,780 to Mr. Haron had been entered in Mr. Hamon’s account.

(b) The purchase of a machine on credit from Mr. Labeb for L.E.43,900 had been completely omitted from our books.

(c) The purchase of a motor van L.E.38,000 had been entered in error in the Motor Expenses account.

(d) A sale of L.E.2,210 to Mr. Fuzzy had been entered in the books, both debit and credit, as L.E.2,120.

(e) Commission received L.E.2,570 had been entered in error in the Sales account.

(f) A receipt of cash from Mr. Tewfik L.E.770 had been entered on the credit side of the cash book and the debit side of Mr. Tewfik's account.

(g) A purchase of goods L.E.1,890 had been entered in error on the debit side of the Drawing account.

(h) Discounts Allowed L.E.3,660 had been entered in error on the debit side of the Discounts Received account.

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6. Journal entries to rectify the following are required.

(a) Commission received L.E.8,800 have been credited to Rent Received Account.

(b) Bank charges L.E.770 have been debited to Rent account.

(c) Completely omitted from the books is a payment of Sundry Expenses by check L.E.230.

(d) A Purchase of fixtures of L.E.4,780 has been entered in Purchases account.

(e) Returns inwards L.E.8,330 have been entered on the debit side of the Returns outwards account.

(f) A loan from Sami L.E.50,000 has been entered on the credit side of the Capital account.

(g) Loan interest of L.E.5,000 has been debited to Premises account.

(h) Goods taken for own use L.E.2,500 have been debited to purchases account and credited to Drawings.

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7. Your book-keeper extracted a trial balance on 31st December 2021 which failed to agree by L.E.3,300, a shortage on the credit side of the trial balance. A suspense account was opened for the difference.

In January 2022 the following errors made in 2021 were found:

(1) Sales day book had been undercast by L.E.1,000.

(2) Sales of L.E.2,500 to Caribou had been debited in error to Carina's account.

(3) Rent account had been undercast by L.E.700.

(4) Discounts Received account had been undercast by L.E.3,000.

(5) The sale of motor vehicle at book value had been credited in error to Sales account L.E.3,600.

Instructions

You are required to:

(a) Show the journal entries necessary to correct the errors.

(b) Draw up the suspense account after the errors described have been corrected.

(c) If the net profit had previously been calculated at L.E.79,000 for the year ended 31st December 2021, show the calculations of the corrected net profit.

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8. Study the following and answer the questions below.

The trial balance of Mansur Harpy as at 31st December 2021 showed a difference which was posted to a suspense account. Draft final accounts for the year ended 31st December 2021 were prepared showing a net profit of L.E.472,400. The following errors were subsequently discovered:

- Sales of L.E.4,500 to Taha had been had been debited to Taher.
- A payment of L.E.2,750 for telephone charges had been entered on the debit side of the Telephone account as L.E.3,750.
- The sales journal had been undercast by L.E.20,000.
- Repairs to a machine, amounting to L.E.3,900 had been charged to Machinery account.
- A check for L.E.15,000, being rent received from Atlas Ltd., had only been entered in the cash book.
- Purchases from PB, amounting to L.E.7,650 had been received on 31st December 2021 and included in the closing stock at that date, but the invoice had not been entered in the purchase journal.

Questions

(a) (i) Give the journal entries necessary to correct the above errors.

(ii) Show the effect of each of these adjustments on the net profit in the draft accounts and the correct profit for the year ended 31st December 2021.

(b) (i) State briefly the purpose of the journal, giving a suitable example of its use.

(ii) State why it is necessary to distinguish between capital and revenue expenditure.

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CHAPTER TWO

Reconciliation of Bank Balances

CHAPTER TWO

Reconciliation of Bank Balances

2.1 Introduction:

A business may keep accounts with one or more banks. The advantages of keeping accounts with banks are as follows:

(a) **Avoidance of risks.** It is known that keeping large cash balances in the business's offices is a risky matter. In case money is deposited from time to time in the bank, such risks can be avoided.

(b) **Prevention of fraud and misappropriation.** Naturally, deposits of money into the bank and disbursements of money through the bank reduce the chances of misappropriation of funds and fraud being played by the employees of the firm. All receipts can immediately be deposited at the end of the day in the bank. Just the same, all payments may be made by means of checks. Thus, the quantum of cash to be handled by the employees of the business is considerably

reduced resulting into fewer chances of fraud and misappropriations.

(c) **Reduction in accounting work**. Depositing of money into the bank and making payments through a bank considerably reduces the firm's accounting work. As a matter of fact in case of large business houses or institutions, the bank open extension counters where all payments can be received and made. As a result, the accounting work at the business's level is relatively reduced since the business's cash accounting work is more or less done by the bank.

When the money is deposited by the firm into a bank, the firm debits the bank account since bank account is a personal account and according to accounting rule, the bank being the receiver has to be debited. Similarly, when money is withdrawn from the bank, the firms give credit to the bank account since bank is the giver. On the other hand, on receipt of money from the customer (*i.e.* the business), the bank gives credit to the customer because the customer's account is a personal account and he is the giver. Just the same, on money being withdrawn by the customer, the bank debits the account of the customer since he is the receiver.

The above rules of accounting as regards bank transactions can be summarised as follows:

(1) On deposit of money by the business into the bank account, the business debits the bank account while the bank credits the business's account.

(2) On withdrawal of money by the business from the bank, the business credits the bank's account while the bank debits the business's account.

Accordingly, the balance as shown by the business's books in the Bank Account should agree with the balance shown by the bank's books in the Account of the Business. Of course, if in the books of the business the Bank Account shows a debit balance, in the books of the bank, the Business's Account will show a credit balance and *vice-versa*.

However, the two balances rarely agree because of the reasons given later in this chapter.

2.2 Bank Statement

All transactions relating to the bank (*i.e.* deposits or withdrawals of the money in or from the bank) are recorded by the firm in the bank column maintained on each side of the cash book. The deposit of the money into the business bank account is recorded on the debit side of the cash book in the bank column, while the withdrawal of money from the bank is recorded on the credit side in the bank column of the cash book. The bank also maintains the Firm's Account in its books. A copy of this account, it (the bank) submits to the firm from time to time.

The account so submitted by the bank to the customer is known as the ***Bank Pass Book*** or ***Bank Statement.*** The Bank Statement is submitted by the bank to the customer for his information and verification.

Thus, at the end of each calendar month the bank supplies each customer with a **bank statement** (a copy of the bank's account with the customer) together with the customer's checks that the bank paid during the month. If neither the bank nor the customer made any errors, if all deposits made and all checks drawn by the customer reached the bank within the same month, and if no unusual transactions occurred that affected either the business's or the bank's record of cash, the balance of cash (bank) reported by the bank to the customer equals that shown in the customer's own records.

This condition seldom occurs for one or more of the reconciling items presented later. When we look at the closing balance in our cash book, and then compare it with the balance on that date on the bank statement, we will usually find that the two balances are different. A proforma of one page of **Bank Statement** is presented below:

<table>
<tr><td colspan="6" align="center">National Bank of Egypt
Current Bank Account
.... Branch</td></tr>
<tr><td colspan="6">Name of the depositor (s)..........Account No.......
Address ....</td></tr>
<tr><td>Date</td><td>Check No.</td><td>Particulars</td><td>Debit L.E.</td><td>Credit L.E.</td><td>Balance L.E.</td></tr>
<tr><td></td><td></td><td></td><td></td><td></td><td></td></tr>
</table>

2.3 Causes of Difference

An enterprise expects differences between its record of cash and the bank's records. The following are the most common causes of difference between the balance as shown by the Bank Statement and the balance as shown by the business's records.

(1) **Deposits in Transit:** This because end-of-month deposits of cash are recorded on the depositor's books in one month and are received and recorded by the bank in the following month.

(2) **Checks issued but not presented for payment (Outstanding Checks):** Usually, checks written by the depositor are recorded when written but may not be recorded by the bank until the next month. The business issues checks from time to time for making different payments. Once a check is issued the business debits the party's account in whose favour the check is issued and credits the bank's (cash) account. However, the Bank comes to know of issue of such checks only when they are presented for payment. The bank, therefore, debits the business's account only when the check is actually presented for payment. Thus, it may be possible that on a particular date when the Bank is submitting the business's statement of account, it may not include certain checks which have been issued by the firm because they may not have yet been presented. Hence, the balance shown by the Bank's books in the business's account will be higher than the balance shown by the Business's books in the Bank's account.

For example, a business issues a check in favour of a creditor on 28th December 2021 for a sum of L.E.100,000. The check is presented by the creditor on 3rd January 2022 for payment. In case, the Bank submits a statement of account to the business up to 31st December 2021, there will a difference of L.E.100,000 between the balance as shown by the business's books and the balance as shown by the Bank Statement.

(3) **Checks sent for collection but not yet collected.** A business receives from time to time checks from its customers and it sends them to the bank for collection and crediting the proceeds to its account. A business debits the account of the Bank as soon as it sends the checks to the Bank for collection. Nevertheless, the Bank gives credit to the firm only when the checks are actually collected. So, on a particular date, it may be possible that certain checks which were sent for collection by the business to the Bank may not have been collected by the Bank and, therefore, not credited to the firm's account.

The two balances, the balance as shown by the Bank Statement and the business's Cash Book will, therefore, be different. For instance, if a business sends a check of L.E.50,000 on 26th December 2021 to the Bank for collection which is collected by the Bank on 7th January 2022, in the bank statement which may be submitted by the Bank for the year ending 31st December 2021, there will be no credit to the customer for the check which it has not yet collected. Therefore, the balance shown by the business's records will be different from the balance as shown by the Bank Statement.

(4) **Bank charges:** Charges recorded by the bank against the depositor's balance for such items as bank services, printing checks, **not-sufficient-funds (NSF) checks**, and safe-deposit box rentals. The bank debits the customer's account as soon as it renders such a service. The depositor may not be aware of these charges until the receipt of the bank statement. Thus, on a specific date, the balance shown by the Bank Statement may be different from the balance shown by the firm's records.

(5) **Direct collections on behalf of customers (Bank Credits):** Collections or deposits by the bank for the benefit of the depositor that may be unknown to the depositor until receipt of the bank statement. Examples are note collection for the depositor and interest earned on interest-bearing checking accounts. The Bank gives credit to the customer for such collections as soon as it gets such payments. However, the customer comes to know of such collections only when he receives the bank statement from the Bank. Thus, the balance shown by the Bank Statement and the Firm's records may not be the same because of this reason.

(6) **Bank or Depositor errors:** Errors on either the part of the bank or the part of depositor cause the bank balance to disagree with the depositor's book balance. A wrong credit or debit may be given by the customer or the Bank. The two balances, thus, may not agree.

2.4 A Bank Reconciliation Statement

A **bank reconciliation** is a schedule explaining any differences between the Bank's and the business's records of cash. In other words, it is a statement reconciling the balance as shown by the Bank Statement and the balance as shown by the Cash Book. Thus, the objective of preparing such a statement is to know the causes of difference between the two balances and pass necessary correcting or adjusting entries in the books of the firm.

If the difference results only from transactions not yet recorded by the Bank, the Firm's record of cash is considered correct. But, if some part of the difference arises from other items, either the Bank or the Firm must adjust its records. It should be noted that every reason of difference does not require an adjusting or correcting entry. Some reasons for difference are automatically adjusted.

