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Faculty of Commerce
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Lectures in

FINANCIAL ACCOUNTING1

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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

Preface

Praise to Almighty ALLAH who gave me the strength, patience, and ability to complete this textbook.

This textbook has been written to provide student with a very comprehensive introduction to Financial Accounting regarding sole proprietorships, which is covered in two issues. The splitting of this textbook between two issues is a recognition of the fact that many students will get all that they require to have a good idea about the nature of accounting and its environment, the theoretical framework of accounting , the accounting cycle and so on, contained in the first issue: Financial Accounting 1. The second issue: Financial Accounting 2 will be devoted to accounting issues, such as the nature of accounting communication, financial statements in commercial and industrial enterprises, financial statements analysis, and other accounting problems that pay the students attention to a more advanced stage in studying financial accounting.

Therefore, this textbook is divided into a variety of chapters intended to put the students, who study business, on the right way towards understanding financial accounting. Chapter one of this issue covers the nature of accounting. Chapter two introduces to the starting point in the study of accounting. Chapter three is entitled an introduction to the accounting cycle. Chapter four also discusses the accounting for merchandising operations.

CHAPTER ONE

THE NATURE OF ACCOUNTING

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1.1 What is accounting?

Accounting is something that affects people in their affairs and personal lives just as much as it affects small and large firms. In effect, some people think of accounting as a highly technical field which is practiced only by professional and very specialized accountants. However, we all use accounting ideas and actions when we plan what we do and we are going to do with our money and our wealth in general. We have to plan how much of money we have to spend and how much we have to save for future use. Most of us may write down a plan or a note, which is known as a ‘budget’, or we may simply keep it in our minds (Wood, 1993).

Actually, almost entirely everyone practice what we call accounting in one form or another on nearly daily basis. Accounting in its simple nature is the means or the tool by which we measure or evaluate and describe the results of economic activities or events. Whether we are managing a business, making investments, preparing our income tax return (declaration), or only paying our phone or electricity bill, we are practicing and working with accounting concepts and accounting information.

Accounting often is termed as or called the ‘language of business’ because it is so widely and rightly used in expressing and describing all types of business activities. For instance, every investor, manager, and business decision maker needs a clear and thoroughly understanding of accounting terms and concepts if he/she is to take part or participate and communicate effectively and efficiently in the business community (Meigs, et. al, 1996).

Usually, the main function of a language is to serve as a means of communication among its speakers. Similarly, accounting also serve and perform this function. It communicates the results of business operations to various parties who have some interest or stake in the business, namely the proprietor or owner, creditors, investors, government and other parties. Though, accounting is generally related to business, but it is not only business makes use of accounting. For instance, the person who is responsible for housekeeping and his/her family affairs has to keep a record of the money received and spent by him/her during a given period. He/she can record his/her receipts of money on one page of the household diary, while payments for different items such as food, clothing, bills, rent etc. on some another page or pages of the diary in a chronological order. Such a record will help in knowing regarding (Maheshwari, 1996):

1) The sources from which he or she received cash and the purposes for which it was used.

2) Whether his or her receipts are more than his or her payments or vice-versa?

3) The balance (the remaining) of cash in hand or deficit, if any at the end of a particular period.

1.2 Do we need accounting?

As mentioned above, in case the person who is responsible for housekeeping and family affairs, he/she can collect valuable data and information regarding the nature of his/her receipts and payments. For example, this person can find out the total amount spent by him/her during a given period, say a year, on different items he/she purchased. Similarly, he/she can find out the sources of his/her receipts such as salary or wages from work, rent received from let property, selling some properties, and so on. Therefore, at the end of such period, he/she can see for himself/herself regarding his/her financial position i.e., what he/she owns and what he/she owes. Such information will help that person in planning his/her future income and expenses to great extent (or preparing a budget).

Accordingly, the answer on a question such as do we need accounting? Or for what purpose is accounting used?, can be presented on two levels at least: that of the individual and that of the enterprise. If we are considered the individual, accounting information could be used to help plan future levels of expenses, to assist in controlling the level of expenditure, to help raise or increase additional finance and to decide or determine the best way to spend their money. Hence, we think that at the level of individual, accounting can have three roles or functions, i.e. planning, controlling and decision support. On the other hand, at the level of the enterprise, accounting is used to control the activities of the organization, to plan future activities, to assist in raising finance and to report upon the activities and the extent to which the enterprise is considered successful to interested parties. We will see that the main difference between the two levels is that in case of an enterprise, apart from (in addition to) its uses in planning, controlling and decision making which are all internal activities or functions, accounting also has what we could call an external function, which focuses on providing information to parties outside the enterprise (Berry and Jarvis, 1997).

Therefore, the need for accounting is considered all the more importance for a person who is running or planning to run a business. He/she has to know the following:

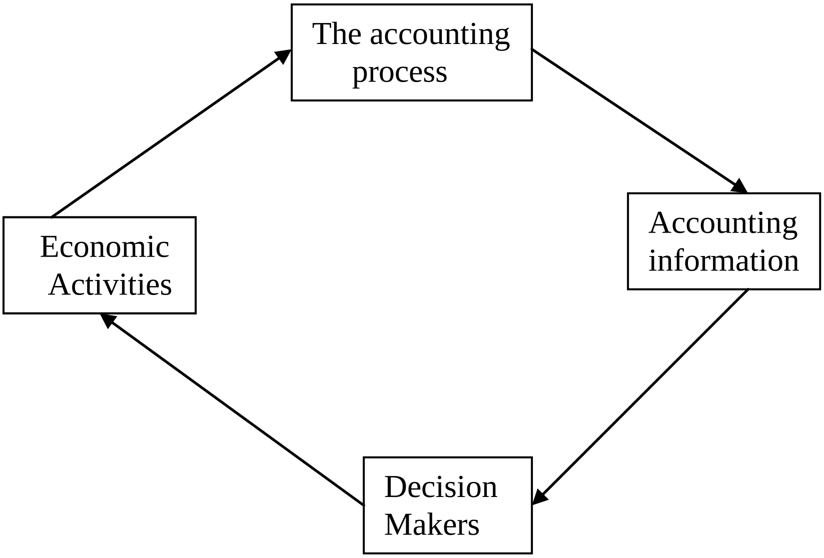
a) What he/she owns?

b) What he/she owes?

c) Whether he/she earned a profit or suffered a loss as a result of running a business?

d) What is his/her financial position (whether he/she will be in a position to meet all his/her commitments or obligations in the near future or he/she is in the process of becoming a bankrupt)?

In short, the major purpose of accounting, whether on the level of the individual or on the level of the enterprise, is to provide decision makers with information useful in making economic decisions. Accordingly, the inputs or the raw materials to the accounting process are the economic activities and the outputs or products are useful information. This relationship could be illustrated as follows:



1.3 Definition of Accounting:

Actually, the role of accounting has been changing greatly with the change in the economic and social developments over the last few centuries. In its early stages, accounting was regarded only as a technique for historic description of financial activities. Over a span of time, new dimensions have been added to the accounting discipline. Until recently, accounting was regarded to be an art. This could be noted from the following definition of accounting cited by the American Institute of Certified Public Accountants (AICPA, 1982, p.5007):

> Accounting is an art of recording , classifying and summarising in significant manner and in terms of money, transactions and events, which are in part at least of a financial characters and interpreting the results thereof.

According to the American Accounting Association's (AAA) definition of accounting, accounting can be considered an information system, which aims at exchanging data and information among a variety of parties, whether inside or outside the organisation. The AAA (AAA, 1966, p.1) defined accounting broadly as:

> … the process of identifying, measuring, and communicating economic information to permit informed judgments and decisions by users of the information.

Accordingly, accounting is being considered as a service activity that is not only concerned with recording, classifying or summarizing the economic transactions, but also an important tool for providing appropriate information to whom it may concern. Therefore, the following functions could be closely related to accounting activity:

1.3.1 Recording.

When people normally talk regarding accounting it means the type used by business and other organizations. They cannot retain all the details in their mind therefore they have to keep records of it. They will not only record cash received and paid out, they will also record goods bought and sold. Recording is considered the basic function of accounting and it is essentially not only concerned with ensuring that all business transactions of financial character are actually recorded, but also that they are recorded in an orderly and systematically manner. As we will see in the next chapters, recording is done in the book which is called '**Journal**'. Accounting deals and records only those transactions and events in terms of money which are of a financial character. Accordingly, transactions which are not of a financial character are not recorded in the books of accounts.

1.3.2 Classifying:

When the data is being recorded it should be sorted out so as to be most useful to the interested parties. Classification process is mainly concerned with the systematic analysis of recorded data, with a view to group transactions or entries of the same nature at one place. The classification process is done in the book termed as ‘Ledger’. The ledger book consists of different pages of individual account heads under which all financial transactions of one nature are collected. For example, all expenses under the head of wage expenses after being recorded in the Journal will be classified under separate head in the Ledger called “Wages Expenses”. The same treatment should be followed regarding all classes of expenses and revenues, which will assist in finding out the total expenditures incurred or revenues realized under appropriate heads.

1.3.3 Summarizing:

Summarizing process involves presenting the data in an understandable and useful manner to both internal and external users of accounting statements. Summarizing process will leads to the preparation of some statements, as we will see later, such as Trial Balance, Income Statement, Balance Sheet, etc.

1.4 Accounting Branches:

Practically and in order to satisfy the various needs of different groups of users and people interested in the accounting information, different branches of accounting have been developed. As there are many types of economic decisions, there are many types of accounting information. To describe the types of accounting information used widely in the business community, many terms of accounting are used, the most prevailing of them are *Financial Accounting* and *Management Accounting*. They are briefly presented as follows:

1.4.1 Financial Accounting:

Financial accounting is the original form of accounting, which is basically confined to the preparation of financial statements for the external users. It is usually interested in providing *general purpose* information. It refers to information describing the financial resources, obligations, and activities of an economic entity, whether it is an organization or an individual entity. Conventionally, accountants use the term *financial position* to describe an entity's financial resources and obligations at one point in time or a given date, and the term *results of operations* to describe or portray the entity's financial activities during the year a part of year.

Basically, financial accounting information is intended and designed to help investors and creditors decide where to place their scare investment resources (FASB, 1999). Such decisions are of great importance to any society, as they determine which enterprises and industries will receive the available financial resources necessary for economic growth.

Moreover, many other decision makers also make a fundamental use of financial accounting information. For example, an enterprise's managers and employees constantly need such information in order to run and control day-to-day business operations. In short, financial accounting information is used to serve so many different purposes that it often is called *general purposes* accounting information.

1.4.2 Management Accounting:

Management (or managerial) accounting is accounting for the management which provides necessary information to the enterprise's management for discharging its functions. Primarily, it involves the development and interpretation of accounting information aimed specifically to assist management in running the business. For example, managers use such information in setting the enterprise's overall goals, evaluating the performance of departments and individuals, deciding whether to introduce a new line of products, and making all types of managerial decisions.

Management accounting covers a variety of areas such as cost accounting, budgetary control, stock or inventory control, statistical methods, internal auditing etc. However, it should be kept in mind the fact that much management accounting information is financial in nature, but has been organized and developed in a manner connected directly to the decision under condition.

1.5 The Main Objective of Accounting:

Accounting did not emerge from a vacuum and thus it is developing to achieve many objectives. The following are the basic objectives of accounting:

(1) Accounting is intended to keep systematic records:

Accounting activity is done to provide regular and systematic records of economic transactions. Imagine the state in the absence of accounting. For example, how the trader keeps a track of numerous transactions occurred during a given period of time. In the absence of accounting there would have been heavy overload or burden on human memory which in most cases would have been impossible to bear or tolerate.

(2) Accounting is intended to protect entity's properties:

It is conceived that accounting provides protection to enterprise properties from misuse or abuse. This could be possible on the base of accounting supplying the following information to the enterprise's manager or the owner (Maheshwari, 1996):

* The amount of the owner's funds invested in the business.

* How much the business has to pay to other interested parties?

* How much the business has to collect from others?

* How much the business has in the form of (a) fixed assets, (b) cash in hand, (c) cash at bank account etc?

(3) Accounting is intended to ascertain the operational profit or loss:

Accounting assists in determining the net profit earned or loss suffered as a result of carrying the business. This process is being done by keeping an appropriate record of revenues and expenses of a given period.

(4) Accounting is intended to determine the financial position of the Entity:

It is not enough to know the net profit or loss resulting from carrying the business during a period of time. It is an important for the businessman to have a good idea about his financial position at specific date. For example, where he stand: what he owes and what he owns? This goal is implemented by a statement which shows the enterprise's financial position.

(5) Accounting is intended to facilitate decision-making process:

The task of collection, analysis and reporting of information at the required point of time to the required levels of authority in order to facilitate economic decision making is the responsibility of accounting.

1.6 Questions:

1. In broad general terms, define accounting?

2. What are the main functions of accounting?

3. What are the main objectives of accounting?

4. State whether each of the following statements is **true** or **false**.

a. Accounting is the language of business.

b. Accounting can be useful only for recording business transactions.

c. The only business events that are entered in accounting records are those that can be expressed in monetary terms.

5. Choose the best answer for each of the following questions:

1) The main function of accounting is to:

a- Record economic data.

b- P rovide the informational basis for action.

c- Classifying and recording business transactions.

d- Attain non-economic goals.

2) The basic function of financial accounting is to:

a- Record all business transactions.

b- Interpret the financial data.

c- Assist the management in performing functions effectively.

3) Management Accounting provides invaluable services to management in performing:

a- All management functions.

b- Co-ordinating management functions.

c- Controlling functions.

CHAPTER TWO

THE STARTING POINT IN THE STUDY OF ACCOUNTING

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2.1 Introduction:

As we had seen from the previous chapter, accounting is described as the language of business by which the business can communicate with the outside parties. To do so, it is important that accounting should be built on certain uniform scientifically laid down standards. These standards are normally termed as accounting principles. Also, these standards may be termed as accounting conventions. The textbooks refer variously to accounting principles, accounting concepts, accounting assumptions and so on, to describe those basic points of agreement on which financial accounting theory and practice are founded (Glautier and Underdown, 1987). Mostly, accounting concept could be used to refer to any of the previous terms and for the study purposes, the term accounting “**concept**” will be used as a synonym to any of those terms.

2.2 Financial Statements:

The basic tool or means of communicating financial information to the outsider or external users is a set of accounting reports that termed "**Financial Statements**". Generally, a set of financial statements includes four related accounting reports that summarize in a few pages the financial resources, obligations (or liabilities), profitability, and cash transactions of an enterprise. This set of financial statements consists of the following:

(1) A Balance Sheet:

The balance sheet is showing at a given date the *financial position* of the enterprise, by indicating the resources that it owns, the debts that it owes, and the amount of the owner's (proprietor) equity (investment) in the enterprise.

(2) An Income Statement:

The income statement is primarily indicating the enterprise's profitability over a period of time-conventionally the preceding year.

(3) A Statement of Owner's Equity:

The statement of owner's equity is prepared to explain given or certain changes in the amount of the owner's equity in his/her business i.e. the increase (or decrease) in owner's investments from the beginning to the end of a certain time period.

(4) A Statement of Cash Flows:

The statement of cash flows is providing a summary of the cash receipts and cash payments of the business over the same period covered by the income statement.

Furthermore, a complete set of financial statements should contain several pages of notes, which include additional information which accountants think that it is useful in the interpretation of the financial statements. From the above discussion on financial statements, it is appeared that the basic purpose of financial statements is to help their users evaluate the *financial position*, *profitability* and *future prospects* of an enterprise.

2.3 Generally Accepted Accounting Principles (GAAP):

Accounting principles can be defined as those rules of action or conduct which are adopted by the accountant universally while recording accounting transactions. They are the ground rules of financial accounting which are based on consensus, but they are not the subject of immutable law. The GAAP provides the general framework determining what information should be included in financial statements, and how this information is to be presented. As mentioned in the commencement of this chapter, the generally accepted accounting principles include the basic objectives of financial reporting, in addition to a variety of broad concepts and many detailed rules. Accordingly, such terms as objectives, standards, concepts, assumptions, methods, and rules often are used in describing specific generally accepted accounting principles.

But, it should be taken into account the fact that there is no comprehensive list of generally accepted accounting principles, as new accounting principles emerge continuously as business organizations enter into new forms of business activity (Meigs, et. al, 1996). The most important accounting concepts (principles) are briefly presented as follows (Maheshwari, 1996, Meigs, et. al, 1996):

1. The Concept of the Business Entity: In accounting, business is considered to be a separate entity from the proprietor (the owner). Thus, the GAAP requires that a set of financial statements describe the affairs of a specific business entity. A **business entity** is an economic unit that engages or involves in specific business activity. For accounting purposes**,** the business entity is regarded as *separate from the personal affairs of its owner(s).* For example, when someone invests

L.E.500,000 into business, it will be assumed that the owner has given that amount of money to the business which will be shown as a **liability** or obligation in the books of the business. When the owner withdraws L.E.30,000 from the business, it will be charged to him/her and the net amount payable by the business will be indicated only as L.E.470,000.

<u>2. The Going Concern Concept (Assumption)</u>: According to this concept, it is assumed that the business will continue for a fairly long time to come. Therefore, there is neither the intention nor the necessity to liquidate the particular business in the foreseeable future. Because of this concept, the accountants do not take into consideration forced sale value of enterprise’s properties while valuing these properties. The going concern concept does not mean permanent continuance of the business.

3. Money Measurement Concept: Accounting records only monetary transactions. As a result, events or transactions which cannot be expressed in terms of money do not record in the books of accounts although they may very useful for the business. Measurement of enterprise events in money assists in understanding the operations of a business in a much better way.

4. Cost Concept: This concept is closely related to going concern concept. According to this concept, enterprise's properties are normally entered on the accounting records at the price paid to acquire them and this cost is the basis for all subsequent accounting for these properties.

5. Dual Aspect Concept: This concept is considered one of the most important concepts of accounting. According to this concept, every business transaction has a dual effect. For instance, if Mohamed starts his business with a capital of

L.E.500,000, there are two aspects or effects of such transaction. The business has properties of L.E.500,000 on one hand, while the business has to pay a sum of L.E.500,000 to the owner which is taken as owner's capital on the other.

6. Accounting Period Concept: The idea behind this concept is that the life of the business is divided into appropriate segments or portions for studying the results shown by the business after each segment. According to going concern concept, the life of the business is considered to be indefinite or unlimited and the measurement of income and studying the financial position of the business after a very long period of time would not be helpful in taking right corrective steps at the appropriate time. Therefore, it will be necessary that after each time interval the business must stop and see back how things are going. In accounting such a time interval is called **accounting period**

and it is usually of a year. At the end of each accounting period, the financial statements are prepared.

7. Periodic Matching of Costs and Revenues: This concept is based upon the accounting period concept. The prime objective of running a business is to earn profit. In order to determine the profit made by the business during a particular period, it is necessary that **revenues** of the period should be matched with the **costs (expenses)** of that period. The term matching means appropriate association of related revenues and expenses. In other words, matching concepts refers that there is a close relationship between the revenues of the period and expenses incurred during such period and hence, income made by the business during a period can be measured only when the revenue earned during a period is compared with the expense borne for earning that revenue.

8. Realisation Concept: According to this concept, revenues should be recognized only when a sale of goods is actually made. Sale is considered to be made at the point when the goods pass to the purchaser and he/she becomes legally liable to pay their value.

2.4 The Starting Point in the Study of Accounting:

In practice, the accounting cycle includes three major steps: recording or journalizing accounting transactions, posting recorded events to related accounts in ledger books, and the preparation of financial statements. Accordingly, the preparation of financial statements is considered the last step in such cycle. However, the preparation of financial statements may be considered a logical point to begin the study of accounting.

Financial statements convey a summarized picture of the profitability and financial position of the business to management and to interested outside users. Financial statements are considered the final product of the accounting cycle, as they summarize the thousands or millions of transactions recorded during the year.

The three most widely used financial statements are the *Balance Sheet,* the *Income Statement,* and the *Statement of Cash Flows*. In the remaining of this chapter we will study or explore the nature of the Balance Sheet, or **Statement of Financial Position**, which is the other name of the balance sheet, to be familiar with the form and arrangement of the balance sheet and with the meanings of technical terms such as **Assets, Liabilities,** and **owner's Equity.**

The Balance Sheet:

The purpose behind the preparation of a balance sheet is to reveal or show the ***financial position*** of a given business entity at a **specific date** or determined point of a period of time. Usually, every enterprise prepares a balance sheet at the end of the year. A balance sheet consists of a listing of the **assets**, the **liabilities**, and the **owner's equity** of an enterprise. The *balance sheet date* is very important, because the financial position of a business may change quickly from date to date. Accordingly, a balance sheet is most useful when it is relatively recent. The following balance sheet illustrates the financial position of Luxor Travel Agency at December 31, 2024.

LUXOR TRAVEL AGENCY
Balance Sheet
December 31, 2024

Assets		**Liabilities & Owner's Equity**	
Cash L.E.	225000	*Liabilities:*	
Notes Receivable	100000	Note payable L.E	410000
Accounts receivable	605000	Accounts payable	360000
Supplies	20000	Salaries payable	30000
Land	1000000	Total Liabilities	800000
Building	900000	*Owner's equity*	
Office Equipment	150000	Amr, Capital	2200000
Total	***3000000***	*Total*	***3000000***

The main features of this balance sheet are presented as follows:

The **Title** (heading) sets forth three things; a) the name of the business entity, b) the name of the financial statement, and c) the balance sheet date. The **Body** of the balance sheet consists of three special sections; *Assets*, *Liabilities*, and *Owner's Equity*.

In the above balance sheet, also, you will see that cash is listed first among the assets, followed by notes receivable, accounts receivable, supplies, and any other assets that will *soon be converted or transferred to cash or used up in business operations*. Following these relatively **liquid** assets are the more **permanent** assets, such as land, buildings, and equipment. **Liabilities** are presented before owner's equity. Each main type of liability, such as notes payable, accounts payable, and salaries payable, is listed separately, followed by a figure which shows total liabilities. Furthermore, you will see that the amount of total assets (L.E.3000000) is ***equal*** to the total amount of liabilities and owner's equity (L.E.3000000). This relationship ***always exists.*** The *equality of these totals* is one reason that this financial statement is termed a ***balance*** sheet.

According to the concept of the **business entity**, **LUXOR** is a business organization operating as a travel agency. The owner of this organization, Mr. Amr, may have a personal bank account, a house, a car, a computer, and even another business. These items or properties are not involved or worked in the operation of the travel agency and must not show or appear in **LUXOR's** financial statements (i.e. balance sheet). When the owner tries to intermix (intermingle) his/her personal affairs with the transactions of the enterprise or entity, the resulting financial statements would fail to show obviously the financial position and the results of operations of this enterprise.

ASSETS:

Assets are defined as economic resources that are owned by a business enterprise and are expected to benefit or utilize future operations of that enterprise. In effect, assets may have determined or definite (clear) physical form or shape such as buildings, cars, equipment, or an inventory (stock) of goods (merchandise), on one hand. Some assets exists not in physical or tangible (material) form, but in form of valuable legal claims or rights such as amounts due from customers (accounts receivable) and patent rights, on the other.

According to accounting principles, the valuation of most assets in a balance sheet should be at cost, rather than at appraised marked values, which is known as the cost principle discussed previously. As such, assets such as land, buildings, cars, and equipment are typical of the many economic resources that will be used in yielding or producing revenues or income for the business. The prevailing accounting point of view is that such assets should be recorded at their original cost. The original cost appeared in the balance sheet of the asset to the business entity means that such asset should be recorded at its ***historical cost***. This amount may be very different from the asset's current market value. For example, when **LUXOR** bought the land paid L.E.1000000 in cash. The amount considered to be entered in the accounting records as the value of the asset was the cost of L.E.1000000. If we assumed that the fair market value of the land 15 years later might be L.E.3000000, although the market or economic value of the land has got up or risen greatly, the accounting value as illustrated in the accounting records and on the balance sheet would continue unchanged at the cost of L.E.1000000.

Another accounting principle or assumption related to cost principle is the **going-concern assumption.** In practice, it will be proper to question why accountants do not change the recorded value of assets to follow or correspond with changing market values of such assets. Perhaps one reason is that the land and building, for example, being used to house the business were obtained or acquired for **use** and not for sale.

LIABILITIES:

Generally, liabilities are debts or obligations and the person or enterprise to which the debt is owed is termed a *creditor*. In fact, most, if not all, businesses have liabilities; even the largest or biggest and most successful enterprises often purchase goods, supplies, and services on account. The liabilities emerged from such purchases are called *accounts payable*. Many organizations borrow money from financial institutions to finance their expansion or the high-cost assets. Among liabilities is a *note payable*, which is a written promise or commitment to repay the amount owed by a specified date and usually calls for the payment of interest, in addition to its value.

In contrast with notes payable, *accounts payable* require no written promises or commitments and in most cases do not call for interest payments. Therefore, a note payable is considered a **more formal** arrangement. When a business entity has both notes payable and accounts payable, the two types of liabilities are listed separately in the business' balance sheet. Other types of short-term obligations, such as salaries (wages) payable can either be listed separately or combined with the amount presented as accounts payable. The liabilities section of the balance sheet should encompass a subtotal indicating the total amount of liabilities, as we saw in **LUXOR's** balance sheet.

It should be noticed that liabilities represent **claims** against the enterprise's assets. The owner of an enterprise also has claims to the business' assets. But legally, creditors' claims **have priority** over those of the owners. As such, creditors are qualified or entitled to be **paid in full**, even if such payment should cover or exhaust the assets of the enterprise and let nothing for its owners.

OWNER'S EQUITY:

As we might understand from preceding discussion, **owner's equity** represents the *owner's claim* to the assets of the enterprise. As creditors' claims have legal priority over those of the owner, owner's equity is a **remaining or residual amount.** If you are the proprietor of a business, you are qualified to *whatever's left* after satisfying the claims of creditors in full. Hence, owner's equity is always equal to *total assets minus total* *liabilities*. For instance, consider the data of Luxor Travel Agency, as follows:

Luxor has total assets of …………….L.E.3000000

And total liabilities of ……………………......800000

Accordingly, the owner's equity should be $\boxed{\textbf{2200000}}$

Therefore, owner's equity does ***not*** represent a determined claim to cash or any other specific asset. But, it is the owner's *overall financial interest* in the entire business. Increase in owner's equity in a business comes from two sources:

a) Investment by the owner.

b) Earnings from profitable operation of the enterprise.

On the other hand, decreases in owner's equity also are occurred or caused in two ways:

a) Withdrawals of cash or other assets by the owner.

b) Losses from unprofitable operation of the business.

2.5 The Accounting Equation:

In effect, the whole body of financial accounting is based upon a very simple idea which is called **accounting equation.** In other words, a fundamental characteristic of every balance sheet is that the total figure for assets always equals the total of liabilities plus owner's equity. This balance of total assets with the total of liabilities and owner's equity is one reason for calling this financial statement a **balance sheet**. The pound totals on the two sides of the balance sheet are always equal because these two sides are merely two views of the same business property. The listing of assets shows us what things the enterprise owns; the listing of liabilities and owner's equity tells us who provided or supplied these resources to the enterprise and how much each group supplied. Anything that an enterprise owns has been supplied to such enterprise either by creditors or by the owner. Accordingly, the total claims of the creditors in addition to the claim of the owner equal the total assets of the enterprise.

The equality of assets on the one hand and of the claims of the creditors and the owner on the other hand can be expressed in the following **accounting equation**:

Assets = Liabilities + Owner's Equity
L.E.3000000 = L.E.800000 + L.E.2200000

Notice that the amounts appeared in this accounting equation were obtained from the balance sheet of Luxor Travel Agency. The balance sheet is considered as a detailed statement of this equation. Also, to assert that the owner's equity is a **remaining claim**, secondary to the claims of creditors, it is often assisting to convert or transfer the terms of the equation as presented below:

Assets – Liabilities = Owner's Equity
L.E.3000000 – L.E.800000 = L.E.2200000

It should be kept in mind that if a business has liabilities more than or in excess of its assets, the owner's equity will be a negative amount.

In practice, every economic transaction can be explained or expressed in terms of its effect or influence on the accounting equation. Regardless of whether an enterprise grows or deflates (contracts) this balancing or equality between the assets and the claims against the assets is always remained or maintained. Any increase in the amount of total assets is imperatively (necessarily) accompanied by an equal increase on the other side of the equation, that is, by an increase in either the liabilities or the owner's equity and vice versa. The continuing equality of the two sides of the balance sheet will be highlighted in the next example to observe the effects of various transactions of a new business on its balance sheet.

A Preliminary Illustration:

In this illustration, the effects of business transactions on its balance sheet and the basic accounting concepts and procedures will be considered. A small auto repair will be used as an example.

The Business Entity: Assume that Ahmed Adel, an experienced auto mechanic, starts his special automotive repair business, **Engineer Auto Service**.

Engineer's Accounting Policies: Ahmed Adel has taken several courses in accounting in the Accounting Department, at the Faculty of Commerce, South Valley University and he will maintain Engineer accounting records himself.

The Business' First Transaction:

Ahmed Adel began his business officially on November 1, 2024, by allocating L.E.800,000 of his personal savings, for his business . This transaction provided Engineer with its first **asset-** Cash - and also created the initial owner's equity in the business entity. A balance sheet indicating the enterprise's financial position after this initial transaction shows below:

ENGINEER AUTO SERVICE
Balance Sheet

Assets November 1, 2024 **Liabilities & O. Equity**

Cash L.E.	800000	Ahmed Adel, Capital	800000
Total	*800000*	*Total*	*800000*

Engineer's next two transactions included the acquisition of a suitable site for its business operations.

Purchase (Buying) of an Asset for Cash: Representing the enterprise, Ahmed Adel negotiated with the City Council of Qena to purchase an abandoned old bus garage that its building is owned by the City Council and its land is owned to some people.

On November 3, Engineer purchased the land from its owner for **L.E.520,000 cash.** The analysis of this transaction revealed that it had two immediate effects on the business' financial position: first, Engineer's cash was reduced by L.E.520,000; and second, the business acquired a new asset-Land. The Enterprise's financial position following this transaction was as follows:

ENGINEER AUTO SERVICE
Balance Sheet
Assets November 3, 2024 **Liabilities & Owner's Equity**

Cash L.E.	280000	Ahmed Adel, capital	800000
Land	520000		
Total	*800000*	*Total*	*800000*

Purchase of an Asset and Financing Part of the Cost: On November 5, Engineer purchased the old garage building from the City Council for

L.E.360,000. Engineer made a cash down payment of **L.E.60,000** and issued a 90-day non-interest-bearing note payable for the **L.E.300,000** balance owed.

Because of this transaction, Engineer had (a) **L.E.60,000** less cash; (b) a new asset, Building, which cost **L.E.360,000**; and (c) a new liability, Note Payable, in the amount of **L.E.300,000.** This transaction is shown in the following balance sheet:

ENGINEER AUTO SERVICE
Balance Sheet
Assets November 5, 2024 **Liabilities & Owner's Equity**

Cash L.E.	220000	Notes Payable	300000
Land	520000	Owner's equity	
Building	360000	Ahmed Adel, capital	800000
Total	*1100000*	*Total*	*1100000*

Purchase of an Asset "On Account": On November 17, Engineer purchased tools and automotive repair equipment from United Tools Group. The purchase price was **L.E.138,000,** due within 60 days. Following this purchase, Engineer's financial position was as follows:

ENGINEER AUTO SERVICE
Balance Sheet
Assets November 17, 2024 **Liabilities & Owner's Equity**

Cash L.E.	220000	Notes Payable	300000
Land	520000	Accounts Payable	138000
Building	360000	Owner's equity	
Tools and equipment	138000	Ahmed Adel, capital	800000
Total	*1238000*	*Total*	*1238000*

Sale of an Asset: After taking delivery of the new tools and equipment, Engineer discovered that it had purchased more than it required. Some neighboring business offered to buy the excess items. On November 20, Engineer sold some of its new tools for **L.E.18,000,** which is equal to Engineer's cost. The purchaser made no down payment, but agreed to pay the amount due within 60 days. A balance sheet after this transaction, as of November 20 appears below:

ENGINEER AUTO SERVICE
Balance Sheet

Assets November 20, 2024 **Liabilities & Owner's Equity**

Cash L.E.	220000	Notes Payable	300000
Accounts receivable	18000	Accounts Payable	138000
Land	520000	Owner's equity	
Building	360000	Ahmed Adel, capital	800000
Tools & equipment	120000		
Total	*1238000*	*Total*	*1238000*

Collection of an Account Receivable: On November 25, Engineer collected **L.E.6,000** as partial settlement of Accounts receivable. This transaction will result in an increase in Engineer's cash and a decrease of the same amount in accounts receivable. In fact, this transaction only converts one asset into another of equal value; there is no change in the amount of total assets. A balance sheet of Engineer as of November 25 appears below:

ENGINEER AUTO SERVICE

Balance Sheet

Assets November 25, 2024 **Liabilities & Owner's Equity**

Cash L.E.	226000	Notes Payable	300000
Accounts receivable	12000	Accounts Payable	138000
Land	520000	Owner's equity	
Building	360000	Ahmed Adel, capital	800000
Tools & equipment	120000		
Total	*1238000*	*Total*	*1238000*

Payment of a Liability: On November 30, Engineer made a partial payment of **L.E.68,000** on its accounts payable. In essence, this transaction reduced Engineer's cash and accounts payable by the same amount, leaving total assets and the total of liabilities in addition to owner's equity equal. Engineer's balance sheet at November 30 may be summarized as follows:

ENGINEER AUTO SERVICE

Balance Sheet

Assets November 30, 2024 **Liabilities & Owner's Equity**

Cash L.E.	158000	Notes Payable	300000
Accounts receivable	12000	Accounts Payable	70000
Land	520000	Total liabilities……	370000
Building	360000	Owner's equity	
Tools & equipment	120000	Ahmed Adel, Capital	800000
Total……	*1170000*	*Total……………*	*1170000*

Summarizing the Effects of the Above Transactions Made by Engineer on the Accounting Equation:

As we noted in the preceding discussion, it is appeared that the balance sheet is a detailed expression of the accounting equation, as summarized below:

Assets = Liabilities + Owner's Equity

In the preceding pages, the impacts of Engineer's November transactions upon the balance sheet were illustrated in detail. Now, the impacts of these transactions on the ***accounting equation*** will be presented below:

To remember, Engineer's business transactions during November were as follows:

-November 1 Ahmed Adel started his new business by allocating **L.E.800,000** for his business.

-November 3 Purchased land for **L.E.520,000**, paying by cash.

-November 5 Purchased an old building for **L.E.360,000**, paying **L.E.60,000** in cash and issuing a note payable for the rest of due amount, **L.E.300,000.**

-November 17 Purchased tools and equipment on account, **L.E.138,000.**

-November 20 Sold some of the tools at a value equal to their cost, **L.E.18,000,** collectible within 60 days.

-November 25 Received **L.E.6,000** in partial collection of the accounts receivable from the sale of tools.

-November 30 Paid **L.E.68,000** in partial payment of an accounts payable.

The effects of these transactions on the accounting equation are shown in the following table:

	Assets					**=Liabilities**			**Owner's +Equity**
	Cash	**+Accounts Receivable**	**+Land**	**+Building**	**+Tools and Equipment**	**=**	**Notes payable**	**+Accounts payable**	**+Adel's capital**
1	**800000**					**=**			**800000**
B.	800000					=			800000
3	**-520000**		**+520000**			**=**			______
B.	280000		520000			=			800000
5	**- 60000**		______	**+360000**		**=**	**+300000**		______
B.	220000		520000	360000		=			800000
17	______		______	______	**+138000**	**=**	______	**+138000**	______
B.	220000		520000	360000	138000	=	300000	138000	800000
20	______	**+18000**	______	______	**-18000**	**=**	______	______	______
B.	220000	18000	520000	360000	120000	=	300000	138000	800000
25	**+6000**	**-6000**	______	______	______	**=**	______	______	______
B.	226000	12000	520000	360000	120000	=	300000	138000	800000
30	**-68000**	______	______	______	______	**=**	______	**-68000**	______
B.	158000	12000	520000	360000	120000	=	300000	70000	800000
	=====	====	======	======	======		=====	======	======

Notice: B. (Balances).