For example, if a check has been sent for collection, but it has not yet been collected, this is a cause of difference between the balance as shown by the Bank Statement and the balance as shown by the Business's records of cash, but no adjusting entry is required in the Business's records for such a difference even after it has been discovered. This is because the Bank will credit the Business's account as soon as the check is collected. This is only a question of time.

However, if the check sent for collection to the Bank has been returned because of its being dishonoured, the Firm should pass an adjusting entry for return of such check if it has not already been passed. Just the same, the firm has also to pass in its books, the entries for bank charges or direct payments received by the Bank on behalf of the firm.

2.4.1 Technique of preparing a Bank Reconciliation Statement

The bank reconciliation statement is prepared usually at the end of a period, say a quarter, a half year or year, as may be found convenient and necessary by the business, taking into account the number of transactions involved. The following steps may be taken for preparing the Bank Reconciliation Statement:

(a) The Cash Book (Bank Account, as the case may be) should be completed and the balance as per the Bank column on a particular date should be found out covering the period for which the Bank Reconciliation Statement has to be prepared.

(b) The Bank should be requested to complete and send to the Bank Statement up to the date mentioned in ***(a)***.

(c) The balance as shown by any (*i.e.,* the Cash Book or the Bank Statement) should be taken as the base.

(d) The effect of the particular cause of difference should be studied on the balance shown by the other book.

(e) In case, the cause has resulted in an increase in the balance shown by the other book, the amount of such increase should be added to the balance as per the former book which has been taken as the base.

(f) In case, the cause has resulted in a decrease in the balance shown by the other book, the amount of such decrease should be subtracted from the balance as per the former book which has been taken as the base.

In case, the books show an adverse balance (***i.e.*** an overdraft) the amount of overdraft should be put in the minus column. The reconciliation statement should then be prepared on the same pattern as if there is a favorable balance instead of their being an overdraft.

An enterprise may prepare two forms of bank **reconciliation**. One form reconciles from the *bank statement balance* to the *book balance* or vice versa. The other form reconciles both the **bank balance** and the **book balance** to correct cash balance. Most businesses use this latter form. The following illustration shows a sample of that form and its common reconciling items.

Bank Reconciliation Statement:

* Balance per bank statement…………………		xxx
Add: Deposit in transit………………………..	xx	
Undeposited receipts (cash on hand)……	xx	
Bank errors that understate the bank statement balance………………………	<u>xx</u>	<u>xx</u>
		xxx
Deduct: Outstanding checks…………………	xx	
Bank errors that overstate the bank statement balance……………………	<u>xx</u>	<u>xx</u>
Correct cash balance…………………………		***xxx***
		===
* Balance per depositor's books……………		xxx
Add: Bank credits and collections not yet recorded in the books…………………	xx	
Book errors that understate the book balance…………………………………	<u>xx</u>	<u>xx</u>
		xxx
Deduct: Bank charges not yet recorded in the books………………………………	xx	
Book errors that overstate the book balance……………………………	<u>xx</u>	<u>xx</u>
Correct cash balance………………………		***xxx***
		===

This form of reconciliation consists of two sections:

(1) Balance per bank statement and

(2) Balance per depositor's books.

Both sections end with the same "**Correct cash balance**". The correct cash balance is the amount to which the books must be adjusted and is the amount reported on the balance sheet. ***Enterprises prepare***

adjusting journal entries for all the addition and deduction items appearing in the "Balance per depositor's books" section. Enterprises should immediately call to the bank's attention any errors attributable to it.

2.4.2 Illustrative Example

New-Egypt Mining Company's books show a cash balance at the National Bank on Nov- ember 30, 2021, of L.E.205,020. The bank statement covering the month of November shows an ending balance of L.E.221,900. An examination of New-Egypt's accounting records and November bank statement identified the following reconciling items.

1 A deposit of L.E.36,800 that New-Egypt mailed November 30 does not appear on the bank statement.

2 Checks written in November but not charged to the November bank statement are:

Check No. 7327	L.E.	1,500
No. 7348		48,200
No. 7349		310

3 New-Egypt has not yet recorded the L.E.6,000 of interest collected by the bank November 20 on Siena Company bonds held by the bank for New-Egypt.

4 Bank service charges of L.E.180 are not yet recorded on New-Egypt's books.

5 The bank returned one of New-Egypt's customer's checks for L.E.2,200 with the bank statement, marked 'NSF.' The bank treated this bad check as a disbursement.

6 New-Egypt discovered that it incorrectly recorded check No. 7322, written in November for L.E.1,310 in payment of an account payable, as L.E.3,110.

7 A check for New-Land Oil Company in the amount of L.E.1,750 that the bank incorrectly charged to New-Egypt accompanied the statement.

New-Egypt reconciled the bank and book balances to the correct cash balance as shown in the following solution.

Solution

NEW-EGYPT MINING COMPANY
BANK RECONCILIATION
NATIONAL BANK, NOVEMBER 30,2021

		L.E.	L.E.
*Balance per bank statement (end of period)................................			221,900
Add: Deposit in transit............	(1)	36,800	
Bank error-incorrect check charged to account by bank.	(7)	1,750	38,550
			260,450
Deduct: Outstanding checks.....	(2)		50,010
Correct cash balance...............			***210,440***
			=====
*Balance per books..................			205,020
Add: Interest collected by the bank................................	(3)	6,000	
Error in recording check No. 7322................................	(6)	1,800	7,800
			212,820
Deduct: Bank service charges...	(4)	180	
NSF check returned.....	(5)	2,200	2,380
Correct cash balance................			***210,440***
			=====

Adjusting journal entries

The journal entries required to adjust and correct New-Egypt's books in early December 2021 are taken from the items in the "Balance per books" section and are as follows:

Cash (Bank)..................................	6,000	
Interest Revenue......................		6,000
(To record interest on Siena Co. bonds, collected by bank)		
....		
Cash (Bank)………………………	1,800	
Accounts payable…………..		1,800
(To correct error in recording amount of check No. 7322)		
……………………………………		
Office Expense-Bank Charges…..	180	
Cash (Bank)………………….		180
(To record bank service charges for November)		
…………………………………….		
Accounts Receivable………………	2,200	
Cash (Bank)……………………		2,200
(To record customer's check returned NSF)		

After posting the above entries, New-Egypt's cash (bank) account will have a balance of L.E.210,440. New-Egypt should return the New-Land

Oil Company check to National Bank, informing the bank of the error. Finally, the Cash (Bank) Account will be shown as below.

Dr Cash (Bank) Account Cr

Nov 30	L.E.	Nov 30	L.E.
Balance....	205,020	Office Expense	180
Interest Revenue	6,000	Accounts Receivable	2,200
Accounts Payable	1,800	Balance c/d	210,440
	212,820		212,820
	======		======

2.5 Questions

1- Anglo Arab Company deposits all receipts and makes all payments by check. The following information is available from the cash records.

June 30, 2021 Bank reconciliation

Balance per bank	L.E.70,000
Add: Deposits in transit	15,400
Deduct: Outstanding checks	(20,000)
Balance per books	L.E.65,400
	========

Month of July Results

	Per Bank	Per Books
	L.E.	L.E.
Balance July 31	86,500	92,500
July deposits	50,000	58,100
July check	40,000	31,000
July note collected (not included in July deposits)	10,000	-------
July bank service charge	150	....
July NSF check from a customer, returned by the bank	3,350	-------

Instructions

(a) Prepare a bank reconciliation going from balance per bank and balance per book to correct cash balance.

(b) Prepare the general journal entry or entries to correct the Cash (Bank) account.

2- Lokman Company has just received the August 31, 2021, bank statement, which is summarised below.

National Bank of Egypt	Disbursements L.E.	Receipts L.E.	Balance L.E.
Balance, August 1......			93,690
Deposits during August.		322,000	415,690
Note collected for depositor, including L.E.400 interest		10,400	426,090
Checks cleared during August……….	345,000		81,090
Bank service charges…	200		80,890
Balance, August 31….			80,890

The general ledger Cash (Bank) account contained the following entries for the month of August.

Cash (Bank) account

Balance, Aug. 1	100,500	Disbursements in Aug.	349,030
Receipt during Aug.	350,000		

Deposits in transit at August 31 are L.E.38,000, and checks outstanding at August 31 total L.E.10,500. Cash on hand at August 31 is L.E.3,100. The bookkeeper improperly entered one check in the books at L.E.1,460.50 which was written for

L.E.1,640.50 for supplies (expense); it cleared the bank during the month of August.

Instructions

(a) Prepare a bank reconciliation dated August 31, 2021, proceeding to a correct balance.

(b) Prepare any entries necessary to make the books correct and complete.

(c) What amount of cash should be reported in the August 31 balance sheet?

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3- The cash account of Judah Co. showed a ledger balance of L.E.396,985 on June 30, 2021. The bank statement as of that date showed a balance of L.E.415,000. Upon comparing the statement with the cash records, the following facts were determined.

(1) There were bank service charges for June of L.E.2,500.

(2) A bank memo stated that Bader Dhabi's note for L.E.90,000 and interest of L.E.3,600 had been collected on June 29, and the bank had made a charge of L.E.550 on the collection. (No entry had

been made on Judah's books when Bader Dhabi's note was sent to the bank for collection.)

(3) Receipts for June 30 for L.E.289,000 were not deposited until July 2.

(4) Checks outstanding on June 30 totalled L.E.213,605.

(5) The bank had charged the Judah Co.'s account for a customer's uncollectible check amounting to L.E.45,320 on June 29.

(6) A customer's check for L.E.9,000 had been entered as L.E.6,000 in the cash receipts journal by Judah Co. on June 15.

(7) Check no. 74200 in the amount of L.E.49,100 had been entered in the cash journal as L.E.41,900, and check no. 74700 in the amount of L.E.5,820 had been entered as L.E.58,200. Both checks had been issued to pay for purchases of equipment.

Instructions

a. Prepare a bank reconciliation statement dated June 30, 2021, proceeding to a correct cash balance.

b. Prepare any entries necessary to make the books correct and complete.

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4- The following information relating to the bank checking account is available for Mustafa Sports Hall at December 31, 2021:

	L.E.
- Balance per bank statement at December 31..........................	**1,989,325**
- Balance per depositor's records..	**1,868,135**
- Outstanding checks......................	**210,250**
- Deposit in transit..........................	**87,260**
- Service charge by bank...............	**1,800**

Prepare bank reconciliation for Mustafa Sports Hall at December 31.

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5- The following information relating to the bank checking account is available for Walled Belal Taxi Co. at December 31, 2021.

	L.E.
- Balance per bank statement at December 31..........................	**974,015**
- Balance per depositor's records..	**746,065**
- Outstanding checks......................	**335,270**
- Deposit in transit..........................	**110,630**
- Service charge by bank...............	**1,000**
- Interest credited by the bank.....	**4,310**

Prepare bank reconciliation at December 31.

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6- Equipment Rental Company had poor internal control over its cash transactions. Facts about the company's cash position at November 30, 2021, were as described below.

The accounting records showed a cash balance of L.E.2,995,900, which included a deposit in transit of L.E.342,060. The balance indicated in the bank statement was L.E.1,829,940. Included in the bank statement were the following debit and credit memoranda:

Debit Memoranda:

***Check from customer Dabo, deposited by Equipment Rental Co., but charged back as NSF of L.E.150,000.**

***Bank service charges for November of L.E.2,500.**

Credit Memoranda:

***Proceeds from collection of a note receivable from Rajab Farm which Equipment Rental Co. had left with the bank's collection department amounted to L.E.300,000.**

Outstanding checks as of November 30 were as follows:

Check No.	**Amount L.E.**
823100.........................	**34,030**
826300.........................	**80,050**
828800.........................	**14,520**
829400.........................	**210,000**

Milano Charm, the company's cashier, has been abstracting (stealing) portions of the company's cash receipts for several months. Each month, Charm prepared the company's bank reconciliation in a manner that concealed her thefts. Her bank reconciliation for November is illustrated below (amounts in L.E.):

Balance per bank statement, Nov. 30............		**1,829,940**
Add: Deposits in transit...	**432,060**	
Collection of note from Rajab Farms...............	**300,000**	**732,060**
Subtotal...		**2,662,000**
Less: Outstanding checks:		
No. 8231.......................	**34,030**	
8263......................	**80,050**	
8288......................	**14,520**	**118,600**
Adjusted cash balance per Bank statement...............................		**2,543,400**
		========
Balance per accounting records, Nov. 30................................		**2,995,900**
Add: Credit memoranda from bank..		**300,000**
Subtotal...		**2,695,900**
Less: Debit memoranda from bank:		
NSF check of Dabo....	**150,000**	
Bank service charges...	**2,500**	**152,500**
Adjusted cash balance per accounting records..........................		**2,543,400**
		========

Instructions

a. Determine the amount of the cash shortage which has been concealed by Charm in her bank reconciliation. (As a format, it is suggested that you prepare the bank reconciliation correctly. The amount of the shortage then will be the difference between the adjusted balances per bank statement and per the accounting records. You can then list this unrecorded cash shortage as the final adjustment necessary to complete your reconciliation.)

b. Carefully review Charm's bank reconciliation and explain in detail how she concealed the amount of the shortage. Include a listing of the pound amounts that were concealed in various ways. This listing should total the amount of the shortage determined in part **a.**

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CHAPTER THREE

AN INCOME STATEMENT: A CLOSER LOOK

CHAPTER THREE

AN INCOME STATEMENT: A CLOSER LOOK

3.1 Introduction:

An **Income Statement** measures the income of a business during a particular period of time. Accordingly, the **Income** Statement is the report that measures the success of company operations for a given period of time. It is also often called the statement of income or statement of earnings.

The business and investment community uses the income statement to determine some indicators, such as profitability, investment value, and creditworthiness. Therefore, it provides investors and creditors with information that helps them predict the *amount, timing, and uncertainty of future cash flows.*

3.2 Usefulness and Limitations of the Income statement

The income statement assists users of financial statements predict future cash flows in a number of fields. For instance, investors and creditors use the income statement information to:

1. **Evaluate the past performance of the company.** Examining company's revenues and expenses shows how the company performed and allows comparison of its performance to its competitors.

2. **Provide a basis for predicting future performance.** It is perceived that information about past performance helps to determine important trends that, if continued, provide information about future performance. Clearly, it does not necessarily that past success will translate into future success. Notwithstanding, financial analysts can better predict future revenues, and hence earnings and cash flows.

3. **Help assess the risk or uncertainty of achieving future cash flows.** Information on the various components of income (revenues, expenses, gains, and losses) highlights the relationships among them. Additionally, it helps to assess the risk of not achieving a particular level of cash flows in the future. Results from continuing operations usually have greater significance for predicting future performance than do results from nonrecurring activities and events.

On the other hand, because net income is an estimate and reflects a number of assumptions, users of income statement need to be aware of certain limitations associated with its information. These limitations may include:

(1) **Companies omit items from the income statement that they cannot measure reliably.** Current practice of accounting prohibits recognition of certain items from the determination of income although the effects of these items can arguably affect the company's performance. For instance, a company may not record unrealized gains and losses on certain investment securities in income when there is uncertainty that it will ever realise the changes in value. Additionally, number of companies experience increases in value due to brand recognition, customer service, and product quality. A common framework for identifying and reporting these types of values is still lacking.

(2) **Income numbers are affected by the accounting methods employed.** One company or business may depreciate its plant assets on an accelerated basis; another chooses straight line depreciation. Supposing all other factors are equal, the first company or business will report lower income. In fact, you are comparing pears with mangos.

(3) **Income measurement involves judgment.** For instance, one company in good faith may estimate the useful life of an asset to be 20 years while another company uses a 10-years estimate for the same type of asset. Just the same, some organisations may make optimistic estimates of future warranty returns and bad debt write-off, which results in lower expense and higher income.

To sum up, several limitations of the income statement may reduce the usefulness of its information for predicting the amounts, timing, and uncertainty of future cash flows.

3.3 Format of the Income Statement

3.3.1 Elements of the Income Statement

While studying basics of business accounting, you known that net income results from revenue, expense, gain, and loss transactions. Thus, the income statement summarizes these transactions. This method of income measurement, called the ***Transaction Approach,*** focuses on the income-related activities that occurred during the accounting period.

On the other hand, the most common alternative to the transaction approach is the ***Capital Maintenance Approach*** to income measurement. Under this approach, a company determines income for the accounting period based upon the change in equity, after adjusting for capital contributions (such as, investments by owners) or distributions (such as, dividends). The main drawback associated with the capital maintenance approach is that the components of income are not evident in their measurement.

Under the ***Transaction Approach***, the income statement can additionally classify income by customer, product line, or function or by operating and nonoperating, continuing and discontinued, and regular and irregular categories. To clarify, the term ***irregular*** includes transactions and other events that are derived from developments outside the normal operations of the business.

The major elements of the income statement are:

a.* Revenues.** In a merchandising enterprise, the revenue element of the income statement usually contains only one line, entitled ***net sales. Revenues represent inflows or other enhancements of assets of an entity or settlements of its liabilities during a period from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations. Revenues may take many forms, such as sales, fees, interest, dividends, and rents.

***b.* Expenses.** Normally, expenses represent outflows or other using-up of assets or incurrence of liabilities during an accounting period from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations. Expenses also may take many forms, such as cost of goods sold, depreciation, interest, rent, salaries and wages, and taxes.

***c.* Gains.** Gains represent increases in equity (net assets) from peripheral (secondary) or incidental transactions of an entity except those that result from revenues or investments by owners.

***d.* Losses.** Losses represent decreases in equity (net assets) peripheral (secondary) or incidental transactions of an entity except those that result from expenses or distributions to owners.

Gains and **Losses** also are of many types, resulting from the sale of investments or plant assets, settlement of liabilities, write-offs of assets due to impairments or casualty.

On the other hand, the distinction between revenues and gains, and between expenses and losses, depend, to a great extent, upon the typical activities of the company.

Reporting of elements of income statement is of all importance to a variety of information users. Most decision makers find the ***parts*** of a financial statement to be more useful than the ***whole***. For example, investors and creditors are interested in predicting the amounts, timing, and uncertainty of future income and cash flows. Having income statement elements shown in some detail and in comparison with prior year's data allows decision makers to better assess future income and cash flows.

3.3.2 Classifications in the Income Statement

An income statement may be prepared in either the ***multiple-stem*** or the ***single-step*** format.

Single-Step Income Statement

When reporting revenues, gains, expenses, and losses, companies often use a format known as the ***Single-Step Income Statement.*** The single-step statement consists of just *two groupings:* **revenues** and **expenses**. Expenses are deducted from revenues to arrive at net income or loss, accordingly the expression *'single-step.'* Frequently companies report income tax separately as the last item before net income to indicate its relationship to income before income tax. Illustration 3.1 shows the single-step income statement of Dandarawy Company

Illustration 3.1

DANDARAWY COMPANY INCOME STATEMENT FOR THE YEAR ENDED DECEMBER 31ST, 2021	
Revenues	**L.E.**
Net sales	2,972,413
Dividend revenue	98,500
Rental revenue	72,910
Total revenues	3,143,823
Expenses	
Cost of goods sold	1,982,541
Selling expenses	453,028
Administrative expenses	350,771
Interest expense	126,060
Income tax expense	66,934
Total expenses	2,979,334
Net income	164,489
Earnings per common share	1.74 ====

Typically, companies that use the single-step income statement in financial reporting do so because of its simplicity. Nevertheless, the multiple-step form has gained popularity in recent years.

Multiple-Step Income Statement

The multiple-step income statement is more useful in illustrating accounting concepts. Some contend that including other important revenue and expense classifications makes the income statement more useful. These further classifications include:

1. A separation of operating and nonoperating activities of the company. For instance, companies often present "**income from operations**" followed by sections entitled "**Other revenues and gains**" and "**Other expenses and losses**." These other categories include such transactions as interest revenue and expense, gains or losses from sales of long-term assets, and dividends received.

2. A classification of expenses by functions, such as merchandising (cost of goods sold), selling, and administration. This method permits immediate comparison with costs of previous years and with other departments in the same year.

Enterprises use a ***multiple-step income statement*** to recognise these additional relationships. This form of statements separates operating transactions from nonoperating transactions, and matches costs and expenses with related revenues. This statement highlights certain intermediate components of income that analysts use to compute ratios for assessing the performance of the company.

Multiple-step Income Statement Sections

When a company uses a multiple-step income statement, it may prepare some or all of the following sections or subsections which include the intermediate components of the income statement.

1. OPERATING SECTION. A report of the revenues and expenses of the company's principal operations.

(a) Sales or Revenue section. This is a subsection which presents sales, discounts, allowances, returns, and other related information.

Its purpose is to arrive at the net amount of sales revenue.

(b) Cost of Goods Sold Section. A subsection that shows the cost of goods that were sold to produce the sales.

(c) Selling Expenses. A subsection that lists expenses resulting from the company's efforts to make sales.

(d) Administrative or General Expenses. A subsection reporting expenses of general administration.

2. NONOPERATING SECTION. A report of revenues and expenses resulting from secondary or auxiliary (additional) activities of the company. In addition, special gains and losses that are infrequent or unusual, but not both, are normally reported in this section. Generally these items break down into two main subsections:

(a) Other Revenues and Gains. A list of the revenues earned or gains incurred, generally net of related expenses, from nonoperating transactions.

(b) Other Expenses and Losses. A list of the expenses or losses incurred, generally net of any related incomes, from nonoperating transactions.

3. INCOME TAX. A short section reporting taxes levied on income from continuing operations.

4. DISCONTINUED OPERATIONS. Material gains or losses resulting from the disposition of a segment of the business.

5. EXTRAORDINARY ITEMS. Unusual and infrequent material gains and losses.

6. EARNINGS PER SHARE.

But, although the content of the operating section is always the same, the organization of the material can differ. The breakdown above adopts a ***natural expense classification.*** Manufacturing concerns and merchandising companies in the wholesale trade commonly use this classification. Another classification of operating expenses, recommended for retail stores, uses a **functional expense classification** of administrative, occupancy, publicity, buying, and selling expenses.

Commonly, financial statements provided to external users have less detail than internal management reports. Irregular transactions such as discontinued operations and extraordinary items are reported separately, following income from continuing operations.

Dandarawy Company's statement of income illustrates the multiple-step income statement. This statement is shown in Illustration 3.2, which includes items 1, 2, 3, and 6.