2.6 Exercises and Problems:

1- The accounting data for Crystal Auto Wash at December 31, 2024, are shown below. The figure for Sayed Hamed, capital is not given but it can be determined when all the available information is assembled in the form of a balance sheet.

Accounts payable **L.E.70,000** Land **L.E.340,000** Accounts receivable **L.E.4,000** Machinery & equipment **L.E.325,000** Buildings **L.E.260,000** Note payable **L.E.145,000** Cash **L.E.46,000** Salaries payable **L.E.15,000** Sayed Hamed**,** capital **?** Supplies **L.E.2,000.**

Required:

Prepare a balance sheet at December 31, 2024.

Solution:

CRYSTAL AUTO WASH
Balance Sheet
December 31, 2024

Assets (L.E.)		**Liabilities & Owner's Equity(L.E.)**	
Cash	46000	Liabilities:	
Accounts receivable	4000	Notes payable	145000
Supplies	2000	Accounts payable	70000
Land	340000	Salaries payable	15000
Building	260000	Total liabilities	230000
Machinery & Equipment	325000	Owner's equity:	
		Sayed H, Capital	**747000**
Total…………..	*977000*	*Total………*	*977000*

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2- The night manager of Cairo Limousine Service, who had no accounting background, prepared the following balance sheet for the enterprise at December 31, 2024. The pound amounts were taken directly from the enterprise's accounting records and are correct. Nevertheless, the balance sheet contains a number of errors in its headings, format, and the classification of assets, liabilities, and owner's equity.

CAIRO LIMO

Manager's Report

Assets (L.E.) 12 Noon Monday Owner's Equity (L.E.)

Aatif, capital	810000	Accounts receivable	390000
Cash	345000	Notes payable	1440000
Building	400000	Supplies	70000
Automobiles	825000	Land	350000
		Accounts payable	130000
Total	*2380000*	*Total*	*2380000*

Required:

Prepare a corrected balance sheet. Include a proper heading.

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3-The balance sheet items of the Gold Star Enterprise as of December 31, 2024, are shown below in random order. You are required to prepare a balance sheet for the enterprise, using a similar sequence of assets as you understood from your study of accounting. You should calculate the amount for Maha, Capital.

Land	L.E.450,000	Office equipment	L.E.51,000
Accounts payable	219,000	Building	1050,000
Accounts receivable	283,500	Maha, capital	?

Cash	181,500	Notes payable	1068,000

* * *

4- Compute the missing amount in each of the following three lines:

	Assets	=	Liabilities	+	Owner's Equity
a.	L.E.2,790,000	=	1,710,000	+	?
b.	?	=	2,812,500	+	1,875,000
c.	1,537,500	=	?	+	712,500

* * *

5- Listed below are some items to be included in the balance sheet of **Freedom Hotel** at December 31, 2024:

Land	L.E.2,125,000	Manar, capital L.E.	?
Equipment	146,000	Buildings	2,250,000
Accounts payable	274,000	Cash	107,000
Accounts receivable	53,000	Furnishings	293,500
Salaries payable	167,500	Car	77,000
Interest payable	60,000	Notes payable	3,100,000

Required:

Prepare an organised balance sheet at December 31, 2024, including a proper heading.

* * *

6- Listed below are some items to be included in the balance sheet of **Travel Golden Arrow Business** owned by Mai as on January 31, 2025:

Accounts payable L.E.130,500 Notes payable L.E.900,000 Accounts receivable L.E.37,250 Notes receivable L.E.47,500 Cars L.E.945,300 Equipment L.E.447,900 Land L.E.123,150 Mai, capital L.E.1,686,150 Cash L.E. ? Salaries payable L.E.48,750 Tents L.E.472,500 Trucks L.E.529,200

Required:

Prepare a balance sheet by using these items and computing the amount of cash at January 31, 2025.

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7- Listed below in random order are the balance sheet items for **Toshka Farms** at June 30, 2025:

Land L.E.2,750,000 Fences & gates L.E.167,850 Barns & sheds L.E.391,500 Irrigation system L.E.100,625 Notes payable L.E.2,650,000 Cash L.E.83,550 Accounts receivable L.E.111,825 Livestock L.E.715,725 Citrus trees L.E.383,250 Farm machinery L.E.214,850 Accounts payable L.E.385,475 Adam, capital L.E. ? Taxes payable L.E.45,675 Wages payable L.E.9,100.

<u>Required:</u>

Prepare a balance sheet by using these items and computing the amount for Adam, capital.

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8- The balance sheet items for the Qena Bakery were as follows at December 1, 2024. (You are to compute the missing figure for owner’s equity):

Accounts payable L.E.81,000 Capital L.E.? Accounts receivable L.E.56,300 Land L.E.335,000 Building L.E.420,000 Notes payable L.E.374,500 Cash L.E.34,700 Salaries payable L.E.44,500 Equipment & fixtures L.E.222,500 Supplies L.E.35,000.

During the next two days, the following transactions occurred:

Dec. 2 The owner invested an additional L.E.125,000 in the business. The accounts payable were paid in full.

Dec. 3 Equipment was purchased at a cost of L.E.36,000 to be paid within 10 days. Supplies were purchased for L.E.6,250 cash from a restaurant supply centre which was going out of business. These supplies would have cost

L.E.9,450 if purchased through normal channels.

Required:

a- Prepare a balance sheet at December 1, 2024.

b- Prepare a balance sheet at December 3, 2024.

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9- The balance sheet items of The Egyptian Food Shop (arranged in alphabetical order) were as follows at the close of business on December 31, 2024:

Accounts payableL.E.42,500 Land L.E.275,000 Accounts receivable L.E.6,250 Notes payable L.E. ? Building L.E.227,500 Capital L.E.270,450 Cash L.E.37,000 Supplies L.E.17,200 Furniture L.E.100,000.

During the first week of January 2025, the following transactions were occurred:

(1) **Jan. 3** The owner invested an additional L.E.150,000 cash in the business. The accounts payable were paid in full.

(2) **Jan 6** More furniture was purchased on account at a cost of L.E.90,000, to be paid within 30 days. Supplies were purchased for L.E.5,000 cash from a restaurant supply centre which was going out of business. These supplies would have cost L.E.9,375 if purchased under normal circumstances.

Required:

a- Prepare a balance sheet at December 31, 2024. (You are to compute the missing figure for notes payable).

b- Prepare a balance sheet at January 6, 2025.

CHAPTER THREE

AN INTRODUCTION TO THE ACCOUNTING CYCLE

CHAPTER THREE

AN INTRODUCTION TO THE ACCOUNTING CYCLE

3.1 Introduction:

In Chapter One of this text, it has been discussed that accounting is the process of recording, classifying and summarizing the financial transactions. The continuance or sequence of accounting procedures used to record, classify, and summarize accounting information is often called or termed the ***Accounting Cycle***. In practice, the accounting cycle starts with the initial recording of business transactions and concludes with the preparation of financial statements summarizing the effects of these transactions on the assets, liabilities, and owner's equity of the enterprise.

The term ***cycle*** refers that these procedures must be repeated continuously to enable the enterprise to prepare new and up-to-date financial statements at reasonable periods or intervals. Therefore, the accounting procedures must be followed to complete accounting cycle involves the following stages:

1- **Recording of transactions in the book termed as "Journal".** When each business transaction occurs, it is entered in the journal, thus creating a chronological record of event. This stage completes the recording step in the accounting cycle.

2- **Posting to the accounts in the book termed as "Ledger" (Classifying the transactions).** As it will be discussed, the debit and credit changes in account balances are posted from *journal* to *ledger*. This procedure classifies the effects of the financial transactions in terms of specific assets, liability, and owner's equity accounts.

***3*- Summarizing the transactions.** This stage includes preparation of the trial balance and financial statements. **A trial balance** proves the equality or the balance of the debit and credit entries in the *ledger*. The purpose of this procedure is to verify the accuracy of the posting process and the computation of ledger account balances. **The preparation of financial statements** summarizes the effects of business transactions occurring through the date of the statements and completes the accounting cycle.

3.2 The Double-Entry System for Accounting (The Equality of Debits and Credits):

The system or rules for debits and credits are designed so that *<u>every transaction is recorded by equal pound amounts of debits and credits</u>*. The reason for this equality lies in the relationship of the debit and credit rules to the accounting equation, explained earlier in Chapter Two, as follows:

Asset	**= Liabilities + Owner's Equity**
Debit balances	**= Credit balances**

As such, if this equation is to remain in balance, any change in the left side of the equation (**assets**) ***<u>must be followed by an equal change</u>*** in the right hand side (**either liabilities or owner's equity**). According to the debit and credit rules, increases in the left side of the equation (**assets**) are recorded by **<u>debits</u>**, while increases in the right side (**liabilities and owner's equity**) are recorded by **credits**.

This system is often termed or called **double-entry accounting**. The term "**double-entry**" refers to the need for both *debit entries* and *credit entries*, equal in pound amount, to record every transaction. In practice, every business organization uses the double-entry system. The double-entry system allows us to measure net income at the same time we record the effects of business transactions on balance sheet accounts.

Historically, double-entry accounting is not a new idea. The system has been in use for more than 600 years. It was discussed in accounting literature that the first systematic presentation of the double-entry system appeared in a mathematics textbook written by Luca Pacioli. This text was published in 1494. Although Pacioli wrote the first textbook on this subject, surviving accounting records show that double-entry accounting had already been in use for at least 150 years (Meigs et. al, 1996).

3.3 The Journal:

In an actual accounting system, the information regarding each business transaction is initially recorded or journalized in an accounting record called the ***journal***. All daily transactions of a business are recorded in the journal in the order in which they occur. A journal may accordingly be defined as a book including a chronological record of transactions. It is the book in which the transactions are recorded first of all according to the double-entry system. Because the journal is the accounting record in which transactions are **first recorded**, it is sometimes called the ***book of original entry or record***.

As it was mentioned above, the journal is a chronological or **day-by-day** record of business transactions. The information recorded about each transactions contains the date of the transaction, the debit and credit changes in specific ledger accounts, and a brief explanation of the recorded transaction. At convenient intervals or periods, the debit and credit amounts recorded in the journal are transferred or **posted** to the accounts in the ledger and the updated ledger accounts, in turn, serve as the basis for preparing the balance sheet and other financial statements, as we will see in the succeeding sections.

3.3.1 The Usefulness of the Journal:

In accounting domain, the unit of organization for the journal is the **transaction**, whereas the unit of organization for the ledger is the **account.** By having both a journal and a ledger, we achieve several advantages which would not be possible or attained if transactions were recorded directly in ledger accounts, such as:

1. **The journal shows all information about a transaction in one place and also provide an explanation or particulars of the transaction.** In a journal entry, the debits and credits for a given transaction are recorded together, in the contrary, when the transaction is recorded in the ledger, the debits and credits are entered in different accounts. As a ledger may include hundreds of accounts, it would be very difficult to locate all the facts regarding a given transaction by looking in the ledger. The journal is the record which shows the complete story of a transaction in one entry.

***2.* The journal provides a chronological record of all the events in the life of the enterprise.** For example, if we would like to look up the facts about a transaction of some months or years back, all we need is the date of the transaction in order to find or locate it in the particular journal.

3. The use of a journal assists in preventing errors. If transactions were recorded directly in the ledger, it would be very easy to make errors such as omitting or neglecting the debit or the credit, or entering the debit twice or the credit twice (errors of repeating). Such errors are not likely to be made in the journal, since the offsetting or compensating debits and credits appear together for each transaction.

3.3.2 The General Journal:

In practice, many enterprises keep several types of journals. However, the nature of operations and the volume of transactions in the given business enterprise determine the number and type of journals required. The simplest and most famous type of journal is called a **general journal** and a pro forma of this journal is given below:

GENERAL JOURNAL				**Page 1**
Date	**Account Title & Explanation**	**LP**	**Debit**	**Credit**
(1)	(2)	(3)	(4)	(5)
2025	xxxxxx	xx	xxxx	
Jan. 1	xxxxxx			xxxx

A general journal has only two money columns, one for debits and the other for credits and it may used for recording any type of transaction. The process of recording a transaction in a journal is called **journalizing** the transaction. The main sections of a particular page of the general journal include the following information:

***1*- Date:** The date on which the transaction was entered is recorded here.

***2*- Account Title and Explanation:** the two aspects of the transaction are recorded in this column. In other words, the details regarding accounts which have to be debited and credited are recorded here.

***3*- LP:** It means Ledger Page. The transactions entered in the journal are later posted to the Ledger. Procedures about posting the transactions in the Ledger will be explained later.

***4*- Debit:** In this column, the amount to be debited is entered.

***5*- Credit:** In this column, the amount to be credited is entered.

3.3.3 Rules of Debit and Credit:

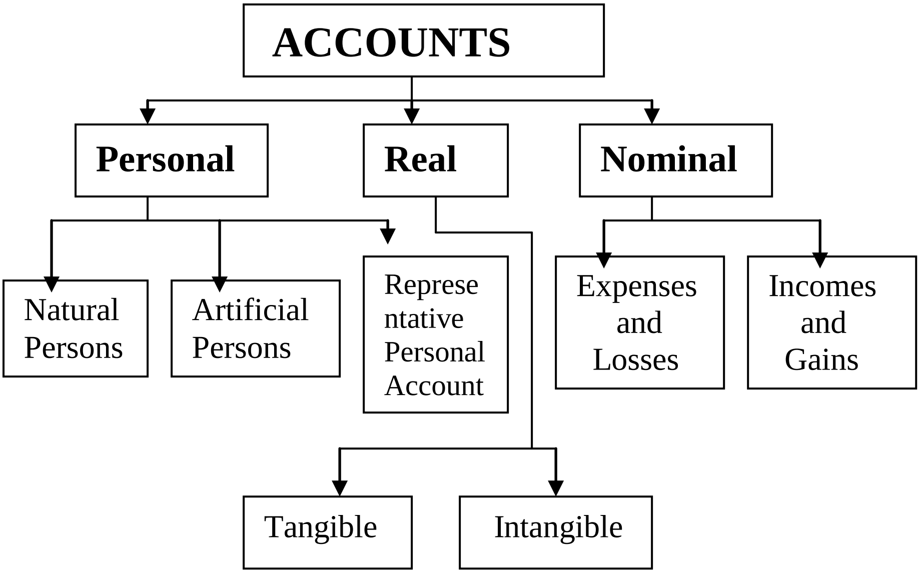
The transactions in the Journal are recorded or journalized on the basis of the rules of debit and credit and for this purpose business transactions have been classified into three categories as follows:

***1*- Transactions relating to persons.**
***2*-Transactions relating to properties and assets.**
***3*- Transactions relating to income and expense.**

Accordingly, it is necessary for the business entity to keep or maintain an account of:

***1)* Each person with whom it deals.**
***2)* Each property or asset which the business entity owns.**
***3)* Each item of income or expense.**

The accounts which fall under the first one of the above headings are called ***Personal Accounts***. The accounts which fall under the second one of the above headings are termed as ***Real Accounts***. The accounts which fall under the third one of the above headings are termed as ***Nominal Accounts***. The above classification of accounts can be presented as follows:



3.3.3.1 Personal Accounts:

Personal accounts encompass the accounts of persons with whom the business entity deals or contacts. These accounts can be classified also into three categories as follows:

(1) Natural Personal Accounts: The term ***Natural Persons*** refers to persons who are creation of **Allah**, for instance, Mohamed's Account, Adel's Account, Yaser's Account, Kamal's Account etc.

(2) Artificial Personal Accounts: This category of accounts includes accounts of corporate bodies or institutions which are recognized as persons in business dealings. For example, the account of Insurance Company, the account of a Club, the account of a Society, the account of Government, the account of the Tax Administration etc.

(3) Representative Personal Accounts: By these account we mean accounts which represent a certain person or group of persons. For instance, if the salaries are due to the employees, an outstanding salaries account will be opened in the business books. Also, if the rent is due to the landlord, an outstanding rent account will be opened. The outstanding salaries account represents the accounts of the persons to whom the salaries have to be paid while the outstanding rent account represents the account of the landlord to whom the rent is to be paid. Such accounts are thus termed as ***Representative Personal Accounts***.

Accordingly, the **rule** is:

Debit the receiver, and
Credit the giver.

For instance, if cash have been paid to Mostafa, Mostafa Account will have to be **debited** and Cash Account will have to be **credited**. Similarly, if the business entity received cash from Adel, Cash Account will have to be **debited** and Adel Account will have to be **credited.**

3.3.3.2 Real Accounts:

This category of accounts may include the following types:

(1) Tangible Real Accounts: Tangible Real Accounts are those accounts which relate to such things which can be touched, felt, measured etc. They are often material things. Examples of such accounts include building account, car account, furniture account, cash account, stock account etc. It should be kept in mind that bank account is a personal account, because it represents the account of the banking enterprise- an artificial person.

(2) Intangible Real Accounts: Intangible Real Accounts are those accounts that represent such things which cannot be touched. However, they can be measured in terms of money. For example, goodwill account, patent account etc.

Accordingly, the **rule** is:

Debit what comes in, and
Credit what goes out.

For instance, if car has been purchased for cash, car account should have to be **debited**, as it is coming in the business, while cash account should have to be **credited**, because cash is going out the business. Similarly, when equipment is purchased for cash, equipment account should have to be **debited** while the cash account should have to be **credited.**

3.3.3.3 Nominal Accounts:

Nominal Accounts are opened in the enterprise books to simply explain the nature of the transactions. They do not really exist. For example, in a business, salary is paid to the manager or employee, rent is paid to the landlord, commission is paid to the salesperson, cash goes out of the business and it is something real, while salary, rent or commission, as such do not exist. The accounts of these items are opened simply to explain how the cash has been used or spent. In the absence of such information, it will be difficult for the person concerned to explain how the cash at his disposal was utilized. Nominal Accounts include accounts of all expenses, losses, incomes and gains. Examples of such accounts are rent, salary, lighting, insurance, dividends, loss by fire etc.

Accordingly, the **rule** is:

Debit all expenses and losses, and
Credit all incomes and gains.