Illustration 3.2

DANDARAWY COMPANY INCOME STATEMENT FOR THE YEAR ENDED DECEMBER 31ST, 2021			
Sales Revenue	L.E.	L.E.	L.E.
Sales			3,053,081
Less: Sales discounts		24,241	
Sales returns and allowance		56,427	80,668
Net sales revenue			2,972,413
Cost of Goods Sold			
Merchandise inventory, Jan. 1,2021		461,219	
Purchases	1,989,693		
Less: Purchase discounts	19,270		
Net purchases	1,970,423		
Transportation-in	40,612	2,011,035	
Total merchandise available for sale		2,472,254	
Less: merchandise inventory, Dec. 31, 2021		489,713	
Cost of goods sold			1,982,541
Gross profit on sales			989,872
Operating Expenses			
Selling expenses			
Sales salaries and commissions	202,644		
Sales office salaries	59,200		
Travel & entertainment	48,940		
Advertising expense	38,315		
Freight & transport-out	41,209		
Shipping supplies	24,712		
Postage and stationery	16,788		
Depreciation of sales equipment	9,005		
Telephone & Internet Ex	12,215	453,028	
Administrative expenses			

Officers' salaries	**186,000**		
Office salaries	**61,200**		
Legal and professional services	**23,721**		
Utilities expense	**23,275**		
Insurance expense	**17,029**		
Depreciation of building	**18,059**		
Depreciation of office equipment	**16,000**		
Stationery and postage	**2,875**		
Miscellaneous office Ex.	**2,612**	**350,771**	**803,799**
Income from operations			**186,073**
Other Revenues & Gains			
Dividend revenue		**98,500**	
Rental revenue		**72,910**	**171,410**
			357,483
Other expenses & Losses			
Interest on bonds and notes			**126,060**
Income before income tax			**231,423**
Income tax			**66,934**
Net income for the year			**164,489**
Earnings per common share			**1.74**

3.4 Reporting Irregular Items:

The accounting profession has adopted a **modified all-inclusive concept** and requires application of this approach in practice. This approach indicates that companies record most items, including irregular ones, as part of net income. Additionally, companies are required to highlight irregular items in the financial statements so that users can better determine the long-run earning power of the company.

Irregular items fall into six general categories, which will be briefly highlighted in the following subsections.

3.4.1 Discontinued Operations

Practically, one of *the most common types of irregular items is discontinued operations.* **A discontinued operation** exists when two things occurs, namely: (1) a company eliminates the results of operations and cash flows of a **component** from its ongoing operations, and (2) there is no significant continuing involvement in that component after the disposal transaction.

In order to illustrate a component, assume that Elmasryeen Company manufactures and sells consumer products. It has several product groups, each with different product lines and brands. For Elmasryeen, a product group is the lowest level at which it can sharply distinguish the operations and cash flows from the rest of the company's operations. Accordingly each product group is a component of the company. Therefore, if a component were disposed of, Elmasryeen Company would classify it as a discontinued operation.

Companies report as discontinued operations (in a separate income statement category) the gain or loss from ***disposal of a component of a business.*** Furthermore, companies report the **results of operations of a component that has been or will be disposed of** separately from continuing operations. Companies show the effects of discontinued operations ***net of tax*** as a separate category, ***after*** continuing operations ***but before*** extraordinary items.

As an illustration, assume that National Products, Inc., a highly diversified company, decides to discontinue its electronics division. During the current year, the electronics division lost L.E.600,000 (net of tax). National Co. sold the division at the end of the year at a loss of L.E.1,000,000 (net of tax). National Co. shows the information on the current year's income statement as follows:

Illustration 3.3

Income from continuing operation...L.E.		**40,000,000**
Discontinued operations		
Loss from operation of discontinued Electronics division (net of tax)...	**600,000**	
Loss from disposal of electronics division (net of tax)....................	**1,000,000**	**1,600,000**
Net income..		***38,400,000***
		=========

Note: Companies use the expression ***"Income from continuing operations"*** only when gains or losses on discontinued operations happens.

3.4.2 Extraordinary Items

Extraordinary items are material items that differ significantly from a company's typical business activities. The criteria for extraordinary items are as follows.

*Extraordinary items are events and transactions that are distinguished by their unusual nature **and** by the infrequency of their occurrence. Classifying an event or transaction as an extraordinary item requires meeting the following criteria:*

(a) Unusual Nature. The underlying event or transaction should possess a high degree of abnormality and be of a type clearly unrelated to, only incidentally related to, the ordinary and typical activities of the company, taking into account the environment in which it operates.

(b) Infrequency of Occurrence. The underlying event or transaction should be of a type that the company does not reasonably expect to recur in the foreseeable future, taking into account the environment in which the company operates.

You should take in your consideration that the following gains and losses are **not extraordinary items.**

(1) Write-down or write-off of receivables, inventories, and equipment leased to others, deferred research and development costs, or other intangible assets.

(2) Gains or losses from exchange or translation of foreign currencies, including those relating to major devaluations and revaluations.

(3) Gains or losses on disposal of a component of an entity (reported as a discontinued operation).

(4) Other gains or losses from sale or abandonment of property, plant, or equipment used in the business.

(5) Effects of a strike, including those against competitors and major suppliers.

(6) Adjustment of accruals on long-term contracts.

The preceding items are not considered extraordinary ***because they are usual in nature and may be expected to recur as a consequence of customary and continuing business activities.***

Only rarely does an event or transaction clearly meet the criteria for extraordinary item.

Companies must present extraordinary items net of taxes in a separate section in the income statement, usually just before net income, as shown in the following illustration.

Illustration 3.4

Income before extraordinary item L.E.	**23,276,000**
Extraordinary item-flood loss	**2,432,000**
Net income..	***20,844,000***
	=========

3.4.3 Unusual Gains and Losses

As a result of the restrictive criteria for extraordinary items, financial statement users must carefully examine the financial statements for items that are **unusual or infrequent but not both.** Remember that companies cannot consider items such as write-down of inventories and transaction gains and losses from fluctuation of foreign exchange as extraordinary items. Thus, companies sometimes show these items with their normal recurring revenues and expenses. If not material in amount, companies combine these with other items in the income statement. If material, companies must disclose them separately, and report them ***above*** "***Income (loss) before extraordinary items***."

Illustration 3.5 below shows how a company presents an unusual charge in its income statement.

Illustration 3.5

Amounts in millions		**L.E.**
Net sales		**41,834**
Costs and expenses, net		
Cost of sales		**17,050**
Selling, general, and administrative expense		**18,482**
Amortisation of intangible assets		**398**
Unusual items (Note 2)		***580***
Operating income		**5,324**
Note 2 (Restructuring Charge)		
Dispose and write down assets	**L.E.366**	
Improve productivity	**188**	
Strengthen the brand structure	**26**	
Net loss	**580**	
	======	

Restructuring charges have been common in recent years. A ***restructuring charge*** relates to a major reorganization of company affairs, such as costs associated with employee layoffs, plant closing costs, write-offs of assets, and so on. A company should not report a restructuring charge as an extraordinary item, because these write-offs are part of a company's ordinary and typical activities.

Companies tend to ***report unusual items in a separate section just above "Income from operations before income taxes" and "Extraordinary items"*** especially when there are multiple unusual items. For instance, when WXYZ Company experienced multiple unusual items in one year, it reported them in a separate "Unusual items" section of the income statement **below** "Income before unusual items and income taxes." **For homework and examination tests purposes,** you should report unusual gains and losses in the *"Other revenues and gains" or "Other expenses and losses"* section, when preparing a multiple-step income statement.

In summary, companies classify **discontinued operations of a component** of a business as a separate item in the income statement, after "Income from continuing operations." Companies show the **unusual, material, nonrecurring items** that significantly differ from the typical or customary business activities in a separate "Extraordinary items" section **below** "Discontinued operations." They separately disclose other items of a material amount that are of an **unusual or nonrecurring** nature and are **not considered extraordinary.**

3.4.4 Intraperiod Tax Allocation

Companies report irregular items (except for unusual gains and losses) on the income statement or statement of retained earnings net of tax. This treatment is called ***Intraperiod Tax Allocation***, that is, allocation within a period. It relates the income tax expense of the fiscal period to the **specific items** that give rise to the amount of the tax provision.

Companies use intraperiod tax allocation on the income statement for the following items:

(a) Income from continuing operations,

(b) Discontinued operations, and

(c) Extraordinary items.

This procedure follows the idea that the general concept is ***'let the tax follow the income.'***

To compute the income tax expense attributable to **'Income from continuing operations**,' a company would find the income tax expense related to both the revenue and expense transactions used in determining this income. (In this computation, the company does not consider the tax consequences of items excluded from the determination of ***"Income from continuing operations."***) Companies then associate a separate tax effect with each irregular item-discontinued operations and extraordinary items. This will be more clear with the help of the following illustrations.

Illustration 3.6 (Extraordinary Gains)

Assume that Shawky Company has income before income tax and extraordinary item of L.E.500,000. It has an extraordinary gain of L.E.200,000 from a condemnation settlement received on one of its properties. Assuming a 30 percent income tax rate, Shawky Co. presents the following information on the income statement:

	L.E.	L.E.
Income before income tax and extraordinary item..........................		**500,000**
Income tax.....................................		**150,000**
Income before extraordinary item….		**350,000**
Extraordinary gain-condemnation settlement...	**200,000**	
Less: Applicable income tax............	**60,000**	**140,000**
Net income......................................		**490,000**

Shawky Co. determines the income tax of L.E.150,000 (L.E.500,000 × 30%) attributable to "Income before income tax and extraordinary item" from revenue and expense transactions related to this income. Shawky Co. omits the tax consequences of items excluded from the determination of "Income before income tax and extraordinary item." The company shows a separate tax effect of L.E.60,000 as "Extraordinary gain, condemnation settlement."

Illustration 3.7 (Extraordinary Losses)

Suppose that Shawky Company has income before income tax and extraordinary item of L.E.500,000. It suffers an extraordinary loss of L.E.200,000 from a major casualty. Assuming a 30% income tax rate, Shawky Co. presents the income tax on the income statement as shown below. In this case, the loss provides a positive tax benefit of L.E.60,000. Shawki Co., hence, subtracts it from the L.E.200,000 loss.

	L.E.	L.E.
Income before income tax and extraordinary item.........................		**500,000**
Income tax.....................................		**150,000**
Income before extraordinary item….		**350,000**
Extraordinary item - loss from casualty..	**200,000**	
Less: Applicable income tax...........	**60,000**	**140,000**
Net income.....................................		**210,000**

Companies may also report the tax effect of an extraordinary item by means of a note disclosure as illustrated below.

Illustration 3.8 (Extraordinary Losses)

	L.E.
Income before income tax and extraordinary item................................	**500,000**
Income tax..	**150,000**
Income before extraordinary item.......	**350,000**
Extraordinary item, less applicable income tax reduction (Note 1)..................	**140,000**
Net income...	**210,000**
***Note 1*: During the year the Company suffered a major casualty loss of L.E.140,000, net of applicable income tax reduction of L.E.60,000.**	

3.4.5 Earnings per Share

Conventionally, an enterprise sums up the results of its operations in one important figure, namely net income. Nevertheless, the financial world has widely accepted an even more concentrated and compact figure as the most significant business indicator, called ***Earnings per Share (EPS).***

The computation of earnings per share is usually straightforward. ***Earnings per share is net income minus preferred dividends (income available to common stockholders), divided by the weighted average of common shares outstanding.*** While calculating earnings per share, companies deduct preferred dividends from net income if the dividends are declared or if they are cumulative though not declared.