Important Notice: **It should be noted that when some prefix or suffix is added to a Nominal Account, it becomes a Personal Account.**

Examples which explain this notice are given below:

Nominal Account	**Personal Account**
1- Rent Account	**- Prepaid rent account, Outstanding rent (payable) account.**
2- Interest Account	- Outstanding interest (payable) account, Interest received in advance account, Prepaid interest account
3- Salary Account	**- Outstanding salaries (payable) account, Prepaid salaries account.**
4- Insurance Account	- Outstanding insurance (payable) account, Prepaid insurance account.
5- Commission Account	**- Outstanding commission (payable) account, Prepaid commission account, Commission received in advance account.**

Illustration 3.1:

You are given the following transactions; you are required to determine the nature of account (a/c) and also state which account should be debited and which account should be credited:

(1) Lighting paid. (2) Salaries paid. (3) Interest received. (4) Dividends received. (5) Furniture purchased for cash. (6) Machinery sold.

(7) Outstanding for salaries. (8) Telephone charges paid. (9) Paid to Mohamed. (10) Rent paid.
(11) Received from Adel (the owner).

Solution:

Transaction	**Accounts involved**	**Nature of Accounts**	**Debit or Credit**
(1) lighting paid	Lighting a/c	Nominal a/c	Debit
	Cash a/c	Real a/c	Credit
(2) salaries paid	Salaries a/c	Nominal a/c	Debit
	Cash a/c	Real a/c	Credit
(3) Interest Received	Cash a/c	Real a/c	Debit
	Interest a/c	Nominal a/c	Credit
(4) Dividends received	Cash a/c	Real a/c	Debit
	Dividends a/c	Nominal a/c	Credit
(5) Furniture purchased	Furniture a/c	Real a/c	Debit
	Cash a/c	Real a/c	Credit
(6) Machinery Sold	Cash a/c	Real a/c	Debit
	Machinery a/c	Real a/c	Credit
(7) Outstanding for salaries	Salaries a/c	Nominal a/c	Debit
	Outstanding Salaries a/c	Personal a/c	Credit
(8) Telephone charge paid	Telephone charge a/c	Nominal a/c	Debit
	Cash a/c	Real a/c	Credit
(9) Paid to Mohamed	Mohamed a/c	Personal a/c	Debit
	Cash a/c	Real a/c	Credit
(10) Rent paid	Rent a/c	Nominal a/c	Debit
	Cash a/c	Real a/c	Credit
(11) Received from Adel (the owner)	Cash a/c	Real a/c	Debit
	Capital a/c	Personal a/c	Credit

With the help of the following illustrations we will now explain the recording or journalizing of the various transactions occurring in a business entity:

Illustration 3.2:

(1) Ramadan commences a business with a capital of L.E.200,000 on January 1, 2025.

In this transaction, there are two accounts involved, which are:

a- The account of Ramadan, and

b- Cash account.

Ramadan is a natural person and, hence, his account is a Personal Account. Cash Account is a tangible asset and, therefore, it is a Real Account. According to the **rules of Debit and Credit** applicable to Personal Accounts, Ramadan is the giver and, thus, his account, Capital Account should be credited. Cash is coming in the business and, therefore, as per the rules applicable to Real

Accounts, it should be debited. This transaction can be entered in the Journal as follows:

GENERAL JOURNAL				**Page 1**
Date	**Account Title and Explanation**	**LP**	**Debit**	**Credit**
2025 Jan.1	By Cash Account To Capital Account Being commencement of business.		200000	 200000

Notices:

Efficient use of a general journal needs two things:

a. Ability to analyze the effect of a transaction upon assets, liabilities, and owner’s equity (Capital); and

b. Familiarity with the standard form and arrangement of journal entries.

At this point, the primary interest is in the analytical phase of recording or journalizing; the procedural steps can be learned quickly by observing the following points in the illustration of the above entry:

1- The year, month, and day of the first entry on the page are written in the date column. The year and month need not be repeated for subsequent entries until a new page or a new month is begun.

2- The name of the account to be debited is written for the first line of the entry and is conventionally placed at the extreme left next to the date column. The amount of the debit is entered on the same line in the **left-hand** money column.

3- The name of the account to be credited is entered on the line below the debit entry and is **indented**, that is, placed about 1 inch to the right of the date column. The amount credited is entered on the same line in the **right-hand** money column.

4- A brief explanation of the transaction begins on the line immediately below the last account credited. This explanation includes any data required to identify the transaction, such as the name of the customer or supplier. The explanation is not intended (For example, being commencement of business.

5- A blank line should be left after each entry. This spacing causes each journal entry to appear or stand out clearly as a separate unit and makes the journal easier to read.

6- The LP (Ledger page) column just to the left of the debit money column is left blank at the time of making the journal entry. When the debits and credits are later transferred to ledger accounts, the numbers of the ledger accounts will be listed in this column to provide an appropriate cross-reference with the ledger.

(2) Ramadan purchased furniture for cash for L.E.50,000 on January 5, 2025.

In this transaction, the two accounts involved are the Furniture Account and the Cash Account. Both are Real Accounts. Furniture is coming in and, thus, it should be **debited** while cash is going out and, accordingly, it should be **credited**. The journal entry will be presented as follows:

GENERAL JOURNAL Page 1				
Date	**Account Title and Explanation**	**LP**	**Debit**	**Credit**
5	By Furniture Account		50000	
	To Cash Account			50000
	Being purchase of furniture.			

(3) Ramadan paid rent for business premises L.E.20,000 on January 10, 2025.

Two accounts involved in this transaction which are the Rent Account and the Cash Account. Rent Account is a Nominal Account. It is an expense and, therefore, it should be **debited.** Cash Account is a Real Account. It is going out of the business and, accordingly, it should be **credited.** The journal entry of this transaction will be as follows:

GENERAL JOURNAL		Page 1		
Date	**Account Title and Explanation**	**LP**	**Debit**	**Credit**
10	By Rent Account To Cash Account Being payment of rent.		20000	 20000

(4) Ramadan purchased goods on credit (on account) of L.E.20,000 from Hassan on January 20, 2025.

The two accounts involved in this transaction are those of Hassan and Goods. The account of Hassan is a personal Account while that of Goods is a Real Account. Hassan is the giver of goods and, hence, his account should be **credited** while Goods are coming in the business and, therefore, Goods Account should be **debited**. The journal entry of this transaction will be as follows:

GENERAL JOURNAL Page 1				
Date	**Account Title and Explanation**	**LP**	**Debit**	**Credit**
20	By Goods Account To Hassan Account Being purchase of goods on credit.		20000	20000

Classification of Goods Account:

At this point, it may be necessary to explain what is meant by the term **Goods**. The term goods include things or articles purchased by the business enterprise for resale. Goods purchases by the business may be returned back to the supplier. On the other hand, goods sold by the business to its customers can also be returned by the customers back to the business as a result of certain reasons. In business enterprises, it could be desired that a separate record and account be kept of all sale, purchase and return of goods. Therefore, Goods Account can be classified into the following categories:

1- ***Purchases Account*:** The account is used for recording all purchases of goods. Goods **“come in”** on purchasing of goods and, therefore, the **Purchase Account** is debited on purchase of goods.

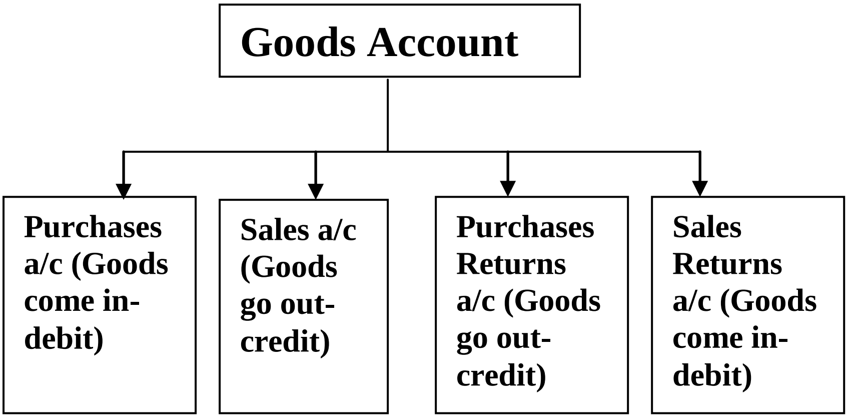
2- ***Sales Account:*** the account is used for recording of selling of goods. The goods “**go out**” on selling of goods, and accordingly, on sale of goods, the **Sales Account** is credited.

3- ***Purchases Returns Account:*** The account is used for recording return of goods purchased. The goods “**go out**” on returning of goods to the suppliers and, therefore, the **Purchases Returns Account** should be credited on returning goods purchased.

4- ***Sales Returns Account:*** The account is used for recording return of goods sold by the customers. The goods “**come in**” and, hence, the **Sales**

Returns Account should be debited on return of goods.

The above classifications of Goods Account can be presented as follows:



3.3.4 Compound Journal Entry:

In practice, there are a number of transaction on the same date relating to one particular account or of one particular nature. Such transactions may be recorded by means of a single entry instead of passing several journal entries. Such entry about recording a number of transactions is termed as a **Compound Journal Entry**. Accordingly, **an**

entry which include more than one debit or more than one credit is called compound journal entry. Also, regardless of how many debits or credits are included in a compound journal entry, *all the debits* are entered *before any credits* are listed.

The compound journal entry may recorded in any of the following three ways:

1- One given or particular account may be debited while several other accounts may be credited.

2- One particular account may be credited while several accounts may be debited.

3- Several accounts may be debited and several accounts may also be credited.

Illustration 3.3:

You are required to pass a compound journal entry in each of the following cases:

1. Cash payments was mad to Usama L.E.10,000 after he had allowed a cash discount of L.E.500.

2. Cash received from Ashraf of L.E.8,000 and a cash discount of L.E.500 was allowed to him.
3. Mahmoud purchased a running business enterprise with the following assets and liabilities: Cash L.E.20,000, land L.E.40,000, Furniture L.E.10,000, stock L.E.20,000, creditors (accounts payable) L.E.10,000, and bank overdraft L.E.20,000.

Solution:

GENERAL JOURNAL			**Page 1**	
Date	**Description**	**LP**	**Debit**	**Credit**
	By Usama		10500	
	To Sundries			
	Cash Account			10000
	Discount Account			500
	Being payment made to Usama of L.E.10,000, and he allowed L.E.500 as discount.			
	By sundries			
	Cash a/c		8000	
	Discount a/c		500	
	To Ashraf			8500
	Being cash received from Asraf of L.E.8,000			

	and discount allowed of L.E.500.			
	By sundries			
	Cash a/c		20000	
	Land a/c		40000	
	Furniture a/c		10000	
	Stock a/c		20000	
	To sundries			
	Creditors a/c			10000
	Bank Overdraft a/c			20000
	Capital a/c			60000
	Being starting of business by Mahmoud by taking over a running business.			

Illustration 3.4:

You are required to journalize (record) the following transactions:

1- On January 1, 2025, Ahmed started his business with cash of L.E.40,000.

2- Jan. 3, he paid into the Bank L.E.20,000.

3- Jan. 5, he purchased goods for cash L.E.15,000.

4- Jan. 8, he sold goods for cash L.E.6,000.

5- Jan. 10, he purchased furniture and paid by check L.E.5,000.

6- Jan. 12, he sold goods to Manar L.E.4,000.

7- Jan. 14, he purchased goods from Maha L.E.10,000.

8- Jan. 15, he returned goods to Maha L.E.5,000.

9- Jan. 16, he received from Manar L.E.3,960 in full settlement.

10- Jan. 18, he withdrew goods for personal use L.E.1,000.

11- Jan. 20, he withdrew cash from business for personal use L.E.2,000.

12- Jan. 24, he paid telephone charges (bill) L.E.1,000 cash.

13- Jan. 26, cash paid to Maha in full settlement L.E.4,900.

14- Jan. 31, paid for stationery L.E.200, rent L.E.500 and salaries to employees L.E.2,000 cash.

15- Jan. 31, goods distributed by way of free samples L.E.1,000.

Solution:

General Journal

Date	**Description**	**LP**	**Debit L.E.**	**Credit L.E.**
2025	By Cash a/c		40000	
Jan.	To Capital a/c			40000
1	Being commencement of business.			
	By Bank a/c		20000	
	To Cash a/c			20000
3	Being cash deposited in the bank			
	By Purchases a/c		15000	
	To Cash a/c			15000
5	Being purchase of goods for cash.			
8	By Cash a/c		6000	
	To Sales a/c			6000
	Being goods sold for cash.			
10	By Furniture a/c		5000	
	To Bank a/c			5000
	Being purchase of furniture paid by check.			

12	By Manar a/c		4000	
	To Sales a/c			4000
	Being sales of goods on			

	account.			
14	By Purchase a/c		10000	
	To Maha a/c			10000
	Being purchase of goods from Maha.			
15	By Maha a/c		5000	
	To Purchases Returns a/c			5000
	Being goods returned to Maha.			
16	<u>By sundries</u>			
	Cash a/c		3960	
	Discount a/c		40	
	To Manar a/c			4000
	Being cash received from Manar in full settlement and allowed her L.E.40 as discount.			
18	By Drawings a/c		1000	
	To Purchases a/c			1000
	Being withdrawal of goods for personal use.			
20	By Drawings a/c		2000	
	To Cash a/c			2000
	Being cash withdrawal from the business for personal use.			
24	By Telephone Expenses a/c		1000	
	To Cash a/c			1000
	Being telephone expenses paid.			
26	By Maha a/c		5000	
	<u>To sundries</u>			

	Cash a/c			4900
	Discount a/c			100
	Being cash paid to Maha and she allowed L.E.100 as discount.			
	By sundries			
31	Stationery Expenses a/c		200	
	Rent Expenses a/c		500	
	Salaries Expenses a/c		2000	
	To Cash a/c			2700
	Being expenses paid.			
	By Advertisement Exp. a/c		1000	
31	To Purchases a/c			1000
	Being distribution of goods by way of free samples.			

3.3.5 Opening Entry:

In the previous discussions, we recorded business transactions of the enterprise when it was starting its new business. In case of a running business, the assets and liabilities appearing in the last year's balance sheet will have to be brought forward to the next year. This process is done by means of a journal entry, with the commencement of the New Year, which is termed as ***Opening Entry***.

Accordingly, all Assets Accounts are **debited** while all Liabilities Accounts are **credited.** The excess of assets over liabilities is the owner’s capital and is credited to his/her Capital Account. This will be clearly understood with the help of the following illustration:

Illustration 3.5:

You are required to pass the **Opening Entry** on January 1, 2025 according to the following information obtained from the books of the business enterprise of Mr. Adel:

Cash in Hand L.E.100,000, Sundry Debtors (Accounts receivable) L.E.300,000, Stock of Goods L.E.200,000, Cars L.E.250,000, Land and Buildings L.E.500,000, and Sundry Creditors (Accounts payable) L.E.500,000.

Solution:

General Journal

Date	Description	Debit	Credit
2025			
Jan.	By sundries		
1	Cash a/c	100,000	
	Sundry Debtors a/c	300,000	
	Stock a/c	200,000	
	Cars a/c	250,000	
	Land & Buildings a/c	500,000	
	To sundries		
	Sundry Creditors a/c		500,000
	Capital a/c		850,000
	Being balances brought forward from the last year.		

Illustration 3.6:

You are given the following transaction about a particular business entity:

Debit Balances on Jan. 1, 2025:

Cash in Hand L.E.80,000, Cash at Bank L.E.250,000, Stock of Goods L.E.200,000, Furniture L.E.20,000, Buildings L.E.100,000, Sundry Debtors- Fahd L.E.20,000, Anis L.E.10,000, and Madhat L.E.20,000.

Credit Balances on January 1, 2025:

Sundry Creditors- Anas L.E.50,000, Loan from Basim L.E.100,000.

The following are further transactions in the month of January, 2025:

1- Jan. 1, purchased goods worth L.E.50,000 for cash less 20% trade discount and 5% cash discount.

2- Jan. 4, Received L.E.19,800 cash from Fahd and allowed him L.E.200 as discount.

3- Jan. 6, purchased goods from Bahgat L.E.50,000.

4- Jan. 8, purchased Equipment from Mostaf for L.E.50,000 and paid L.E.1,000 as cartage for bringing the Equipment to the factory and another L.E.2,000 as installation charge.

5- Jan. 12, sold goods to Ramiz on credit L.E.6,000.

6- Jan. 15, Ramiz became an insolvent and could pay only 50% of his debts.

7- Jan. 18, sold goods to Ramzy for cash of L.E.10,000.

8- Jan. 20, paid salary to Radwan L.E.20,000 cash.

9- Jan. 21, paid to Anas L.E.48,000 cash in full settlement.

10- Jan. 26, interest received from Madhat of L.E.2,000 cash.

11- Jan. 28, paid to Basim interest on loan L.E.5,000 cash.

12- Jan. 31, sold goods for cash of L.E.5,000.

13- Jan. 31, withdrew goods from business for personal use of L.E.2,000.

Required:

Journalize the above transactions in the books of the trader.

Solution:

General Journal

Date	**Explanation**	**Debit**	**Credit**
2025	By sundries		
Jan.	Cash a/c	80,000	
1	Bank a/c	250,000	
	Stock a/c	200,000	
	Furniture a/c	20,000	
	Buildings a/c	100,000	
	Fahd a/c	20,000	
	Anis a/c	10,000	
	Madhat a/c	20,000	
	To sundries		
	Anas a/c		50,000
	Basim's Loan a/c		100,000
	Capital a/c		550,000
	Being balances brought forward from the last year		

	By Purchases a/c	40,000	
1	To sundries		
	Cash a/c		38,000
	Cash Discount a/c		2,000
	Being purchase of goods for cash worth L.E.50,000, allowed 20% trade discount and 5% cash discount on L.E.40,000.		
	By sundries		
4	Cash a/c	19,800	
	Cash Discount a/c	200	
	To Fahd a/c		20,000
	Being cash received from Fahd, allowed L.E.200 as cash discount.		
	By Purchases a/c	50,000	
6	To Bahgat a/c		50,000
	Being purchase of goods from Bahgat.		
	By Equipment a/c	53,000	
	To sundries		
8	Mostafa a/c		50,000
	Cash a/c		3,000
	Being purchase of equipment for L.E.50,000 and payment of L.E.1,000 as cartage and L.E.2,000 as installation charges.		
	By Ramiz a/c	6,000	
12	To Sales a/c		6,000

	Being sale of goods to Ramiz.		
15	<u>By sundries</u>		
	Cash a/c	3,000	
	Bad Debts a/c	3,000	
	To Ramiz a/c		6,000
	Being cash received from Ramiz after his being declared as an insolvent. 50% 0f the amount due has been received and the rest has been taken as bad debt.		
18	By Cash a/c	10,000	
	To Sales a/c		10,000
	Being cash sales.		
20	By Salary a/c	20,000	
	To Cash a/c		20,000
	Being salary paid		
21	By Anas	50,000	
	<u>To sundries</u>		
	Cash a/c		48,000
	Cash Discount a/c		2,000
	Being cash paid to Anas and he allowed L.E.2,000 as discount.		
26	By Cash a/c	2,000	
	To Interest a/c		2,000
	Being receipt of interest.		
28	By Interest on Loan a/c	5,000	
	To Cash a/c		5,000
	Being payment of interest on		

31	loan.		
	By Cash a/c	5,000	
	To Sales a/c		5,000
31	Being goods sold for cash.		
	By Drawings a/c	2,000	
	To Purchases a/c		2,000
	Being goods withdrawn for personal use.		

Notices:

Transaction 1, Trade discount is not shown in the books. Goods purchased or sold are shown at the amount remaining after deducting trade discount. Goods worth L.E.50,000 were purchased and trade discount was 20%. It means that goods have been purchased only for L.E.40,000. Cash discount is allowed for instant or prompt payment of cash. It means that it will be allowed on L.E.40,000 (the purchase price of the goods) at 5%.

Transaction 4, any expenditure incurred for acquisition of an asset for long-term use in the business is a capital expenditure. In addition, the expenditure incurred in bringing an asset and making it ready for use will also be taken as a capital expenditure. Accordingly, Equipment account has been debited not only with the price at which it was purchased from Mostafa but also with the amount of cartage and installation charges paid.

Transaction 6, Ramiz was to pay a sum of L.E.6,000. He became an insolvent and could pay only 50% of the amount due from him. It means that the other 50% could be considered as a bad debt. Bad debt is a nominal account and, hence, it has been debited, Ramiz gets full credit of L.E.6,000 because by paying L.E.3,000, he gets free from the liability of paying L.E.6,000.

Transaction 7, the sales have been made for cash and, therefore, nothing is to be done regarding the account of Ramzy. The two accounts involved are: Cash Account and Sales Account.

Transaction 8, Radwan has been paid cash for services. His account should not be debited. The Salaries Account represents the cost of the services received by him and, therefore, this account has been debited.

Transaction 10, Madhat has paid for interest and, therefore, the Interest Account has been credited and not the Personal Account of Madhat. This has been done on the assumption that when interest became due, an entry was passed. However, in case, it is the practice to pass the entry, for interest on its becoming due, the following entry will be passed:

Madhat a/c debit
To Interest a/c credit

In such a case on receipt of interest, the following entry will have to be passed:

Bank/Cash a/c debit
To Madhat a/c credit

Transaction 11, Basim has been paid interest on the loan which is given to the firm. His Personal Account should not therefore be debited, but the Interest Account should be debited. However, in case, it is the practice of the firm to pass entry for interest on its becoming due, as explained in the above entry, the following entry will be passed:

By Interest a/c debit
To Basim's Loan a/c credit

In such a case on payment of interest, the following entry will have to be passed:

By Basim's Loan a/c debit
To Cash a/c credit

3.4 Ledger Posting and Trial Balance:

In an earlier Chapter, it has already been discussed that accounting includes the process of recording, classifying and summarizing the financial transactions. Recording or journalizing is done in the **Journal**, which has already been explained in the preceding section of this Chapter. Classifying of the recorded transactions is done in the **Ledger**, which is being discussed in the present section.

3.4.1 The Ledger:

In accounting practice, it should be maintained a separate record for each item that appears in the balance sheet of a business entity. For example, a separate record is kept for the asset cash, showing all increases and decreases in cash resulting from the many transactions in which cash received or paid. A similar record is maintained for every other asset, every liability, and for owner’s equity. The record used to keep track of the increases and decreases in a single balance sheet item is termed a **ledger account** or simply an **account**. The entire group of accounts is maintained together in an accounting record called a **ledger**.

Accordingly, **ledger** is a book which contains various accounts. It contains all accounts of the business enterprise whether **Real, Nominal** or **Personal**. Each ledger account is maintained on a separate page of columnar paper. These pages are kept in a loose-leaf binder, which serves as the ledger.

3.4.1.1 Posting Journal Entries to the Ledger:

Transactions are recorded **first** in the journal. Ledger accounts are updated **later**, through a process called ***Posting***. Therefore, the term ***Posting*** means transferring the debit and credit items from the **Journal** to their respective accounts in the **Ledger**. It should be kept in mind that the exact names of accounts used in the **Journal** should be carried to the **Ledger**. For instance, if in the Journal, Expenses Account has been debited, it would not be correct to debit the Office Expenses Account in the Ledger. Hence, in the Journal, it might have been indicated clearly in the explanation that it is an item of office expenses. The correct treatment would have been to record the amount to the Office Expenses Account in the Journal as well as in the Ledger.

In practice, posting may be done at any time, but it should be completed before the preparation of the financial statements. It is advisable to maintain the more active accounts posted to date, such as Cash Account, personal accounts of various parties, etc. Therefore, posting simply means **updating the ledger accounts** for the effects of the transactions recorded in the journal. The posting process may be done by the competent employee (often called the book-keeper) from the Journal to the Ledger by any of the following ways:

1- He/she may take a particular side first. For example, he/she may take the debits first and make the complete postings of all debits from the Journal to the Ledger.

2- He/she may take a particular account and post all debits and credits respecting to that account appearing on one particular page of the Journal. He/she may then take some other account and follow the same procedure.

3- He/she may complete postings of each journal entry before proceeding to the next entry.

Of the above three methods, we think that it will be preferable and advisable to follow the last method (No.3). One should post each debit and credit item of the transaction as it appears in the Journal (one-shot posting).

The Ledger Page (LP) column in the Journal is used at the time when debits and credits are posted to the Ledger. The page number of the Ledger on which the posting has been done is mentioned in the LP column of the Journal. A proper index should be maintained in the Ledger showing the names of the accounts and the page numbers.

3.4.1.2 The Relationship between Journal and Ledger:

Normally, business enterprises do not prepare new financial statements after every transaction. Rather, they accumulate the effects of individual business transactions in their **accounting records**. Then, at regular intervals, the data in these records are used to prepare financial statements and other types of accounting reports.

However, the need for accounting reports is not the only reason business enterprises maintain accounting records. Managers and employees of the business enterprise frequently use these records for such purposes as:

(1) Establishing **accountability** for the assets and/or transactions under an individual's control.

(2) Keeping track of routine business activities such as the amounts of money in enterprise bank accounts, amounts due from credit customers (Debtors), amounts owed to suppliers (Creditors).

(3) Obtaining detailed information about a particular transaction.

(4) Maintaining documentary evidence of the enterprise's business activities.

Accordingly, both Journal and Ledger are the most important books used under Double Entry system of accounting. Their relationships can be expressed as follows:

1- The transactions are recorded first of all in the Journal and then they are posted to the Ledger. Thus, the Journal is the book of first or original entry, while the Ledger is the book of second entry.

2- Journal records transactions in a chronological order, while the Ledger records transactions in an analytical order.

3- Journal is more reliable as compared to the Ledger, as it is the book in which the entry is passed first of all.

4- The process of recording transactions is termed as **Journalizing** while the process of recording transactions in the Ledger is called **Posting**.

3.4.1.3 Rules Regarding Posting:

The following rules should be followed and maintained while posting transactions from the Journal to the Ledger:

(1) Separate accounts should be opened in the Ledger for posting transactions relating to different accounts recorded in the Journal. For instance, separate accounts may be opened for sales, purchases, sales returns, purchases returns, salaries, rent, cash, etc.

(2) The concerned account which has been debited in the Journal should also be debited in the Ledger. However, a reference should be made of the other account which has been credited in the Journal. For example, for salaries paid, the salaries account should be debited in the Ledger, but reference should be given of the Cash Account which has been credited in the Journal.

(3) The concerned account which has been credited in the Journal should also be credited in the Ledger, but reference should be given of the account, which has been debited in the Journal. For example, for salaries paid, Cash Account has been credited in the Journal and it will be credited in the Ledger also, but reference will be given of Salaries Account in the Ledger.

Therefore, it may be concluded that while making posting in the Ledger, the related account which has been debited or credited in the Journal should also be debited or credited in the Ledger, but reference has to be given of the other account which has been credited or debited in the Journal, as the case may be.

Assume that salaries of L.E.20,000 have been paid in cash, the following entry will be passed in the Journal:

By Salaries Account	20,000	
To Cash Account		20,000

In the Ledger, two accounts will be opened, **1.** Salaries Account, and **2.** Cash Account. Because Salaries Account has been debited in the Journal, it will also be debited in the Ledger. Similarly, Cash

Account has been credited in the Journal and, hence, it will also be credited in the Ledger, but reference will be given of the other account involved. Thus, the accounts will appear as follows in the Ledger:

Dr Salaries Account Cr

To Cash a/c L.E.	**20,000**		

Dr Cash Account Cr

		By Salaries a/c L.E.	**20,000**

Use of the Words *To* and *By*:

In practice, it is customary to use words **"To"** and **"By"** while making posting in the Ledger. The word ***To*** is used with the accounts which appear on the debit side of the Ledger Account. For example, in the Salaries Account, instead of writing only Cash, the word ***To*** Cash appeared on the debit side of the Account. In the same way, the word ***By*** is used with accounts which appear on the credit side of a Ledger Account. For example, in the above case, the word ***By*** Salaries a/c appeared on the credit side of the Cash Account instead of only Salaries a/c. The words ***To*** and ***By*** do not have any specific meanings. Modern accountants are, therefore, ignoring the use of these words.

3.4.1.4 The Use of Ledger Accounts and Debit & Credit Entries:

As we have understood from the above discussion, ledger account is a means of accumulating or collecting in one place all the information about changes in a specific asset, a liability, or owner’s equity. For instance, a ledger account for the asset cash provides a record of amount of cash receipts, cash payments, and the current cash balance. By keeping a Cash Account, the business management can keep track of the amount of cash available for meeting payrolls (i.e. salaries or wages) and for making current purchases of assets or services.

This record of cash is also useful in planning future operations and in advance planning of applications for bank loans.

An account, in its simplest form, has only three elements:

1- A title, consisting of the name of the particular asset, liability, or owner’s equity;

2- A left side, which is called the **debit** side, and

3- A right side, which is called the **credit** side.

This form of account, illustrated above and on the following pages, is called a ***T Account*** because of its resemblance or similarity to the letter ***T***. More complete forms of accounts will be illustrated later on the following pages.

Title of Account

Left or Debit Side	**Right or Credit Side**

An amount recorded on the left or debit side is called a **debit**, or a **debit entry**; an amount entered on the right or credit side is called a **credit**, or

credit entry. The act of recording a debit in an account is called **debiting** the account; the process of recording of a credit is called **crediting** the account. In practice, accountants use **debit** to mean an entry on the left-hand side of an account and **credit** to mean an entry on the right-hand side. Therefore, debit and credit simply mean left and right.

Illustration 3.7:

You are required to journalize the following transactions and to post them into the Ledger:

1- Yaser started his business with a capital of L.E.50,000.

2- He purchased furniture for cash of L.E.20,000.

3- He purchased goods from Mohamed on credit L.E.10,000.

4- He paid cash to Mohamed L.E.5,000.

Solution:

(1) The Journal:

Date	Explanation	LP	Debit L.E.	Credit L.E.
	By Cash Account		50,000	
	To Capital Account			50,000
	By Furniture Account		20,000	
	To Cash Account			20,000
	By Purchases Account		10,000	
	To Mohamed a/c			10,000
	By Mohamed Account		5,000	
	To Cash Account			5,000

(2) The Ledger:

Dr Cash Account Cr

To Capital a/c	50,000	By Furniture a/c By Mohamed ac	20,000 5,000

Dr Capital Account Cr

		By Cash a/c	50,000

Dr Furniture Account Cr

To Cash a/c	20,000		

Dr Purchases Account Cr

To Mohamed a/c	10,000		

Dr Mohamed Account Cr

To Cash a/c	5,000	By Purchases a/c	10,000

3.4.1.5 Determining the Balance of a T Account:

In practice, there may be several transactions relating to one particular account. In Journal, these transactions appear on different pages in a chronological order while they appear in a classified form under that particular account in the Ledger. At the end of the period (say a month, a quarter or a year), the owner or the investor will be interested in knowing the position of a particular account. This means that he/she should total or sum the debits and credits of the account separately and find out the net balance.

This technique of finding out the net balance of an account, after considering the totals of both debits and credits appearing in the account is known as **Balancing the Account**. Therefore, the **Balance** of a ledger account is the **difference between the debit and credit entries** in the account.

The **Balance** is put on the side of the account which is smaller and a reference is given that it has been **carried forward** or **carried down (c/f or c/d)** to the next period. On the other hand, in the next period a reference is given that the opening balance which has been **brought forward** or **brought down (b/f or b/d)** from the previous period.

In general, if the debit total exceeds the credit total, the account has a ***debit balance***; if the credit total exceeds the debit total, the account has a ***credit balance***.

Illustration 3.8:

You are required to journalize the following transactions, to post them in the Ledger and to balance the accounts on 31st January.

1- Rashidy started his business with a capital of L.E.250,000.

2- He purchased goods from Mohamed on credit L.E.50,000.

3- He paid cash to Mohamed L.E.25,000.

4- He sold goods to Sarah L.E.50,000.

5- He received cash from Sarah L.E.75,000.

6- He further purchased goods from Mohamed L.E.50,000.

7- He paid cash to Mohamed L.E.25,000.

8- He further sold goods to Sarah L.E.50,000.

9- He received cash from Sarah L.E.25,000.

Solution:

(1) The Journal:

Date	Explanation	LP	Debit	Credit
	Cash Account To Capital Account Being commencement of business.		250,000	250,000
	Purchases Account To Mohamed Account Being purchase of goods on credit.		50,000	50,000
	Mohamed Account To Cash Account Being payment of cash to Mohamed.		25,000	25,000
	Sarah Account To Sales Account Being goods sold to Sarah.		50,000	50,000
	Cash Account To Sarah Account Being cash received from Sarah.		75,000	75,000

	Purchases Account To Mohamed Account Being purchase of goods from Mohamed.		50,000	50,000
	Mohamed Account To Cash Account Being payment of cash to Mohamed.		25,000	25,000
	Sarah Account To Sales Account Being goods sold to Sarah.		50,000	50,000
	Cash Account To Sarah Account Being cash received from Sarah		25,000	25,000

(2) The Ledger:

Dr Cash Account Cr

To Capital a/c	250,000	By Mohamed a/c	25,000
To Sarah a/c	75,000	By Mohamed a/c	25,000
To Sarah a/c	25,000	Balance c/d Jan. 31	300,000
	350,000		350,000
Balance b/d Feb. 1	300,000		

Dr Capital Account Cr

Balance c/d Jan. 31	250,000	By Cash a/c	250,000
	250,000		250,000
		Balance b/d Feb. 1	250,000

Dr Purchases Account Cr

To Mohamed a/c	50,000	Balance c/d Jan. 31	100,000
To Mohamed a/c	50,000		
	100,000		100,000
Balance b/d Feb. 1	100,000		

Dr Mohamed Account Cr

To Cash a/c	25,000	By Purchases a/c	50,000
To Cash a/c	25,000	By Purchases a/c	50,000
Balance c/d Jan. 31	50,000		
	100,000		100,000
		Balance b/d Feb. 1	50,000

Dr Sarah Account Cr

To Sales a/c	50,000	By Cash a/c	75,000
To Sales a/c	50,000	By Cash a/c	25,000
	100,000		100,000

Dr Sales Account Cr

Balance c/d Jan. 31	100,000	By Sarah a/c	50,000
		By Sarah a/c	50,000
	100,000		100,000
		Balance b/d Feb. 1	100,000

It should be noted that the balance of an account is always known by the side which is greater. For example, in the above illustration, the debit side of the Cash Account is greater than the credit side by L.E300,000. It will be, therefore, said that Cash Account is showing a debit balance of L.E.300,000. Similarly, the credit side of the Capital Account is greater than debit side by L.E.250,000. It will be, therefore, said that the Capital Account is showing a credit balance of L.E.250,000.

3.4.1.6 Debit Balances in Assets Accounts:

In the preceding illustration, for example Cash Account, increases were recorded on the left or debit side of the account and decreases were recorded on the right or credit side. The increases were greater than the decreases and the result was a debit balance in the account. **All asset accounts *normally have debit balances***. It will be very hard to imagine an account for an asset such as land having a credit balance, as this would indicate that the business had disposed of more land than it had ever acquired. (For other assets, such as cash, it is possible to acquire a credit balance-but such balance is only ***temporary***).

The fact that assets are located on the left side of the balance sheet is an appropriate means of remembering the rule that an increase in an asset is recorded on the **left** (debit) side of the account, and also that an asset account normally has a debit (***left-hand***) balance.

Asset accounts
Normally have
Debit balances

Any Asset Account

Debit ***(representing an increase)***	**Credit** ***(representing a decrease)***

3.4.1.7 Credit Balances in Liability & Owner's Equity Accounts:

Normally, increases in liabilities and owner's equity accounts are recorded by credit entries and decreases in these accounts are recorded by debits. The relationship between entries in these accounts and their position on the balance sheet may be summed up as follows:

(1) Liabilities and owner's equity belong on the ***right*** side of the balance sheet;

(2) An increase in a liability or an owner's equity account is recorded on the ***right*** (credit) side of the account; and

(3) Liability and owner's equity accounts normally have credit ***(right-hand)*** balances.

Any Liability Account or Owner's Equity Account

Debit (representing a decrease)	**Credit (representing an increase)**

Liability and Owner's equity accounts normally have credit balances

The use of debits and credits to record changes in assets, liabilities, and owner's equity may be summarized as follows:

Asset Accounts	Liability & Owner's Equity Accounts
Normally have debit Balances. Thus, increases are recorded by debits and decreases are recorded by credits.	Normally have credit balances. Thus, increases are recorded by credits and decreases are recorded by debits.