Illustration 3.9

Assume that Al-Salam Company reports net income of L.E.700,000. It declares and pays preferred dividends of L.E.100,000 for the year. The weighted average number of common shares outstanding during the year is 200,000 shares. Al-Salam Co.

computes earnings per share of L.E.3, as presented below:

$$\frac{Net\ Income - Preferred\ Dividends}{Weighted\ Average\ of\ Common\ Shares\ Outstanding} = Earnings\ per\ Share$$

$$\frac{L.E.700{,}000 - L.E.100{,}000}{200{,}000} = L.E.3$$

Note that ***EPS*** measures the number of pounds earned by each share of common stock. It does represent the pound amount paid to stockholders in the form of dividends.

Commonly, prospectuses, proxy material, and annual reports to stockholders use the **"Net income per share"** or **"Earnings per share"** ratio. Because of its importance, ***companies must disclose earnings per share on the face of the income statement.*** A company that reports a discontinued operation or an extraordinary item must report per share amounts for these line items either on the face of the income statement or in the notes to the financial statements.

3.4.6 Retained Earnings Statement

Logically, net income increases retained earnings. On the contrary, a net loss decreases retained earnings. Both cash and stock dividends decrease retained earnings. Generally, changes in accounting principles and prior period adjustments may increase or decrease retained earnings. Companies charge or credit these adjustments (net of tax) to the opening balance of retained earnings. This excludes the adjustments from the determination of net income for the current period.

Companies may show retained earnings information in different ways. For example, some companies prepare a separate retained earnings statement as shown in the following illustration.

Illustration 3.10

BO AL-KHAIR COMPANY RETAINED EARNINGS STATEMENT FOR THE YEAR ENDED DECEMBER 31,2021		
	L.E.	L.E.
Retained earnings, January 1, as reported…………………		2,100,000
Correction for understatement of net income in prior period (inventory error)……………………………		100,000
Retained earnings, January 1, as adjusted………………………		2,200,000
Add: Net income………………		720,000
		2,920,000
Less: Cash dividends……..……..	200,000	
Stock dividends……………	400,000	600,000
Retained earnings, December, 31		2,320,000

The reconciliation of the beginning to the ending balance in retained earnings provides information about why net assets increased or decreased during the year. The association of dividend distributions with net income for the period indicates what management is doing with earnings.

3.4.7 Comprehensive Income

Generally, companies include all revenues, expenses, and gains and losses recognized during the accounting period. In recent years, there is increased use of fair values for measuring assets and liabilities. Additionally, possible reporting of gains and losses related to changes in fair value have placed stress on income reporting.

Because fair values are continually changing, some argue (discuss) that recognizing these gains and losses in net income is misleading. Thus, it has been identified a limited number of transactions that should be recorded directly to stockholders equity. One example is unrealized gains and losses on available-for-sale securities. These gains and losses are excluded from net income, thereby reducing volatility in net income due to fluctuations in fair value. At the same time disclosure of the potential gain or loss is provided.

Companies include these items that bypass (avoid) the income statement in a measure called comprehensive income. ***Comprehensive income*** includes all changes in equity during a period ***<u>except</u>*** those resulting from investments by owners and distributions to owners. Accordingly, comprehensive income includes the following: all revenues and gains, expenses and losses reported in net income, and all gains and losses that avoid the income statement- are referred to as ***other comprehensive income***.

It had been decided that companies must display the components of other comprehensive income in one of three ways: ***(1) a second income statement; (2) a combined statement of comprehensive income; or (3) as a part of the statement of stockholders' equity***. Regardless of the format followed, companies must add net income to other comprehensive income to arrive at comprehensive income. Companies are not required to report earnings per share information related to comprehensive income.

Illustration 3.11

Assume that Galaxy Inc. reports the following information for 2021: sales revenue L.E.1,600,000; cost of goods sold L.E.1,200,000; operating expenses L.E.180,000; and an unrealised holding gain on available-for-sale securities of L.E.60,000, net of tax.

Based upon the above information for Galaxy, the two-income statement format is shown below.

GALAXY INC. INCOME STATEMENT FOR THE YEAR ENDED DECEMBER 31, 2021	
Sales revenue......................................L.E.	**1,600,000**
Cost of goods sold....................................	**1,200,000**
Gross profit...	**400,000**
Operating expenses.................................	**180,000**
Net income...	**220,000**

GALAXY INC. COMPREHENSIVE INCOME STATEMENT FOR THE YEAR ENDED DECEMBER 31, 2021	
Net income...L.E.	**220,000**
Other comprehensive income	
Unrealized holding gain, net of tax.......	**60,000**
Comprehensive income	**280,000**

3.5 Exercises and Practical Problems

E3.1 (Computation of Net Income)

Shown below are changes in all the account balances of Fares Furniture Company during the current year, except for retained earnings.

Items	Increase (Decrease) L.E.	Items	Increase (Decrease) L.E.
Cash.................	79,000	Accounts Payable	(51,000)
Accounts Receivable	45,000	Bonds Payable	82,000
Inventory...........	127,000	Common Stock	125,000
Investments.......	(47,000)	Additional Paid-in Capital.	13,000

Instructions

Compute the net income for the current year, assuming that there were no entries in the Retained Earnings account except for net income and a dividend declaration of L.E.19,000 which was paid in the current year.

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E3.2 (Income Statement Items)

Presented below are certain account balances of Ba Zaki Products, Inc.(L.E.)

Rental revenue	**6,500**
Sales discounts	**7,800**

Interest expense	**12,700**
Selling expenses	**99,400**
Beginning retained earnings	**114,400**
Sales	**390,000**
Ending retained earnings	**134,000**
Income tax	**31,000**
Dividend revenue	**71,000**
Cost of goods sold	**184,400**
Sales returns	**12,400**
Administrative expenses	**82,500**

Instructions

From the foregoing information, compute the following: (1) total net revenue, (2) net income, (3) dividends declared during the current year.

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E3.3 (Single-step Income Statement)

The financial records of Lame Judah Co. were destroyed by fire at the end of 2021. Fortunately the controller had kept certain statistical data related to the income statement as presented below.

a. The beginning merchandise inventory was L.E.92,000 and decreased 20% during the current year.

b. Sales discounts amount to L.E.17,000

c. 20,000 shares of common stock were outstanding for the entire year.

d. Interest expense was L.E.20,000.

e. The income tax rate is 30%.

f. Cost of goods sold amounts to L.E.500,000.

g. Administrative expenses are 20% of cost of goods sold but only 8% of gross sales.

h. Four-fifths of the operating expenses relate to sales activities.

Instructions

From the preceding information prepare an income statement for the year 2021 in single-step form.

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E3.4 (Multiple-step and Single-step)

The accountant of Wasel Homamy Co. has compiled the following information from the company's records as a basis for an income statement for the year ended December 31, 2021 (L.E.).

Rental revenue	**29,000**
Interest on notes payable	**18,000**
Market appreciation on land above cost	**31,000**
Wages and salaries-sales	**114,800**
Materials and supplies-sales	**17,600**
Income tax	**37,400**
Wages and salaries-administrative	**135,900**
Other administrative expenses	**51,700**
Cost of goods sold	**496,000**
Sales	**980,000**
Depreciation on plant assets	
(70% selling, 30% administrative)	**65,000**
Cash dividends declared	**16,000**

There were 20,000 shares of common stock outstanding during the year.

Instructions

(a) Prepare a multiple-step income statement

(b) Prepare a single-step income statement.

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E3.5 (Multiple-step Statement with Retained Earnings)

Presented below is information related to Ibrahim Karat Company for the year 2021(L.E).

Net sales	**1,300,000**
Administrative expenses	**48,000**
Selling expenses	**65,000**
Dividend revenue	**20,000**
Write-off of inventory due to obsolescence	**80,000**
Depreciation expense omitted by accident in 2020	**55,000**
Interest revenue	**7,000**
Cost of goods sold	**780,000**
Casualty loss (extraordinary item) before taxes	**50,000**
Cash dividends declared	**45,000**
Retained earnings, December 31, 2020	**980,000**
Effective tax rate of 34% on all items	

Instructions

(a) Prepare a multiple-step income statement for 2021. Assume that 60,000 shares of common stock are outstanding.

(b) Prepare a separate retained earnings statement for 2021.

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E3.6 (Comprehensive Income)

Roxana Corporation reported the following for 2021: net sales L.E.1,200,000; cost of goods sold L.E.750,000; selling and administrative expenses L.E.320,000; and an unrealized holding gain on available-for-sale securities L.E.18,000.

Instructions

Prepare a statement of comprehensive income, using the two-income statement format.

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E3.7 (Comprehensive Income)

Razzak Corporation reported the following for 2021: sales revenue L.E.700,000; cost of goods sold L.E.500,000; operating expenses L.E.80,000; and an unrealized holding loss on available-for-sale securities for 2021 of L.E.60,000. It declared and paid a cash dividend of L.E.10,000 in 2021.

Razzak Co. has January 1, 2021, balances in common stock L.E.350,000; accumulated other comprehensive income L.E.80,000; and retained earnings L.E.90,000. It issued no stock during 2021.

Instructions

Prepare a statement of stockholders' equity.

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P3.8 (Single-step Income, Retained Earnings, Periodic Inventory)

Presented below is the trial balance of Kowari Corporation at December 31st, 2021.

KOWARI CORPORATION
TRIAL BALANCE
YEAR ENDED DECEMBER 31ST, 2021

Items	Debits L.E.	Credits L.E.
Purchase Discounts............		10,000
Cash....................................	205,100	
Accounts Receivable..........	105,000	
Rent Revenue.....................		18,000
Retained Earnings...............		260,000
Salaries Payable..................		18,000
Sales....................................		1,000,000
Notes Receivable................	110,000	
Accounts Payable...............		49,000
Accumulated Depreciation-Equipment...........................		28,000
Sales Discounts...................	14,500	
Sales Returns......................	17,500	
Notes Payable.....................		70,000
Selling Expenses................	232,000	
Administrative Expenses...	99,000	
Common Stock..................		300,000
Income Tax Expense.........	38,500	
Cash Dividends..................	45,000	
Allowance for Doubtful Accounts............................		5,000
Supplies.............................	14,000	
Freight-in...........................	20,000	
Land..................................	70,000	
Equipment.........................	140,000	
Bonds Payable....................		100,000
Gain on Sale of Land.........		30,000

Accumulated Depreciation-Building...............................		**19,600**
Merchandise Inventory.......	**89,000**	
Building...............................	**98,000**	
Purchases...........................	**610,000**	
Totals.................................	**1,907,600**	**1,907,600**

A physical count of inventory on December 31st resulted in an inventory amount of L.E.124,000.

Instructions

Prepare a single-step income statement and a retained earnings statement. Assume that the only changes in retained earnings during the current year were from net income and dividends. 30,000 shares of common stock were outstanding the entire year.

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CHAPTER FOUR
BALANCE SHEET
AND
STATEMENT OF CASH FLOWS

CHAPTER FOUR

BALANCE SHEET AND STATEMENT OF CASH FLOWS

4.1 BALANCE SHEET

The ***Balance Sheet*** or the ***Statement of Financial Position*** reports the assets, liabilities, and owner(s)'s (stockholders') equity of a business enterprise at a specific date. As one of the financial statements, the balance sheet provides information about the nature and amounts of investments in enterprise resources, obligations to creditors, and the owners' equity in net resources. Accordingly, it helps in predicting the amounts, timing, and uncertainty of future cash flows.

By providing information on assets, liabilities, and stockholders' equity, the balance sheet supplies a basis for computing rates of return and evaluating the capital structure of the enterprise. Analysts use the balance sheet to assess a company's liquidity, solvency, and financial flexibility.

Usually, ***Liquidity***, describes 'the amount of time that is expected to pass or elapse until an asset is realized or converted into cash or until a liability has to be paid.' ***Solvency,*** on the other hand, refers to the ability of a company to pay its debts as they mature. Thus, **liquidity** and **solvency** affect a company's ***Financial Flexibility***, which measures the "*ability of an enterprise to take effective actions to alter the amounts and timing of cash flows so it can respond to unexpected needs and opportunities*."

A company with a high degree of financial flexibility is better able to survive bad times, to recover from unexpected setbacks or obstacles, and to take advantage of profitable and unexpected investment opportunities.

4.1.1 Classification in the Balance Sheet.

Normally, accounts which shown on the balance sheet are classified. In other words, balance sheets group together similar items to arrive at significant subtotals. Additionally, the material is arranged so that important relationships are appeared.

Companies should report and classify individual items in sufficient detail to permit users to assess the amounts, timing, and uncertainty of future cash flows. To classify items in financial statements, companies group those items with similar characteristics and separate items with different characteristics.

The three general classes of items included in the balance sheet are assets, liabilities, and equity. Furthermore, those elements of the balance sheet could be defined as below.

ELEMENTS OF THE BALANCE SHEET

1 *ASSETS.* Probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.

2 LIABILITIES. Probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.

3 EQUITY. Residual interest in the assets of an entity that remains after deducting its liabilities. In a business enterprise, the equity is the ownership interest.

Companies then further divide these items into several sub-classifications. The general format of balance sheet presentation is indicated in Illustration 4.1below.

Illustration 4.1

Balance Sheet Presentation

Assets	Liabilities and Owners' Equity
*Current assets *Long-term investments *Property, plant, and equipment *Intangible assets *Other assets	*Current liabilities *Long-term debt *Owners' Equity -Capital stock -Additional paid-in capital -Retained earnings

A company may classify the balance sheet in some other manner, but we usually see little departure from these major subdivisions in practice. A proprietorship or partnership does present the classifications within the owners' equity section a little differently.

4.1.1.1 Current Assets

Usually **current assets *are cash and other assets a company expects to convert into cash, sell, or consume either in one year or in the operating cycle, whichever is longer.*** The operating cycle is the average time between when a company acquires materials and supplies and it receives cash for sales of the product (for which it acquired the materials and supplies).

The cycle operates from cash through inventory, production, receivables, and back to cash. When several operating cycles occur within one year, a company uses the one-year period. If the operating cycle is more than one year, a company uses the longer period.

Current assets are presented in the balance sheet in order of liquidity. The five major items found in the current assets section, and their bases of valuation, are presented in the following illustration.

Illustration 4.2

Item	Basis of Valuation
*Cash and Cash equivalents	*Fair value
*Short-term investments	*Generally, fair value
*Receivables	*Estimated amount collectible
*Inventories	*Lower of cost or market
*Prepaid expenses	*Cost

A company does not report these five items as current assets if it does not expect to realize them in one year or in the operating cycle, whichever is longer. **Generally, if a company expects to convert an asset into cash or to use it to pay a current liability within a year or the operating cycle, whichever is longer, it classifies the asset as current.**

Cash

Generally, cash is considered to consist of currency and demand deposits (monies available on demand at a financial institution.) **Cash equivalents** are short-term highly liquid investments that will mature within three months or less. Most companies use the caption ***Cash and Cash Equivalents***, and they indicate that this amount approximates fair value.

A company must disclose any restrictions or commitments related to the availability of cash. If a company restricts cash for purposes other than current obligations, it excludes the cash from current assets.

Short-Term Investments.

Companies group investments in debt and equity securities into three separate portfolios for valuation and reporting purposes:

(1) Held-to-maturity: Debt securities that a company has the positive intent and ability to hold to maturity.

(2) Trading: Debt and Equity securities bought and held primarily for sale in the near term to generate income on short-term price differences.

(3) Available-for-sale: Debt and equity securities not classified as held-to-maturity or trading securities.

A company should report trading securities (whether debt or equity) as current assets. It classifies individual held-to-maturity and available-for-sale securities as current or noncurrent depending on the circumstances. It should report held-to-maturity securities at amortized cost. All trading and available-for-sale securities are reported at fair value.

Illustration 4.3 Balance Sheet Presentation of Investments in Securities

Below is an excerpt from the annual report of an enterprise, with regard to its available-for-sale investments.

Current Asset

Cash and cash equivalents	**L.E.**	**170,043**
Short-term investments (Note 3)		**1,036,758**

***Note 3*. The following schedule summarizes the estimated fair value of the short-term investment (all available-for-sale):**

Corporate notes	**L.E.**	**50,471**
Municipal (local) bonds		**931,374**
Government securities		**54,913**

Receivables

An enterprise should clearly identify any anticipated loss due to uncollectible, the amount and nature of any nontrade receivables, and any receivables used as collateral (guarantee).

Major categories of receivables should be shown in the balance sheet or the related notes. For receivables arising from unusual transactions (such as sale of property, or a loan to affiliates or employees), companies should separately classify these as long-term, unless collection is expected within one year.

Illustration 4.4 Balance Sheet Presentation of Receivables

Current Asset	
Trade receivables	
Accounts Receivable	**L.E.102,212,000**
Affiliated companies	**1,157,000**
Instalment notes & contracts	**625,000**
Total	**103,994,000**
Less: Allowance for uncollectible accounts	**8,194,000**
Trade receivables-net	**95,800,000**
Receivables from unconsolidated financial subsidiaries	**22,106,000**

Inventories

In order to present inventories properly, an enterprise discloses the basis of valuation (e.g., lower-of-cost-or-market) and the method of pricing (e.g. FIFO or LIFO). The following illustration concerns a manufacturing enterprise.

Illustration 4.5 Balance Sheet Presentation of inventories

Current Asset	
Inventories	
Finished products	**L.E. 772,478**
Work in process	**338,818**
Materials	**384,148**
Total inventories	**1,495,444**

Prepaid Expenses

An enterprise includes prepaid expenses in current assets if it will receive benefits (usually services) within one year or the operating cycle, whichever is longer. These items are current assets because if they had not already been paid, they would require the use of cash during the next year or the operating cycle. Companies report prepaid expenses at the amount of the unexpired or unconsumed cost.

The most common example for prepayments is the insurance policy. A company classifies it as a prepaid expense because the payment precedes the receipt of the benefit of coverage. Other common prepaid expenses include prepaid rent, advertising, taxes, and office or operating supplies.

The following illustration shows how an enterprise lists its prepaid expenses in current assets.

Illustration 4.6 Balance Sheet Presentation of Prepaid Expenses

Current Asset

Cash	**L.E.**	**41,661**
Accounts receivable, net		**416,498**
Inventories		**52,786**
Prepaids		**30,767**
Other current assets		**34,382**

4.1.1.2 Noncurrent Assets

Logically, noncurrent assets are those not meeting or matching the definition of current assets. They include a variety of items, as it will be shown in the following sections.

Long-Term Investments

Long-term investments, or investments as usually called, normally consist of one of four types:

(1) Investments in securities, such as bonds, common stock, or long-term notes.

(2) Investments in tangible fixed assets not normally used in operations, such as land held for speculation.

(3) Investments set aside in special funds such a sinking fund (fund for paying a liabilityamortizing), pension fund, or plant expansion fund. This includes the cash surrender value of life insurance.

(4) Investments in nonconsolidated subsidiaries or affiliated companies.

Often, companies expect to hold long-term investments for many years. They usually present them on the balance sheet just below ***Current Assets***, in a separate section referred to as ***Investments.*** Realize that many securities classified as long-term investments are, in fact, readily marketable. But a company does not include them as current assets unless it intends to convert them to cash in the short-term, that is, within a year or in the operating cycle, whichever is longer.

Property, Plant, and Equipment

Property, plant, and equipment are tangible long-lived assets used in the regular operations of the business. These assets consist of physical property such as land, buildings, machinery, furniture, tools, and wasting resources (such as timberland and minerals). Except for land, a company either depreciates (e.g., buildings) or depletes (e.g., timberlands or oil reserves) these assets.

Illustration 4.7 Balance Sheet Presentation of Property, Plant, and Equipment

Property, plant, and equipment

Land	**L.E.**	**32,793,000**
Buildings		**257,430,000**
Machinery and equipment		**564,244,000**
Capitalized leases		**23,271,000**
Leasehold improvements		**74,988,000**
		952,726,000
Less: Accumulated Depreciation		**472,986,000**
		479,740,000
Tools, dies and molds, net		**168,092,000**
Property, plant, and Equipment		**647,832,000**

Usually, a company discloses the basis it uses to value property, plant, and equipment; liens (mortgages) against the properties; and accumulated depreciation-usually in the notes to the statements.

Intangible Assets

Intangible assets normally lack physical substance and are not financial instruments. They include patents, copyrights, franchises, goodwill, trademarks, trade names, and customer lists. An enterprise writes off (amortizes) limited-life intangible assets over their useful lives. It periodically assesses indefinite-life intangibles (such as goodwill) for impairment. Intangibles can represent significant economic resources.

Other Assets

The items included in the section ***Other Assets*** vary widely in practice. Some include items such as long-term prepaid expenses, prepaid pension cost, and noncurrent receivables. Other items that might be included are assets in special funds, deferred income taxes, property held for sale, and restricted cash or securities. A company should limit this section to include only unusual items sufficiently different from assets included in specific categories.

4.1.1.3 Liabilities

Similar to assets, companies classify liabilities as current or long-term.

Current Liabilities

Current liabilities are the obligations that a company reasonably expects to liquidate either through the use of current assets or the creation of other current liabilities. This concept includes:

(1) Payables resulting from the acquisition of goods and services: accounts payable, wages payable, taxes payable, and so on.

(2) Collections received in advance for the delivery of goods or performance of services, such as unearned rent revenue or unearned subscriptions revenue.

(3) Other liabilities whose liquidation will take place within the operating cycle, such as the portion of long-term bonds to be paid in the current period or short-term obligations arising from purchase of equipment.

At time, a liability that is payable within the next year is not included in the current liabilities section. This occurs either when the company expects to refinance the debt through another long-term issue or to retire the debt out of noncurrent assets. This approach is used because liquidation does not result from the use of current assets or the creation of other current liabilities.

Companies do not report current liabilities in any consistent order. Generally, companies most commonly list notes payable, accounts payable or short-term debt as the first item. Income taxes payable, current maturities of long-term debt or other current liabilities are commonly listed last. Illustration 4.8 below shows such liabilities.

Illustration 4.8 Balance Sheet Presentation of Current Liabilities

Current liabilities

Short-term notes payable	**L.E. 1,570,000**
Accounts payable	**782,000**
Accrued employee compensation and benefits	**267,000**
Unearned revenues	**386,000**
Income taxes payable	**113,000**
Accrued special charges	**6,000**
Current maturities of long-term debt	**8,000**
Other current liabilities	**694,000**
Total current liabilities	**3,826,000**

Current liabilities include such items as trade and nontrade notes and accounts payable, advances received from customers, and current maturities of long-term debt. If the amounts are material, companies classify income taxes and other accrued items separately.

The excess of total current assets over total current liabilities is referred to as ***working capital*** (sometimes called net working capital). Working capital represents the net amount of a company's relatively liquid resources. In other words, it is the liquidity available to meet the financial demands of the operating cycle.