3.4.1.8 Sequence and Numbering of Ledger Accounts:

Accounts are usually arranged in the ledger in ***Financial Statement Order***, that is, assets first, followed by liabilities, owner's equity, revenues, and expenses. The number of accounts needed by a business enterprise will depend upon its size, the nature of its operations, and the extent to which management and regulatory authorities want detailed classification of information. An identification number is assigned to each account. A ***Chart of Accounts*** is a listing of the account titles and account numbers being used by a particular business entity.

In the following list of accounts, many possible account numbers have been skipped, these numbers are held in reserve so that additional accounts can be inserted in any section of the ledger. In this list, the numbers from 1 to 29 are used exclusively for asset accounts; numbers from 30 to 49 are reserved for liabilities; and numbers in the 50s represent 0wner’s equity accounts. The following ***Chart of Accounts*** show an illustration of a balance sheet accounts:

Account Title	Account No.
Assets:	
Cash Account…………………………	1
Accounts receivable (debtors)………..	4
Land……………………………………	20
Building………………………………..	22
Tools and Equipment…………………	25
Liabilities:	
Note payable (bills payable)…………	30
Accounts payable (creditors)…………	32
Owner’s equity	
Capital…………………………………	50

3.4.2 The Trial Balance:

As equal pound amounts of debits and credits are entered in the accounts for every transaction recorded, the sum of all the debits in the ledger must equal to the sum of all the credits. If the computation of account balances has been correct or accurate, it follows that the total of the accounts with debit balances must be equal to the total of the accounts with credit balances.

It is advisable that before using the account balances to prepare a balance sheet, it is desirable to **prove** that the total of accounts with debit balances is actually equal to the total of accounts with credit balances. This proof of the equality of debit and credit balances is called a ***trial balance***. Therefore, when the various debit balances and the credit balances of the different accounts are taken down in a statement, the statement so prepared is termed as a **Trial Balance**. A **trial balance** is a two-column schedule listing the names and balances of all the accounts **in the order in which they appear in the ledger;** the debit balances are listed in the left-hand column and the credit balances in the right-hand column. The totals of the two columns should agree or equal.

From the above discussion, it appears that **Trial Balance** is a statement containing the various ledger balances on a particular date. For example, with the balances of the ledger accounts prepared in **Illustration 3.8**, the **Trial Balance** can be prepared as follows:

Trial Balance
As on 31st January

Explanation	Debit Amounts	Credit Amounts
Cash Account L.E.	300,000	
Capital Account		250,000
Purchases Account	100,000	
Mohamed Account		50,000
Sales Account		100,000
Total	400,000	400,000

Therefore, the two sides of the Trial Balance identify of tally. It means that the books of accounts are arithmetically accurate.

Uses and Limitations of the Trial Balance:

The preparing of the Trial Balance achieves many objectives as follows:

1- **Checking of the arithmetical accuracy of the accounting entries**. As indicated above, Trial Balance helps in knowing the arithmetical accuracy of the accounting entries. This is because according to the dual aspect concept for every debit, there must be an equivalent credit. Trial Balance represents a summary of all ledger balances and, hence, if the two sides of the Trial Balance tally or identify, it is an indication of this fact that the books of accounts are arithmetically accurate. However, there may be certain errors in the books of accounts in spite of an agreed Trial Balance. For example, if a transaction has been completely omitted from the books of accounts, the two sides of the Trial Balance will tally, in spite of the books of accounts being wrong.

2- **Basis for Financial Statements**. Trial Balance forms the basis for preparing financial statements such as the Income Statement and the Balance Sheet. The Trial Balance represents all transactions relating to different accounts in a summarized form for a particular period. If the Trial Balance is not prepared, it will be almost impossible to prepare the financial statements, as stated above, to know the profit or loss made by the business enterprise during a given period or its financial position on a particular date.

***3*- Summarized Ledger**. As we discussed earlier, a Trial Balance contains the ledger balances on a particular date. Therefore, the entire ledger is summarized in the form of a Trial Balance. The position of a particular account can be judged simply by looking at the Trial Balance. The Ledger may be seen only when details regarding the accounts are required.

***4*- To sum up, the Trial Balance provides proof that the ledger is in balance**. The agreement of the debit and credit totals of the Trial balance gives assurance that: (1) Equal debits and credits have been recorded for all transactions; (2) The debit or credit balance of each account has been correctly computed; and (3) The addition of the account balances in the trial balance has been correctly performed.

Assume that the debit and credit totals of the trial balance do not agree. This situation indicates that one or more errors have been made. Typical of such errors are:

1) The posting of a debit as a credit, or vice versa;

2) Arithmetic mistakes in determining account balances;

3) Clerical errors in copying account balances into the trial balance;

4) Listing a debit balance in the credit column of the trial balance, or vice versa; and

5) Errors in addition of the trial balance.

Therefore, the preparation of a trial balance does **not** prove transactions have been correctly analyzed and recorded in the proper accounts. If, for example, a receipt of cash were erroneously recorded by debiting the Land Account instead of

Cash Account, the trial balance would still balance. Also, if a transaction were completely omitted from the ledger, as we said above, the error would not be disclosed by trial balance. In summary, **the Trial Balance proves only one aspect of the ledger, and that is the equality of debits and credits**.

In spite of these limitations, the Trial Balance is a useful device. It not only provides assurance that the ledger is **"in balance"**, but it also serves as a convenient stepping-stone for the preparation of financial statements. On the other hand, the trial balance is merely an informal ***working paper***, useful to the accountant but not intended for distribution to others. The balance sheet and other financial statements can be prepared more conveniently from the trial balance than directly from the ledger, especially if there are a great many ledger accounts.

Comprehensive Illustration 3.9:

Ahmed, a mechanical engineering, starts his new business by opening a service station “Gold-Key Auto Service”. The following transactions occurred during November 2024:

1- **Nov. 1** Ahmed, the owner, invested L.E.400,000 cash in the business.

2- **Nov. 3** Representing Gold-Key Auto Service, Ahmed negotiated with both the City Council of Qena and Upper Egypt Bus Company (UEBC) to purchase an old bus garage, as the City Council owned the land while the UEBC owned the building. On November 3, Gold-Key purchased the land from the city for L.E.260,000 cash.

3- **Nov. 5** Gold-Key completed the acquisition of its business location by purchasing the old building from UEBC. The purchase price was L.E.180,000, Gold-Key made a L.E.30,000 cash down payment and issued a three-month note payable for the remaining L.E.150,000.

4- **Nov. 17** Gold-Key purchased tools and equipment on account (on credit) from The Nile Tools Company. The purchase price was L.E.69,000, due in 2 months.

5- **Nov. 20** Gold-Key found that it had purchased more tools than it needed. On November 20, it sold the excess tools on account to Nabil Workshop at a price of L.E.9,000. The tools were sold at a price equal to their cost, so there was no gain or loss on this transaction.

6- **Nov. 25** Gold-Key received L.E.3,000 in partial collection of the account receivable from Nabil Workshop.

7- **Nov. 30** Gold-Key made a L.E.34,000 partial payment of its account payable to The Nile Tools Co.

Required:

a- Journalize the above transactions in the books of Gold-Key Auto Services.

b- Prepare the Ledger Accounts and the Trial Balance on the basis of these transactions.

Solution:

a- The Journal Entries:

Date	Explanation	LP	Debit	Credit
2024	By Cash a/c	1	400000	
Nov.	To Capital a/c	50		400000
1	Owner invested cash in the business.			
	By Land a/c	20	260000	
3	To Cash a/c	1		260000
	Purchased land for business site.			

5	Building a/c	22	180000	
	To sundries:			
	Cash a/c	1		30000
	Notes (Bills) payable a/c	30		150000
	Purchased building. Paid part cash; balance payable within 3 months			
17	Tools & Equipment a/c	25	69000	
	To Accounts payable a/ c	32		69000
	Purchased tools and equipment on credit, due in 2 months			
20	Accounts receivable a/c	4	9000	
	To Tools & Equipment a/c	25		9000
	Sold unwanted tools and equipment at cost. Sales price due in 2 months.			
25	Cash a/c	1	3000	
	To Accounts Receivable a/c	4		3000
	Collected part of accounts receivable.			
30	Accounts Payable a/c	32	34000	
	To Cash a/c	1		34000
	Made partial payment of the liability.			

b- The Ledger Accounts and the Trial Balance:

Dr Cash Account (Account No. 1) Cr

To Capital a/c	400000	By Land a/c	260000
To Acc. Receivable	3000	By Building a/c	30000
		By Acc. Payable a/c	34000
		Balance c/d Nov. 30	79000
	403000		403000
Balance b/d Dec. 1	79000		

Dr Accounts Receivable a/c (Account No. 4) Cr

To Tools & Equipment	9000	By Cash a/c	3000
		Balance c/d Nov. 30	6000
	9000		9000
Balance b/d Dec. 1	6000		

Dr Land Account (Account No. 20) Cr

To Cash a/c	260000	Balance c/d Nov. 30	260000
	260000		260000
Balance b/d Dec. 1	260000		

Dr Building Account (Account No. 22) Cr

To Sundries	180000	Balance c/d Nov. 30	180000
	180000		180,000
Balance b/d Dec. 1	180000		

Dr Tools & Equipment Acc. (Acc. No. 25) Cr

To Acc. Payable	69000	By Acc. receivable	9000
		Balance c/d Nov. 30	60000
	69000		69000
Balance b/d Dec. 1	60000		

Dr Notes Payable Account (Account No. 30) Cr

Balance c/d Nov. 30	150000	By Building a/c	150000
	150000		150000
		Balance b/d Dec. 30	150000

Dr Accounts Payable Account (Acc. No. 32) Cr

To Cash a/c	34000	By Tools and Equipment a/c	69000
Balance c/d Nov. 30	35000		
	69000		69000
		Balance b/d Dec. 1	35000

Dr Capital Account (Account No. 50) Cr

Balance c/d Nov.30	400000	By Cash a/c	400000
	400000		400000
		Balance b/d Dec. 1	400000

GOLD-KEY AUTO SERVICE
Trial Balance
November 30, 2024

Explanation	Debit Amounts	Credit Amounts
Cash Account L.E.	79,000	
Accounts Receivable	6,000	
Land	260,000	
Building	180,000	
Tools and Equipment	60,000	
Notes Payable		150,000
Accounts Payable		35,000
Capital Account		400,000
Total	585,000	585,000

3.5 Questions and Exercises:

3.5.1 Questions:

1- Explain the different categories in which the accounting transactions can be classified. Also state the rules of **debit and credit** in this connection.

2- Explain the meaning of term **Journal** and state its significance.

3- Explain the different rules for journalizing the transactions with appropriate illustrations.

4- Explain the rules regarding posting of transactions into the Ledger.

5- What is a Trial Balance? Explain its objectives and limitations.

6- State under what heading (Personal, Real, or Nominal) would you classify each of the following accounts:

(1) Salary Prepaid Account.

(2) Salary Outstanding Account.

(3) Rent Account.

(4) Bank Account.

(5) Insurance Unexpired.

(6) Owner’s Account.

(7) Bad Debts Account.

(8) Furniture Account.

(9) Goodwill Account.

(10) Patent Account.

7- Select the best answer:

1. The amount brought in by the owner in the business enterprise should be credited to

a- Cash Account.

b- Capital Account.

c- Drawings Account.

2. The amount of salary paid to Sarah should be debited to

a- Sarah Account.

b- Salaries Account.

c- Cash Account.

3. The return of goods by a customer should be debited to

    a- Customer’s Account.

    b- Sales Returns Account.

    c- Goods Account.

4. Sales made to Mohamed for cash should be debited to

    a- Cash Account.

    b- Mohamed Account.

    c- Sales Account.

5. The rent paid to the landlord should be credited to

    a- Landlord’s Account.

    b- Rent Account.

    c- Cash Account.

6. The Cash Discount allowed to a debtor should be credited to

    a- Discount Account.

    b- Customer’s Account.

c- Sales Account.

7. In case of a debit becoming bad, the amount should be credited to

a- Debtors Account.

b- Bad Debts Account.

c- Sales Account.

8- State whether each of the following statements is **True** (√) or **False** (×)**.**

(a) The Posting is done in the Journal.

(b) Ledger is a set of accounts.

(c) Transactions are recorded first of all in the Ledger.

(d) Journal records transactions in a chronological order.

(e) Ledger records transactions in an analytical order.

(f) While posting transactions in the ledger, if the account is debited in the Journal, it will be credited in the Ledger.

(g) The word **To** is used with the accounts which appear on the Debit side of a ledger account.

(h) Trial Balance helps in knowing the arithmetical accuracy of the accounting entries.

9- Fill in the blanks:

(a) The process of transferring the debit and credit items from a Journal to their respective accounts in the Ledger is termed as ……….

(b) Journal is the book of ……..entry, while a Ledger is the book of ……..entry.

(c) The word **By** is used with an account while making posting on the …….side of an account.

(d) The technique of finding the net balance of an account after considering the totals of both debits and credits appearing in the account is known as ……….

(e) The statement containing various ledger balances on a particular date is known as ……….

(f) If the two sides of the trial balance tally (identify), it is an indication of the fact that the books of accounts are …….. accurate.

10- According to the rules of debit and credit for balance sheet accounts:

a. Increases in asset, liability, and owner's equity accounts are recorded by debits,

b. Decreases in asset and liability accounts are recorded by credits.

c. Increases in asset and owner's equity accounts are recorded by debits.

d. Decreases in liability and owner's equity accounts are recorded by debits.

11- Which of the following statements about accounting procedures is **not** correct?

a. The journal shows in one place all the information about specific transactions, arranged in chronological order.

b. A ledger account shows in one place all the information about changes in a specific asset or liability, or in owner’s equity.

c. Posting is the process of transferring debit and credit changes in account balances from the ledger to the journal.

d. The end product of the accounting cycle consists of formal financial statements, such as the balance sheet and the income statement.

3.5.2 Exercises and Problems:

(1) Listed below are eight technical terms introduced in this chapter:

Ledger Account Double-entry Posting
Credit Journal Debit Trial balance

Each of the following statements may (or may not) describe one of these technical terms. For each statement, indicate the accounting term described, or answer **“none”** if the statement does not correctly describe any of the terms.

a. The accounting record in which transactions are initially recorded in a manual accounting system.

b. A device that proves the equality of debits and credits posted to the ledger.

c. The accounting record from which a trial balance is prepared.

d. The system of accounting in which all transactions are recorded both in the journal and in the ledger.

e. An entry on the left-hand side of a ledger account.

f. The process of transferring information from a journal to the ledger.

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(2) Enter the following selected transactions in General Journal for Electric Appliance Centre.

Include a brief explanation of the transaction as part of each journal entry.

Jan. 1 The owner, invested an additional L.E.80,000 cash in the business.

Jan. 5 Purchased cars, the price was L.E.102,000 of which L.E.32,000 was paid in cash; a note payable was issued for the balance.

Jan. 15 Paid L.E.5,000 to an account payable, Cairo Supply Co.

Jan. 18 Borrowed L.E.30,000 cash from the bank by signing a 90-day note payable.

Jan. 23 Collected an account receivable of L.E.3,000.

Jan. 30 Acquired office equipment from Ideal Co. for L.E.8,000. Made a cash down payment of L.E.1,500; balance to be paid within 30 days.

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(3) Magic Land Entertainment is a sole proprietorship that owns and operates a chain of children theatres. Selected business transactions of the enterprise during April 2024 are listed below.

April 1 Purchased cleaning supplies on account from Persil Supply Co., L.E.5,000. Payment due within 2 months, to be paid in two equal installments of L.E.2,500.

April 3 Purchased projection equipment for cash from Cairo Sound Co., L.E.6,000.

April 5 Returned to Cairo Sound Co. a projector purchased on April 3, because the lens was defective. The projector had cost Magic Land L.E.2,000; Cairo Sound Co. agreed to refund Magic Land's purchase price within 5 days.

April 10 Received the L.E.2,000 from Cairo Sound Co.

April 12 The owner invested an additional L.E.200,000 cash in the business.

April 15 Purchased the Village Theatre for L.E.630,000, paying L.E.150,000 in cash and issuing a note payable for the balance of the purchase price. The assets included in the purchase price, and their values at April 15, were as follows: **Land L.E.170,000, Building L.E.365,000 and Equipment L.E.95,000.**

April 26 Paid the first installment owed to Persil Supply Co. from April 1 purchase.

<u>Required:</u>

Prepare journal entries to record the above transactions. Select the appropriate account title from the following chart of accounts:

Cash, Land, Notes payable, Accounts receivable, Buildings, Accounts payable, Cleaning supplies, Equipment, and Capital.

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(4) Manar Ali, a dentist, resigned (left) from her position with a large dental group in the hope that she begins her own pediatric (children) dental practice. The practice was organized as a sole proprietorship, called Manar Ali Pediatric

Dentistry. The business transactions during September 2024 while the new venture was being organized are listed below.

Sept. 1 Manar deposited L.E.500,000 cash in her business , which she had saved over a number of years.

Sept. 10 Purchased a small office building for a total price of L.E.912,000, of which L.E.530,000 was applicable to the land and L.E.382,000 to the building. A cash payment of L.E.182,500 was made and a note payable was issued for the balance of the purchase price.

Sept. 15 Purchased a microcomputer system from Computer Stores, Inc., for L.E.23,400 cash.

Sept. 19 Purchased office furnishings, including dental equipment, from Star Operations, Inc., at a cost of L.E.28,800. A cash down payment of L.E.4,800 was made, the balance to be paid in three equal installments due September 28, October 28, and November 28.

Sept. 26 A L.E.700 monitor in the microcomputer system purchased on September 15 stopped working. The monitor was returned to Computer Stores, Inc., which promised to refund the L.E.700 within five days.

Sept. 28 Paid Star Operations, Inc., L.E.8,000 cash as the first installment due on the account payable for office furnishings.

Sept. 30 Received L.E.700 cash from Computer Stores, Inc., in full settlement of the account receivable created on September 26.