Long-Term Liabilities

Long-term liabilities are obligations that a company does not reasonably expect to liquidate within the normal operating cycle. Instead, it expects to pay them at some date beyond that time. Bonds payable, notes payable, some deferred income tax amounts, lease obligations, and pension obligations are the most common examples. *Companies classify long-term liabilities that mature within the current operating cycle as current liabilities if payment of the obligation requires the use of current assets.*

Generally, long-term liabilities are of three types:

(1) Obligations arising from specific financing situations, such as the issuance of bonds, long-term lease obligations, and long-term notes payable.

(2) Obligations arising from the ordinary operations of the company, such as pension obligations and deferred income tax liabilities.

(3) Obligations that depend on the occurrence or non-occurrence of one or more future events to confirm the amount payable, or the payee, or the date payable, such as service or product warranties and other contingencies.

Companies generally provide a great deal of supplementary disclosure for long-term liabilities, because most long-term debt is subject to various covenants (agreements) and restrictions for the protection of lenders. It is preferred to report any premium or discount separately as an addition to or subtraction from the bonds payable.

4.1.1.4 Owners' Equity

The ***owners' equity*** (**stockholders' equity**) section is one of the most difficult sections to prepare and understand. This is due to the complexity of capital stock agreements and the various restrictions on stockholders' equity imposed by laws, liability agreements, and boards of directors. Companies usually divide the section into three parts:

STOCKHOLDERS' EQUITY SECTION

1 CAPITAL STOCK. The par or stated value of the shares issued.

2 ADDITIONAL PAID-IN CAPITAL. The excess of amounts paid in over the par or stated value.

3 RETAINED EARNINGS. The corporation's undistributed earnings.

For capital stock, companies must disclose the par value and the authorized, issued, and outstanding share amounts. A company usually presents the additional paid-in capital in one amount, although subtotals are informative if the sources of additional capital are varied and material. The retained earnings amount may be divided between the **unappropriated** (the amount that is usually available for dividend distribution) and **restricted** (e.g., by bond or other loan agreements) amounts. Additionally, companies show any capital stock reacquired (treasury stock) as a reduction of stockholders' equity.

The ownership or stockholders' equity accounts in a corporation differ considerably from those in a partnership or proprietorship. Partners show separately their permanent capital accounts and the balance in their temporary accounts (drawing accounts). Proprietorships normally use a single capital account that handles all of the owner's equity transactions.

4.1.2 Balance Sheet Format

One common arrangement that companies use in presenting a classified balance sheet is the ***Account Form***. This form lists assets, by sections, on the left side, and liabilities and stockholders' equity, by sections, on the right side. The main disadvantage is the need for a sufficiently wide space in which to present the items side by side. Often, the account form requires two facing pages.

In order to avoid this disadvantage, the ***Report Form*** lists the sections one above the other, on the same page. Illustration 4.9 below, lists assets followed by liabilities and stockholders' equity directly on the same page.

ELHORIA COMPANY BALANCE SHEET DECEMBER 31, 2022			
Assets	L.E.	L.E.	L.E.
Current assets			
Cash		42,485	
Available-for-sale securities		28,250	
Accounts receivable	165,824		
Less: Allowance for doubtful accounts	1,850	163,974	
Notes receivable		23,000	
Inventories		489,713	
Supplies on hand		9,780	
Prepaid expenses		16,252	
Total current assets			773,454
Long-term investments			
Investment in Misr Co.			87,500
Property, plant, and equipment			
Land		125,000	
Buildings	975,800		
Less: Accumulated Depreciation	341,200	634,600	
Total property, P., and Equip.			759,600
Intangible assets			
Goodwill			100,000
Total assets			1,720,554
Liabilities & Stockholders' Equity			
Current liabilities			
Notes payable to banks		50,000	

Accounts payable		**197,532**	
Accrued interest on notes payable		**500**	
Income taxes payable		**62,520**	
Accrued salaries, wages and other liabilities		**9,500**	
Deposits received from customers		**420**	
Total current liabilities			**320,472**
Long-term debt			
Twenty-year 12% bonds, due 2019			**500,000**
Total liabilities			**820,472**
Stockholders' equity			
Paid in on capital stock			
-Preferred: Authorized, issued, and outstanding, 30,000 shares of L.E.10 par value	**300,000**		
-Common: Authorized, 500,000 shares of L.E.1 par value; issued and outstanding, 400,000 shares	**400,000**		
-Additional paid-in capital	**37,500**	**737,500**	
Retained earnings		**162,582**	
Total stockholders' equity			**900,082**
Total liabilities and stockholders' equity			**1,720, 554**

4.2 STATEMENT OF CASH FLOWS

The primary purpose of a statement of cash flows is to provide relevant information about the cash receipts and cash payments of an enterprise during a period. To accomplish this purpose, the statement of cash flows reports the following:

(1) The cash effects of operations during a period.

(2) Investing transactions.

(3) Financing transactions.

(4) The net increase or decrease in cash during the period.

Reporting the sources, uses, and net increase or decrease in cash helps investors, creditors, and others know what is happening to a company's most liquid resource. Because most individuals maintain a checkbook and prepare a tax return on cash basis, they can comprehend the information reported in the statement of cash flows, such as causes and effects of cash inflows and outflows and the net change in cash.

Accordingly, the statement of cash flows provides answers to the following simple but important questions:

a. Where did the cash come from during the period?

b. What was the cash used for during the period?

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

4.2.1. Content and Format of the Statement of Cash Flows

Usually, companies classify cash receipts and cash payments during a period into three different activities in the statement of cash flows-that is, operation, investing, and financing activities, defined as follows:

1 **Operating Activities:** Operating activities involve the cash effects of transactions that enter into the determination of net income.

2 **Investing Activities:** Investing activities include making and collecting loans and acquiring and disposing of investments (both debt and equity) and property, plant, and equipment.

3 **Financing Activities:** Financing activities involve liability and owners' equity items. They include: ***(a)*** Obtaining resources from owners and providing them with a return on their investment, and ***(b)*** Borrowing money from creditors and repaying the amounts borrowed.

The basic format of the statement of cash flows is shown in the following illustration.

Illustration 4.10

Statement of Cash Flows

Cash flows from operating activities	**XXX**
Cash flows from investing activities	**XXX**
Cash flows from financing activities	**XXX**
Net increase (decrease) in cash	**XXX**
Cash at beginning of year	**XXX**
Cash at end of year	**XXX**

Again, **the statement's value is that it helps users evaluate liquidity, solvency, and financial flexibility.** *Liquidity* refers to the "nearness to cash" of assets and liabilities. *Solvency* is the firm's ability to pay its debts as they mature. *Financial flexibility* is a company's ability to respond and adapt to financial adversity and unexpected needs and opportunities.

4.2.2 Preparation of the Statement of Cash Flows

Practically, companies obtain the information to prepare the statement of cash flows from several sources:

1- Comparative balance sheets.

2- The current income statement.

3- Selected transaction data.

Preparing the statement of cash flows from these sources involves four steps:

(1) Determine the cash provided by or used in operating activities.

(2) Determine the cash provided by or used in investing and financing activities.

(3) Determine the change (increase or decrease) in cash during the period.

(4) Reconcile the change in cash with the beginning and the ending cash balances.

The following simple example demonstrates how companies apply these steps in preparing a statement of cash flows.

Illustration 4.11

On January 1st, 2022, in its first year of operations, Egypt-Telecom Company issued 500,000 shares of L.E.1 par value common stock for L.E.500,000 cash. The company rented its office space, furniture, and telecommunications equipment and performed marketing services, throughout the first year. In June 2022 the company purchased land for L.E.150,000. Below are the company's comparative balance sheets at the beginning and end of 2022.

EGYPT TELECOM COMPANY
COMPARATIVE BALANCE SHEETS

Items	Dec. 31 2022 L.E.	Jan.1 2022 L.E.	Increase/ Decrease L.E.
Assets			
Cash	310,000	-0-	310,000 Inc.
Accounts receivable	410,000	-0-	410,000 Inc.
Land	150,000	-0-	150,000 Inc.
Total	870,000	-0-	
Liabilities & Stockholders' Equity			
Accounts payable	120,000	-0-	120,000 Inc.
Common stock	500,000	-0-	500,000 Inc.
Retained earnings	250,000	-0-	250,000 Inc.
Total	870,000	-0-	

Additionally, the company's income statement and other information are presented as follows:

EGYPT TELECOM COMPANY INCOME STATEMENT FOR THE YEAR ENDED DECEMBER 31, 2022	
Revenues	**L.E.1,720,000**
Operating expenses	**1,200,000**
Income before income tax	**520,000**
Income tax	**130,000**
Net income	***390,000***
	========

Additional information:
Dividends of L.E.140,000 were paid during the year.

Cash provided by operating activities is the excess of cash receipts over cash payments from operating activities. Companies determine this amount by converting net income on an accrual basis to a cash basis. In order to achieve this, they add to or deduct from net income those items in the income statement that do not affect cash. This procedure requires that a company analyze not only the current year's income statement but also the comparative balance sheets and selected transaction data.

Analysis of Egypt Telecom's comparative balance sheets reveals two items that will affect the computation of net cash provided by operating activities:

(1) The increase in accounts receivable reflects a noncash increase of L.E.410,000 in revenues.

(2) The increase in accounts payable reflects a noncash increase of L.E.120,000 in expenses.

Therefore, to arrive at cash provided by operations, Egypt Telecom Company deducts from net income the increase in accounts receivable (L.E.410,000), and it adds back to net income the increase in accounts payable (L.E.120,000). As a result of these adjustments, the company determines cash provided by operations to be L.E.100,000, computed as shown below:

Computation of Net Cash Provided by Operations		
Net income	**L.E.**	**L.E.390,000**
Adjustments to reconcile net income to net cash provided by operating activities:		
Increase in accounts receivable	**(410,000)**	
Increase in accounts payable	**120,000**	**(290,000)**
Net cash provided by operating activities		***100,000***
		=======

Egypt Telecom Company's only investing activity was the land purchase. It had two financing activities. They are: (1) the increase of L.E.500,000 in common stock resulting from the issuance of 500,000 shares for cash, and (2) the payment of L.E.140,000 cash in dividends.

According to the information presented in the preceding sections, the following is the statement of cash flows of Egypt Telecom Company.

EGYPT TELECOM COMPANY STATEMENT OF CASH FLOWS FOR THE YEAR ENDED DECEMBER 31, 2022		
***Cash flows from operating activities**		
Net income	**L.E.**	**L.E.390,000**
Adjustments to reconcile net income to net cash provided by operating activities:		
Increase in accounts receivable	**(410,000)**	
Increase in accounts payable	**120,000**	**(290,000)**
Net cash provided by operating activities		***100,000***
***Cash flows from investing activities**		
Purchase of land	**(150,000)**	
Net cash used by investing activities		***(150,000)***
***Cash flows from financing activities**		
Issuance of common stock	**500,000**	
Payment of cash dividends	**(140,000)**	
Net cash provided by financing activities		***360,000***
Net increase in cash		**310,000**
Cash at beginning of year		**---0----**
Cash at end of year		***310,000***
		=======

The increase in cash of L.E.310,000 reported in the statement of cash flows agrees with the increase of L.E.310,000 in cash calculated from the comparative balance sheets.