Required:

Prepare journal entries to record the above transactions. Select the appropriate account titles from the following chart of accounts:

Cash, Land, Notes payable, Accounts receivable, Buildings, Accounts payable,

Computer system, Office Furnishings, and Capital.

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(5) Mohamed Hazim is the founder and owner of Qena Gymnastics Centre, a youth gymnastics training facility. A few of the Centre's business transactions occurring during July 2024 are described below:

1. On July 2,, collected cash of L.E.3,500 from accounts receivable.

2. On July 7, purchased gymnastics equipment for L.E.21,750, paying L.E.5,000 in cash and charging the remainder on the centre's 30-day account at Sohag Fitness Co.

3. On July 9, returned to Sohag Fitness Co. L.E.2,000 of gymnastics equipment which was not needed. The return of this equipment reduced by L.E.2,000 the amount owed to Sohag Fitness Co.

4. On July 25, Mohamed made an additional investment in Qena Gymnastics Centre by depositing L.E.25,000 cash in the business.

5. On July 31, paid the remaining L.E.14,750 owed to Sohag Fitness Co.

<u>Required:</u>

Prepare journal entries, including explanations, for the above transactions.

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(6) After several years of working as chef at a five-star restaurant in Luxor, Soultan has saved enough money to open his own restaurant in Alexandria, to be known as El-Hana Restaurant. During July 2024, while organizing the business, Soultan prepared the following journal entries to record the first week's transactions. He has not posted these entries to ledger accounts. The ledger accounts numbers to be used are: Cash 1, Supplies 9, Land 20, Building 22, Kitchen Equipment 25, Notes Payable 30, Accounts Payable 31, and Soultan, Capital 50.

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2024	Cash		250,000	
July	To Capital			250,000
1	Investment in business by owner			
	By sundries			
2	Land		300,000	
	Building		217,000	
	To sundries			
	Cash			129,250
	Notes Payable			387,750
	Purchased land and building to be used as a restaurant.			
	Kitchen Equipment		23,400	
3	To Accounts Payable			23,400
	Bought equipment on credit from Major-Chef, Inc.			
	Supplies		6,300	
	To Accounts Payable			6,300
3	Bought supplies from HB Restaurant.			
	Accounts Payable		3,625	
5	To Kitchen Equipment			3,625
	Returned defective equipment to Major-Chef, Inc. for credit on accounts.			
	Accounts Payable		3,150	
7	To Cash			3,150
	Made partial payment of liability to HB Restaurant			

	Supply.			
7	Accounts Payable To Cash Made payment of liability to Major-Chef, Inc.		19,775	19,775

Required:

a. Post the journal entries to ledger accounts.

b. Prepare a Trial Balance at July 8, 2024.

c. Prepare a Balance Sheet at July 8, 2024.

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(7) An owner formed a business entity to provide bus service for a fee to public and private school in the New City area. The business is organized as sole proprietorship called New City Transportation Services. The transactions during July 2024, while the new business was being organized, are listed below:

July 1 The owner deposited L.E.1,125,000 cash in the business.

July 3 The business purchased land and a building at a cost of L.E.600,000, of which L.E.360,000 was regarded as applicable to the land and L.E.240,000 to the building. The transaction involved a cash payment of L.E.150,000 and the issuance of a note payable for the balance of the purchase price.

July 5 Purchased 9 new buses at L.E.135,000 each from General Motors Sales Company. Paid L.E.382,500 cash, and agreed to pay L.E.400,000 by July **31** and the remaining balance by August **15**. The liability was viewed as an account payable.

July 7 Sold one of the buses at cost Car Camping Services. The buyer paid L.E.75,000 in cash and agreed to pay the balance within one month.

July 8 Upon inspection, one of the buses was found to be defective and was returned to Motors Sales Company. The amount payable to this creditor was thereby reduced by L.E.135,000.

July 20 Purchased office equipment at a cost of L.E.12,000 cash.

July 31 Paid amount of L.E.400,000 in partial payment of the liability to Motors Sales Company.

The account titles and the account numbers used by the business are as follows:

Cash 10, Accounts receivable 11, Land 16, Buildings 17, Office equipment 20, Buses 22, Notes payable 31, Accounts payable 32, and Capital 50.

Required:

a. Journalize the July transactions.

b. Post to ledger accounts.

c. Prepare a trial balance at July 31, 2024.

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(8) In April, licensed real estate Hamdy Yosif organized a proprietorship, Hamdy Property Management, to provide management services for owners of flat (apartment) buildings. The organization period extended throughout April and included the transactions listed below.

April 1 Hamdy Yosif deposited in the business amount of L.E.200,000 cash.

April 4 Purchased land and an office building for a price of L.E.875,000, of which L.E.500,000 was considered applicable to the land and L.E.375,000 attributable to the building. A cash down payment of L.E.175,000 was made and a note payable for L.E.700,000 was issued for the balance of the purchase price.

April 7 Purchased office equipment on credit from MOHM Office Equipment, L.E.31,750, due in 30 days.

April 9 A copier (cost L.E.4,475), which was part of the April 7 purchase of office equipment, proved defective and was returned for credit to MOHM Office Equipment.

April 17 Sold one-fourth of the land acquired on April 4 to Car Parking Area at a price of L.E.125,000. This price is equal to the business' cost for this portion of the land, so there is no gain or loss on this transaction. Received a L.E.25,000 cash down payment from Car Parking Area and a note receivable in the amount of L.E.100,000, due in four monthly instalments of L.E.25,000 each, beginning on April 30.

April 28 Paid L.E.8,000 in partial settlement of the liability to MOHM.

April 30 Received cash of L.E.25,000 as partial collection of the note receivable from Car Parking Area.

The account titles and account numbers to be used are:

Cash 1, Notes receivable 5, Land 21, Building 23, Office equipment 25, Notes payable 31, Accounts payable 32, and Capital 51.

Required:

a. Prepare journal entries for the month of April.

b. Post to ledger accounts.

c. Prepare a trial balance at April 30, 2024.

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(9) Orbit Broadcasting was organized in May 2024 to operate as a local television station. The account titles and numbers used by the sole proprietorship are:

Cash 11, Accounts receivable 15, Supplies 19, Land 21, Building 22, Transmitter 23, Telecasting equipment 24, Film library 25, Notes payable 31, Accounts payable 32, and Mahmoud Ali, Capital 51.

The transactions for May 2024, were as follows:

May 1 Mahmoud Ali deposited L.E.1,750,000 cash in his business, Orbit Broadcasting.

May 3 The new business purchased the land, buildings, and telecasting equipment previously used by a local television station which had gone bankrupt. The total purchase price was L.E.1,625,000, of which L.E.600,000 was attributable to the land, L.E.475,000 to the building, and the remainder to the telecasting equipment. The terms of purchase required a cash payment of L.E.1,000,000 and the issuance of a note payable for the balance; due in 3 years.

May 5 Purchased a transmitter at a cost of L.E.1,125,000 from Cairo Radio & Television Co., making a cash down payment of L.E.375,000. The balance, in the form of a note payable, was to be paid in monthly installments, of L.E.62,500, beginning May 15.

May 9 Purchased a film library at a cost of L.E.250,000 from Modern Film Productions, making a down payment of L.E.75,000 cash, with the balance on account payable in 30 days.

May 12 Bought supplies costing L.E.15,950, paying cash.

May 15 Paid L.E.62,500 to Cairo Radio & Television Co. as the first monthly payment on the note payable created on May 5.

May 25 Sold part of the film library to South Valley University; cost was L.E.44,500 and the selling price also was L.E.44,500. South Valley University agreed to pay the full amount in 30 days.

Required:

a. Prepare journal entries for the month of May.

b. Post to ledger accounts.

c. Prepare a trial balance at May 31, 2024.

d. Prepare a balance sheet at May 31, 2024.

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(10) After playing several seasons of professional football, Mahmoud El-Khatib had saved enough money to start a business, to be called Number 10 Auto Rental. The transactions during March 2024, while the new business was being organised are listed below:

Mar. 1 Mahmoud El-Khatib invested L.E.700,000 cash in the business.

Mar. 2 The new business enterprise purchased land and a building at a cost of L.E.600,000, of which L.E.360,000 was regarded as applicable to the land and L.E.240,000 to the building. The transaction involved a cash payment of L.E.207,500 and the issuance of a note payable for the balance. The note is due in 5 years.

Mar 4 Purchased 20 new automobiles at L.E.43,000 each from Motors Sales Company. Paid L.E.200,000 cash; the balance, in the form of note payable, is to be paid in 4 monthly installments of L.E.165,000 each, beginning March 15.

Mar. 7 Sold an automobile at cost to Mostafa Abdo, who paid L.E.12,000 in cash and agreed to pay the balance within 60 days.

Mar. 8 One of the automobiles was found to be defective and was returned to Motors Sales Company. The amount payable to this creditor was thereby reduced by l.E.43,000.

Mar. 15 Paid L.E.165,000 to Motors Sales Company as the first monthly payment on note payable created on March 4.

Mar. 20 purchased office equipment on credit; total cost, L.E.20,000, due in 30 days.

The account titles and account numbers used by the business are as follows:

Cash 10, Accounts receivable 11, Land 16, Buildings 17, Office equipment 20, Automobiles 22, Notes payable 31, Accounts payable 32, and Capital 50.

Required:

a. Journalize the March transactions.

b. Post to ledger accounts.

c. Prepare a trial balance at March 31, 2024.

d. Prepare a balance sheet at March 31, 2024.

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(11) You are required to journalize the following transactions and post them into ledger accounts, for September 2024:

Sept. 1 Started business with L.E.250,000, out of which paid into Bank L.E.100,000.

Sept. 2 Bought furniture for L.E.25,000 and machinery for L.E.50,000, all for cash.

Sept. 3 Purchased goods for L.E.70,000 cash.

Sept. 6 Sold goods for L.E.40,000 cash.

Sept. 8 Purchased goods from Mansour and Co. for L.E.55,000 on credit.

Sept. 10 Paid telephone rent for the year by check of L.E.2,500.

Sept. 11 Bought one computer for L.E.10,500 from Universal Computer Co. on credit.

Sept. 15 sold goods to Kamel for L.E.60,000.

Sept. 17 Sold goods to Rajab Omer for L.E.10,000 cash.

Sept. 19 Amount withdrawn from bank for personal use of L.E.500.

Sept. 21 Received cash from Kamel of L.E.59,500, discount allowed of L.E.500.

Sept. 22 Deposited into bank L.E.29,000 from the owner savings.

Sept. 25 Goods worth L.E.5,000 found defective were returned to Mansour and Co. and the balance of the amount due to them settled by issuing a check in their favour.

Sept. 28 Purchased goods worth L.E.10,000 from Ramzy and sold them to Sami at L.E.12,000.

Sept. 30 Sami returned 25% of sold goods, which in turn were sent to Ramzy.

Sept. 30 Issued a check for L.E.5,000 in favour of the landlord for rent of September.

Sept. 30 Paid salaries to staff L.E.7,500.

Sept. 30 Paid for stationery L.E.2,250 and postage l.E.1,750.

CHAPTER FOUR
ACCOUNTING FOR MERCHANDISING OPERATIONS

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ACCOUNTING FOR MERCHANDISING OPERATIONS

4.1 Merchandising Enterprises:

In the previous chapters, the main stress was upon illustrating the accounting cycle for organizations that render ***services*** to their customers. On the contrary, merchandising organizations earn their revenue by selling **Goods.** The goods, that merchandising enterprise sells to its customers, are called ***inventory or merchandise***. Accordingly, the inventory of an automobile dealership consists of automobiles and trucks offered for sale, whereas the inventory of a grocery store consists of a wide variety of food items and others. In most cases, inventory is a relatively ***liquid*** asset which it usually will be sold within a few weeks or months. As a result, the asset inventory appears near the top of the balance sheet, immediately below accounts receivable (debtors). In other words, the asset inventory is included into what it is called **“Current Assets”** group.

4.2 The Operating Cycle of a Merchandising Enterprise:

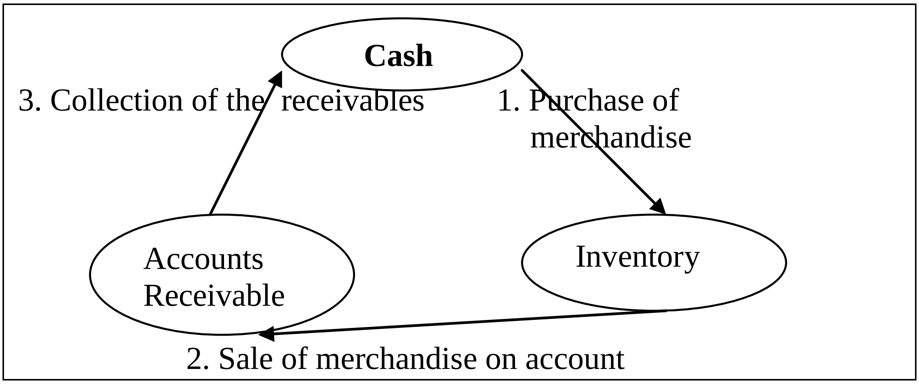
There is a series of transactions through which an enterprise generates its revenue and its cash receipts from customers. This series of transactions is called **“Operating Cycle”.** The operating cycle of a merchandising enterprise includes the following major transactions:

(1) Purchases of merchandise;

(2) Sales of the merchandise, often on account (credit); and

(3) Collection of the accounts receivable from customers.

The word **cycle** means that this sequence of transactions repeats continuously. In other words, some of the cash collected from the customers is used to purchase more merchandise, and the **cycle** begins anew. Such continuous sequence of merchandising transactions can be illustrated in the following diagram (Meigs & Meigs et. al, 1996):



In comparison with **manufacturing** enterprises, most **merchandising** enterprises purchase their inventories from other business organizations in a ***ready-to-sell*** condition. Enterprises that **manufacture** their inventories are called **manufactures** rather than **merchandisers.** Of course, the operating **cycle** of a **manufacturing** enterprise is longer and more complex than that of a **merchandising** enterprise, because the first transaction, purchasing merchandise, is replaced by the many transactions involved in manufacturing the merchandise. However, the concentration in this chapter will be confined to enterprises that purchase their inventory in a ready-to-sell condition.

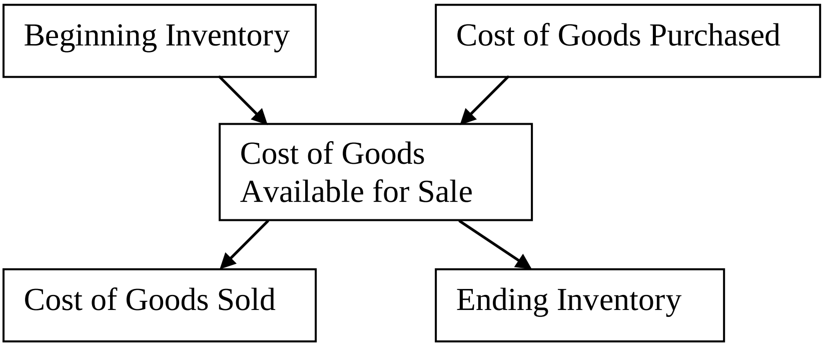
4.3 Retailers and Wholesalers:

In effect, merchandising firms include two types of traders: retailers and wholesalers. A ***retailer*** is a business enterprise that sells merchandise directly to the public or consumers. Retailers may be large or small; they vary in size from giant department store chains, such as Omer Efendy Stores, to small business, such as grocery shops. Actually, more businesses engage in retail sales than in any other types of business activity.

In contrast, the other main type of merchandising enterprise is the ***wholesaler.*** **Wholesaler** buy large quantities of merchandise from several different manufacturers and after that resell this merchandise to many different retailers. As wholesalers do not sell directly to the public, even the largest wholesalers are not well known to most consumers. Nevertheless, wholesaling is a chief type of merchandising activity.

4.4 Systems used in Accounting for Merchandising Transactions:

The flow of costs for a merchandising enterprise is as follows: Beginning inventory plus the cost of goods purchased is the cost of goods available for sale. Those goods, that are not sold by the end of the accounting period, represent ending inventory. The following illustration describes these relationships (Kimmel, Weygandt, and Kieso, 2011):



In practice, enterprises use one of two systems to account for inventory. They are:

1. A **Perpetual Inventory System,** or

2. A **Periodic Inventory System.**

4.4.1 Perpetual Inventory System:

In this system, *perpetual inventory system*, merchandising transactions are recorded **as they occur.** This system draws its name from the fact that the accounting records are maintained perpetually up-to-date. Accordingly, **purchases** of merchandise are recorded by debiting an asset account entitled **"Inventory Account."** When merchandise is sold, **two** entries are needed: **one** to recognize the **revenue earned** and the **second** to recognise the related **cost of goods sold.** As such, this second entry also reduces the balance of the **Inventory Account** to reflect the sale of some of the firm's inventory.

In a ***perpetual inventory system,*** enterprises maintain detailed records of the cost of each inventory purchase and sale. These records continuously-perpetually- show the inventory that should be on hand for every time. For example, a car dealership has separate inventory records for each automobile, truck, and van on its lot and showroom floor. Similarly, a grocery store uses bar codes and optical scanners to keep daily running records of every box of cereal and every jar of jelly that it buys and sells. Under this system, a firm determines the cost of goods sold ***each time a sale occurs.***

This system includes an ***Inventory Subsidiary Ledger***. Such ledger provides enterprise's employees with updated information about each type of product that the enterprise sells, including the per-unit cost and the number of units purchased, sold, and currently on hand.

An Illustration:

The following are some transactions regarding specific items of merchandise through the operating cycle of **Computer World,** a retail store.

Sept. 1 Purchased 10 CX-21 computer monitors (screens) on account from National Wholesale Co. The monitors cost **L.E.3,000** each, for a total of **L.E.30,000**; payment is due in 30 days.

Sept. 7 Sold 2 monitors on account to Luxor Travel Agency at a retail sales price of **L.E.5,000** each, for a total of **L.E.10,000.** Payment is due in 30 days.

Oct. 1 Paid the **L.E.30,000** account payable to National Wholesale Co.

Oct. 7 Collected the **L.E.10,000** account receivable from Luxor Travel Agency.

In addition to a general ledger, **Computer World** maintains separate subsidiary ledger for inventory.

Required:

Record the above transactions according to perpetual inventory system.