Note that not all of a company's significant activities involve cash. Examples of significant noncash activities are:

(1) Issuance of common stock to purchase assets.

(2) Conversion of bonds into common stock.

(3) Issuance of debt to purchase assets.

(4) Exchange of long-lived assets.

Significant financing and investing activities that do not affect cash are not reported in the body of the statement of cash flows. Rather, these activities are reported in either a separate schedule at the bottom of the statement of cash flows or in separate notes to the financial statements. ***In solving homework assignments and tests, you should present significant noncash activities in a separate schedule at the bottom of the statement of cash flows.***

Illustration 4.12, presents an example of a comprehensive statement of cash flows. You will note that the company has purchased equipment through the issuance of L.E.50,000 of bonds, which is a significant noncash transaction.

Illustration 4.12: Comprehensive Statement of Cash Flows

EGYPT ELHORA COMPANY STATEMENT OF CASH FLOWS FOR THE YEAR ENDED DECEMBER 31, 2022		
***Cash flows from operating activities**		
Net income	L.E.	L.E.320,750
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense	88,400	
Amortization of intangibles	16,300	
Gain on sale of plant assets	(8,700)	
Increase in accounts receivable	(11,000)	
Decrease in inventory	15,500	
Decrease in accounts payable	(9,500)	91,000
Net cash provided by operating activities		*411,750*
***Cash flows from investing activities**		
Sale of plant assets	90,500	
Purchase of equipment	(182,500)	
Purchase of land	(70,000)	
Net cash used by investing activities		*(162,000)*
***Cash flows from financing activities**		
Issuance of common stock	100,000	
Redemption of bonds	(50,000)	
Payment of cash dividends	(19,800)	
Net cash provided by financing activities		*30,200*
Net increase in cash		279,950
Cash at beginning of year		135,000
Cash at end of year		*414,950*
		=======
Noncash investing and financing activities		
Purchase of equipment through issuance of L.E.50,000 of bonds		

4.2.3 Free Cash Flow

Free cash flow is the amount of discretionary (optional) cash flow a company has for purchasing additional investments, retiring its debt, purchasing treasury stock, or simply adding to its liquidity. Financial statement users calculate free cash flow as net cash provided by operating activities less capital expenditures and dividends.

Obviously, the greeter the amount of free cash flow, the greeter the company's amount of financial flexibility. Illustration 4.13 shows free cash analysis, using the cash flow statement for Egypt Elhora Company.

Illustration 4.13: Free Cash Flow Computation

EGYPT ELHORA COMPANY FREE CASH FLOW ANALYSIS	
Net cash provided by operating activities	**L.E.411,750**
Less: Capital expenditures	**(252,500)**
Dividends	**(19,800)**
Free cash flow	***139,450***

This analysis shows that the company has a positive, and substantial, net cash provided by operating activities of L.E.411,750. The company's statement of cash flows reports that the company purchased equipment of L.E.182,500 and land of L.E.70,000 for total capital spending of L.E.252,500.

In a free cash flow analysis, you first deduct capital spending, to indicate it is the least discretionary expenditure a company generally makes. You then deduct dividends. The amount resulting after these deductions is the company's free cash flow. The company has more than sufficient cash flow to meet its dividend payment and therefore has satisfactory financial flexibility.

4.3 Questions and Practical Problems

Ex.4.3.1 (Balance Sheet Classifications)

Presented below are a number of balance sheet accounts of a Company.

(a) Investment in Preferred Stock.

(b) Treasury Stock.

(c) Common Stock.

(d) Cash Dividends Payable.

(e) Accumulated Depreciation.

(f) Warehouse in Process of Construction.

(g) Petty Cash.

(h) Accrued Interest on Notes Payable.

(i) Deficit.

(j) Trading Securities.

(k) Income Taxes Payable.

(l) Unearned Subscription Revenue.

(m) Work in Process.

(n) Accrued Vacation Pay.

Instructions

For each of the accounts above, indicate the proper balance sheet classification.

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Ex.4.3.2 (Classification of Balance Sheet Accounts)

Presented below are the captions of Fauly Company's balance sheet.

(a) Current assets.

(b) Investments.

(c) Property, plant, and equipment.

(d) Intangible assets.

(e) Other assets.

(f) Current liabilities.

(g) Non-current liabilities.

(h) Capital Stock.

(i) Additional paid-in capital.

(j) Retained Earnings.

Instructions

Indicate by letter where each of the following items would be classified.

1. Preferred stock.
2. Goodwill.
3. Wages payable.
4. Trade accounts payable.
5. Buildings.

6. Trading securities.

7. Current portion of long-term debt.

8. Premium on bonds payable.

9. Allowance for doubtful accounts.

10. Accounts receivable.

11. Cash surrender value of life insurance.

12. Note payable (due next year).

13. Office supplies.

14. Common stock.

15. Land.

16. Bond sinking fund.

17. Merchandise inventory.

18. Prepaid insurance.

19. Bonds payable.

20. Taxes payable.

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Ex.4.3.3 (Balance Sheet Preparation)

Presented below is the adjusted trial balance of Kinsey Corporation at December 31, 2021(L.E.):

Balances	Debits	Credits
Cash………………………………	?	
Office Supplies…………………..	1,200	
Prepaid Insurance……………….	1,000	
Equipment……………………….	48,000	
Accumulated Depreciation-Equip.		4,000
Trademarks………………………	950	
Accounts Payable………………..		10,000
Wages Payable…………………..		500
Unearned Service Revenue………		2,000
Bonds Payable, due 2029………..		9,000
Common Stock……………………		10,000
Retained Earnings……………….		25,000
Service Revenue………………….		10,000
Wages Expense…………………..	9,000	
Insurance Expense……………….	1,400	
Rent Expense…………………….	1,200	
Interest Expense…………………	900	
Total………………	?	?

Additional information:

1- Net loss for the year was L.E.2,500.

2- No dividends were declared during 2021.

Instructions

Prepare a classified balance sheet as of December 31,2021.

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Ex.4.3.4 (Preparation of a Balance Sheet)

Presented below is the trial balance of Noaman Corporation at December 31, 2022 (L.E.):

Balances	Debits	Credits
Cash……………………	197,000	
Sales …………………..		8,100,000
Trading Securities (cost, 145,000)	153,000	
Cost of Goods Sold…………..	4,800,000	
Long-term Investments in Bonds	299,000	
Long-term Investments in Stocks	277,000	
Short-term Notes Payable……..		90,000
Accounts Payable………….		455,000
Selling Expenses……………	2,000,000	
Investment Revenue…………		63,000
Land…………………………..	260,000	
Buildings…………………….	1,040,000	
Dividends Payable………….		136,000
Accrued Liabilities………….		96,000
Accounts Receivable………….	435,000	
Accumulated Dep.-Buildings		152,000
Allowance for Doubtful Accounts		25,000
Administrative Expenses……..	900,000	
Interest Expense…………..….	211,000	
Inventories…………………..	597,000	
Extraordinary Gain…………		80,000
Long-term Notes Payable…..		900,000
Equipment………………….	600,000	
Bonds Payable………………		1,000,000
Accumulated Dep.-Equipment…		60,000
Franchise…………………….	160,000	
Common Stock (L.E.5 par)		1,000,000
Treasury Stock…………….	191,000	
Patent………………………	195,000	
Retained Earnings………...		78,000
Additional Paid-in Capital….		80,000
Total……………….	12,315,000	12,315,000

Instructions

Prepare a balance at December 31, 2022. Ignore income taxes.

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Ex.4.3.5 (Preparation of a Statement of Cash Flows)

The comparative balance sheets of Cano Cava Company at the beginning and the end of the year 2022 appear below (L.E.):

CANO CAVA COMPANY
BALANCE SHEETS

	Dec.31, 2022	Jan. 1, 2022	Inc./Dec.
Assets			
Cash..............	45,000	13,000	32,000 Inc.
Accounts receivable…	91,000	88,000	3,000 Inc.
Equipment…….	39,000	22,000	17,000 Inc.
Less: Accumulated Dep.	(17,000)	(11,000)	6,000 Inc.
Total………..	158,000	112,000	
Liabilities & Stockholders' Equity			
Accounts payable	20,000	15,000	5,000 Inc.
Common stock….	100,000	80,000	20,000 Inc.
Retained earnings….	38,000	17,000	21,000 Inc.
Total	158,000	112,000	

Net income of L.E.44,000 was reported, and dividends of L.E.23,000 were paid in 2022. New equipment was purchased and none was sold.

Instructions

Prepare a statement of cash flows for the year 2022.

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Ex.4.3.6 (Preparation of a Statement of Cash Flows and a Balance Sheet)

Grant Wood Corporation's balance sheet at the end of 2021 included the following items.

	2021 L.E.
Assets	
Current assets……………………	235,000
Land……………………………..	30,000
Building………………………….	120,000
Equipment……………………….	90,000
Accumulated Depreciation-building…………	(30,000)
Accumulated Depreciation-Equipment………	(11,000)
Patents………………………….	40,000
Total………………	474,000
Liabilities & Stockholders' equity	
Current liabilities………………	150,000
Bonds payable…………………..	100,000
Common stock……………………	180,000
Retained earnings……………….	44,000
Total……………..	474,000

The following information is available for 2022.

1. Net income was L.E.55,000.

2. Equipment (cost L.E.20,000 and accumulated depreciation L.E.8,000) was sold for L.E.10,000.

3. Depreciation expense was L.E.4,000 on the building and L.E.9,000 on equipment.

4. Patent amortization was L.E.2,500.

5. Current assets other than cash increased by L.E.29,000. Current liabilities increased by L.E.13,000.

6. An addition to the building was completed at a cost of L.E.27,000.

7. A long-term investment in stock was purchased for L.E.16,000.

8. Bonds payable of L.E.50,000 were issued.

9. Cash dividends of L.E.30,000 were declared and paid.

10. Treasury stock was purchased at a cost of L.E.11,000.

Instructions

(Show only totals for current assets and current liabilities.)

(a) Prepare a statement of cash flows for 2022.

(b) Prepare a balance sheet at December 31, 2022.

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P4.3.7 (Preparation of a Statement of Cash Flows and Balance Sheet)

Jihad Corporation had the following balance sheet at December 31, 2021(L.E.):

JIHAD CORPRATION
BALANCE SHEET
DECEMBER 31, 2021

Cash ………..	**20,000**		
Accounts receivable	**21,200**	**Accounts payable**	**30,000**
Investments……….	**32,000**	**Bonds payable**	**41,000**
Plant assets………	**81,000**	**Common stock….**	**100,000**
Land……………….	**40,000**	**Retained earnings**	**23,200**
	194,200		**194,200**

During 2022 the following occurred.

1. Jihad Co. liquidated its available-for-sale investment portfolio at a loss of L.E.3,000.

2. A tract of land was purchased for L.E.38,000.

3. An additional L.E.26,000 in common stock was issued at par.

4. Dividends totaling L.E.10,000 were declared and paid to stockholders.

5. Net income for 2022 was L.E.35,000, including L.E.12,000 in depreciation expense.

6. Land was purchased through the issuance of L.E.30,000 in bonds.

7. At December 31, 2022, Cash was L.E.66,200, Accounts Receivable was L.E.42,000, and Accounts Payable was L.E.40,000.

Instructions

(a) Prepare a statement of cash flows for 2022.

(b) Prepare the balance sheet as it would appear at December 31, 2022.

(c) Compute the free cash flow for the company.

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TABLE OF CONTENTS