Solution:

<u>Purchases of Merchandise on Sept. 1:</u>

Of course, purchases of inventory are recorded at cost. Hence, Computer World records its purchase of the 10 computer monitors on September 1 as follows:

By Inventory Account………… 30,000
To Accounts Payable Account
(National Wholesale C0.) 30,000
Purchased 10 computer monitors for L.E.3,000 each; Payment due in 30 days.

Note that, the data contained in this entry are posted to the general ledger **<u>in addition to the subsidiary ledgers.</u>** First of all, the entry is posted to the **Inventory and Accounts Payable** in the General Ledger. The debit to **Inventory** also is posted to the CX-21 Monitors Account in the inventory subsidiary ledger. The quantity of monitors purchased (**10**) and the per-unit cost

(**L.E.3,000**) also are recorded in this subsidiary ledger account (as it will be illustrated below).

Sales of Merchandise on Sept. 7:

The revenue earned in a sales transaction is equal to the **Sales Price** of the merchandise and is credited to a revenue account entitled **Sales.** Except in scarce circumstances, sales revenue is considered ***recognized*** when the merchandise is *delivered to the customer*, even if the sale is made on account. As a result, Computer World will recognize the revenue from the sale to Luxor Travel Agency on September 7, as presented below:

By Accounts Receivable (Luxor Travel Agency)	10,000	
To Sales Account………………		10,000

Sold 2 CX-21 monitors for L.E.5,000 each; payment due in 30 days.

Furthermore, a *second journal entry* is needed at the date of sale to record the cost of goods sold, as shown below:

By cost of Goods Sold a/c……	6,000	
To Inventory a/c………		6,000

To transfer the cost of 2 CX-21 monitors (L.E.3,000 apiece) from Inventory to the Cost of Goods Sold Account.

You will notice that this second entry is based on the **cost** of the merchandise to Computer world, not on its retail sales price. The per-unit cost of the CX-21 monitors (L.E.3,000) was determined from the inventory subsidiary ledger. Both of the journal entries relating to this sales transaction are posted to Computer World’s General Ledger. Moreover, the **L.E.10,000** debit to Accounts Receivable (first entry) is posted to the account for Luxor Travel Agency in the accounts receivable ledger. The credit to Inventory (second entry) also is posted to the CX-21 Monitors Account in the inventory subsidiary ledger.

Payment of Accounts Payable to Suppliers on Oct. 1:

The payment to National Wholesale Co. on October 1 can be recorded as follows:

By Accounts Payable a/c (N. Wholesale Co.)…………	30,000	
To Cash a/c…………………		30,000
Paid account payable.		

Collection of Accounts Receivable from Customers on Oct. 7:

On October 7, the process of collection of the account receivable from Luxor Travel Agency will be recorded as shown below:

By Cash a/c……………………	10,000	
To Accounts Receivable a/c (Luxor Travel agency)……….		10,000
Collected an account receivable from a credit customer.		

Also, both portions of this entry are posted to the general ledger; the **credit** to **Accounts Receivable** also is posted to **Luxor Travel Agency Account** in the accounts receivable ledger. In addition, it can be said that the collection of the cash from Luxor Travel Agency completes Computer World's operating cycle with regard to these 2 units of merchandise.

The Inventory Subsidiary Ledger:

In fact, an inventory subsidiary ledger contains a separate account (or **inventory card**) for each type of product in the enterprise's inventory. Computer World's subsidiary inventory record for CX-21 monitors can be shown as follows:

Item CX-21 **Primary supplier** N. Wholesale Co.
Description 21” Gray scale Mon. **Sec. Supplier** United Importers Co.
Location Storeroom 2 **Inventory Level: Min** 2 **Max:** 10

	Purchased			**Sold**			**Balance**		
Date	**Units**	**Unit Cost**	**Total**	**Units**	**Unit Cost**	**Cost of Goods Sold**	**Units**	**Unit Cost**	**Total**
Sep.		**L.E.**	**L.E.**					**L.E.**	**L.E.**
1	**10**	**3000**	**30000**		**L.E.**	**L.E.**	**10**	**3000**	**30000**
7				**2**	**3000**	**6000**	**8**	**3000**	**24000**

As you notice above, when CX-21 monitors are purchased, the quantity, unit cost, and total cost are entered in this subsidiary ledger account. On the other hand, when any of these monitors are sold, the number of units, unit cost, and total cost of the units sold are recorded in this subsidiary ledger account. After each purchase or sales transaction, the **Balance** columns are updated to show the quantity, unit cost, and total cost of the monitors still on hand.

4.4.2 Periodic Inventory System:

In the merchandising enterprise, a **Periodic Inventory System** is an *alternative* system to a **perpetual inventory system**. In this system, a **periodic inventory system**, no effort is made to maintain **up-to-date** records of either the inventory or the cost of goods sold. Alternatively, these amounts are determined only **"Periodically"**, usually at the end of each year. Thus, in this system, enterprises do not keep detailed inventory records of the goods on hand throughout the period. They determine the cost of goods sold ***only at the end of the accounting period***. At that point, the enterprise takes a physical inventory count to determine the cost of goods on hand.

To determine the cost of goods sold under a periodic inventory system, the following steps are necessary:

1. Determine the cost of goods on hand at the beginning of the accounting period.

2. Add to it the cost of goods purchased.

3. Subtract the cost of goods on hand at the end of the accounting period.

Operation of a Periodic Inventory System:

In practice, a periodic inventory system operates as follows: When merchandise is purchased, its cost is debited to an account entitled **Purchases Account**, rather than to the **Inventory Account.** When merchandise is sold, an entry is made to recognize the sales revenue, but **No entry** is made to record the **cost of goods sold** or to **reduce** the **balance** of the **Inventory Account.** As the inventory records are not updated as transactions occur, there is **No** inventory subsidiary ledger. The basic procedure of the **periodic inventory system** is the taking of a **complete physical inventory** at year-end. Such physical count determines the amount of inventory appearing in the balance sheet. The cost of goods sold for the entire year then is determined by a **short computation.**

An Illustration:

For example, assume that Happy Occasions, a special occasion supply store, has a periodic inventory system. At December 31, 2024, the following information is obtained from the enterprise's records:

1- The inventory on hand at the end of 2023 cost **L.E.70,000.**

2- During 2024, purchases of merchandise for resale to customers totaled **L.E.650,000.**

3- Inventory on hand at the end of 2024 cost **L.E.60,000.**

The inventories at the ends of 2023 and 2024 were specified by taking a **complete physical inventory** at (or very near) each year-end. As the **Inventory Account** was **not updated** as transactions occurred during 2024, it still shows a **balance** of **L.E.70,000** (the inventory on hand at the **beginning** of the year). Moreover, the **L.E.650,000** cost of merchandise purchased during 2024 was recorded in the **Purchase Account.**

Recording Purchases of Merchandise:

Happy Occasions made several purchases of merchandise during 2024. The required to record the first of these purchases can be illustrated as follows:

Jan. 6
By Purchases a/c……… 650,000
To Accounts Payable
(Food Products Co.) 650,000
Purchased inventory on account; payment due in 30 days.

Of course, the above entry was posted to the **Purchases** and **Accounts Payable Accounts** in the general ledger. The **debit** to Purchases was **not** *double-posted*, as there is **no inventory subsidiary ledger** in a periodic system.

Computing the Cost of Goods Sold:

The inventory at the year-end is determined by taking a complete physical count of the merchandise on hand. Once the ending inventory is known, the **cost of goods sold** for the entire year can be specified by a short computation, as shown below, using the 2024 data for Happy Occasions:

Beginning inventory (1) L.E.	70,000
Add: Purchases (2)……………	650,000
Cost of goods available for sale	720,000
Less: Ending inventory (3)…….	60,000
Cost of goods sold……………	660,000

Recording Inventory and the Cost of Goods Sold:

Happy Occasions has at the moment determined its inventory at the end of 2024 and its **cost of goods sold** for the year. Nevertheless, neither of these amounts has yet been recorded in the firm’s accounting records. In adopting a periodic system, the ending inventory and the cost of goods sold are **recorded** during the firm's year-end **closing procedures.** The term *closing procedures* can be referred to the making of **end-of-period adjusting and closing entries.**

In summary, an operation of a periodic inventory system can follow the following procedures:

(1) Purchase of Merchandise:

As it has been explained above, under a periodic inventory system, the cost of merchandise purchased for resale is recorded by an account called **Purchase Account**, as shown in the following entry:

By Purchases a/c……………	140,000	
To Accounts Payable a/c (Yahya Wholesale Co.)……		140,000
Purchased merchandise on account.		

(2) Other Accounts Included in the Cost of Goods Sold:

The *cost of goods sold* for the entire year is determined at year-end by a simple computation as shown below:

Inventory: beginning of the year (per last year physical count)… L.E.	10,000
Add: Purchases …………….	140,000
Cost of goods available for sale during the year………………………	150,000
Less: Ending inventory (per this year's physical count)…………………	12,000
Cost of goods sold………………	138,000

In the above illustration, only three items were used in computing the *cost of goods sold*: beginning inventory, purchases, and ending inventory. Nevertheless, in most cases two further accounts may be involved in this computation; that is, **Purchase Returns and Allowances,** and **Transportation-in.** these items will be highlighted as follows:

Purchase Returns and Allowances:

When merchandise purchased from wholesalers or suppliers is found to be unsatisfactory, the goods may be returned or a request may be made for an allowance on the price. When goods are returned to the suppliers, the journal entry to record this process can be as follows:

By Accounts Payable a/c (Yahya Wholesale Co.)……	3,000	
To Purchase Returns and Allowances a/c……….........		3,000
To reduce liability to Yahya Wholesale Co. by the cost of goods returned for credit.		

Purchase Returns and Allowances Account may be considered a reduction in the cost of purchases made during the period. So, it is preferable to credit this **contra- purchase account** when merchandise is returned to supplier rather than crediting the **Purchase Account** directly.

Transportation-in:

Practically, **transportation** charges concerning merchandise are treated in the same manner in both **periodic** and **perpetual systems.** As such, the freight charges which are paid on coming shipments are debited to an account called **Transportation-in Account** that is added to the **cost of goods sold.** On the other hand, delivery costs on sold shipments are debited to **Delivery Expense Account,** which is classified as a selling expense.

Accounting for Sales Transactions:

Also, accounting for sales transactions does not change under both periodic and perpetual inventory system. But, there is one notable exception. In a periodic inventory system, no entries are made to transfer costs from the **Inventory Account** to the **Cost of Goods Sold Account.** For example, assume that Mohamed Stores sells merchandise on account to Yousif Shop for **L.E.6,000.** Yousif Shop finds **L.E.1,000** worth of this merchandise defective and returns it to Mohamed Stores immediately. Yousif Shop then pays for the remainder of these goods. The entry required for recording the original sales transaction by Mohamed Stores will be as follows:

By Accounts Receivable (or Debtors)
a/c (Yousif Shop)………… 6,000
To Sales a/c……………… 6,000
To record credit sale, terms.

You will notice that **<u>only one journal entry</u>** is needed to record a sale. Hence, the basic advantage of a periodic inventory system is that it is not necessary to record the **cost of goods sold** concerning individual sales transactions.

By Sales Returns and Allowances a/c 1,000
To Accounts Receivable a/c
(Yousif Shop) 1,000
Credit customer returned defective merchandise.

Again, only one journal entry is required. Under a periodic inventory system, no entry is made to update the **Inventory Account** or to adjust the **cost of goods sold.** As a result of this sales return, Yousif Shop owes Mohamed Stores only of **L.E.5,000.** Hence, the journal entry necessary to record the collection of this account receivable will be as follows:

By Cash a/c……………………	5,000	
To Accounts Receivable a/c (Yousif Shop)………………………		5,000
To record collection of account receivable.		

4.5 Additional Transactions Related to Purchases and Sales of Merchandise:

In practice, merchandising transactions are not limited to the basic transactions discussed in the preceding sections of this chapter. In addition to those transactions, merchandising enterprises must pay much attention to and account for a variety of additional transactions, such as discount offered to credit customers for prompt payment, merchandise returns and refunds, transportation costs, and so on.

4.5.1 Additional Transactions Related to Purchases:

Conventionally, purchases of merchandise are usually recorded at cost. Nevertheless, this cost can be affected by some factors such as **Cash Discount** and **Transportation Charge.**

4.5.1.1 Credit Terms and Related Cash Discounts:

Normally, wholesalers and manufacturers sell their merchandise ***on account*** (also called on credit). As such, the **credit** terms are often stated in the seller's bill (also called **invoice**). In the usual conditions, wholesalers and manufacturers allow their customers **one or to months** in which to pay for credit purchases. This period may be varied from firm to firm depending upon its circumstances. Nevertheless, sellers frequently offer their customers (purchasers or buyers) a small discount to encourage them for earlier payment.

In practice, perhaps the most common credit terms provided by manufacturers or wholesalers are ***2/10, n/30.*** This expression is read ***2, 10, net 30,*** and **means** that full payment is due in **30 days**, but that the purchaser may take ***2% discount*** if payment is made within ***10 days***. Accordingly, the period during which the discount is available is **called** the ***discount period***. As the discount offers an incentive for the customer to make any early **cash** payment, it is termed a ***cash discount***. In the buyers or purchasers point of view, these discounts are referred to as ***purchase discounts***, while sellers frequently refer to them as ***sales discounts*****.**

Enterprises, which benefit from advantage of all cash discounts offered on purchases of merchandise, firstly record purchases of merchandise at the **net cost.** In other words, theses enterprises initially record these purchases using **invoice price** *minus* any available discount.

For instance, suppose that on November 3 **Computer World** purchases **100** power-point programmes from **PC Products.** The cost of these programmes is **L.E.500** each, for a total of **L.E.50,000.** Nevertheless, **PC Products** provides credit terms of **2/10, n/30.** If **Computer World** pays for this purchase within the discount period, it will have to pay only **L.E.49,000, or 98%** of the full invoice price. Hence, Computer World will record this purchase as follows:

By Inventory a/c (or Purchases)   49,000
    To Accounts Payable a/c (PC Products)   49,000
To record purchase of 100 power-point programmes at net cost (L.E.500 x 98% x 100).

Therefore, if the invoice is paid within the discount period, **Computer World** will record payment of a **L.E.49,000** account payable. On the other hand, **Computer World** could fail, depending upon its financial conditions, to make payment within the discount period. In this case, **Computer World** shall pay **PC Products** the entire invoice price of **L.E.50,000,** rather than the recorded liability of **L.E.49,000.** As such, the journal entry which is required to record payment ***after the end of discount period***, for example, on December 3, will be as follows:

By Sundries:
Accounts Payable a/c (PC Products) 49,000
Purchase Discounts Lost…………   1,000
    To Cash a/c…………………   50,000
To record payment of invoice after expiration of Discount period.

From the above entry, you will notice that the additional amount of **L.E.1,000** paid since the discount period has expired is debited to an account entitled **Purchase Discounts Lost. Purchase Discounts Lost** is an ***expense discount.*** Therefore, the only benefit to Computer World from this **L.E.1,000** expenditure was a **20-days delay** in paying for its obligation (an accounts payable). Accordingly, the lost purchase discount is basically considered a **finance charge,** the same as interest expense. Moreover, in an **Income Statement**, **finance charges** usually are classified as **non-operating** expenses.

Additionally, the fact that purchase discounts ***not taken*** (lost) are recorded in a separate expense account is the major reason why an enterprise has to record purchases of merchandise at **net cost.** The idea beyond the use of a **Purchase Discounts Lost Account** is that this treatment immediately brings to enterprise management's attention any failure to take advantage of the cash discounts offered by suppliers.

Recording Purchases at Gross Invoice Price:

As an alternative to recording purchases at **net cost**, and following more conservative policy, some business enterprises may select to record merchandise purchases at the **gross (total)** invoice price. Accordingly, if payments are made within the **discount period**, the enterprises must record the amount of the **purchase discount *taken*** (also called **Discounts Received**).

For example, assume that **Computer World** adopted a policy of recording purchases at **gross** invoice price. The required entry on November 3 to record the purchase from **PC Products** would have been shown as below:

By Inventory (or Purchases) a/c.. 50,000
To Accounts Payable (PC Products) 50,000
To record purchase of 100 power-point programmes at gross invoice price (L.E.500 x 100 units).

As such, if agreed payment is made within the discount period, **Computer World** discharge this **L.E.50,000** account payable by paying only **L.E.49,000**, as shown below:

By Accounts Payable a/c (PC Product) 50,000
To sundries:
Cash a/c……………… 49,000
Purchase Discounts Taken a/c 1,000
Paid a L.E.50,000 invoice within the discount period; taking a 2% purchase discount.

Notice that **Purchase Discounts Taken Account (or Discounts Received Account)** is considered as a reduction in the cost of goods sold.

Anyway, the above two methods, the **net cost and gross price,** are widely used and tend actually to the same results in financial statements. Perhaps the basic shortcoming in the **gross price** method is that it does **not** direct or pay management's attention to discounts lost.

4.5.1.2 Returns of Unsatisfactory Purchased Merchandise:

Sometimes, a buyer may discover that the purchased merchandise is unsatisfactory and want to return it to the supplier for a refund. The majority of sellers permit such refunds. For example, suppose that on November 9 **Computer World** returns to **PC Products** 5 of the power-point programmes purchased on November 3, because these programmes were not appropriately labelled. Since **Computer World** has not yet paid for this merchandise, the return will reduce the amount that **Computer World** owes **PC Products.** The gross invoice price of the returned merchandise was **L.E.2,500 (L.E.500 per**

programme). You must keep in mind, however, that **Computer World** records purchases at **<u>net cost.</u>** Built on this fact, these power-point programmes are posted into **Computer World's** inventory subsidiary ledger at a per-unit cost of **L.E.490, or L.E.2,450** for the 5 programmes being returned. Therefore, the proper entry to record this purchase return will be as follows:

By Accounts Payable a/c (PC Products)	2,450	
To Inventory a/c…………		2,450
Returned 5 defective power-point programmes to supplier.		

The reduction in inventory must also be recorded in the subsidiary ledger accounts.

4.5.1.3 Transportation Costs on Purchases

The sales agreement should indicate who-the seller or the buyer-is to pay for transporting the goods to the buyer's place of business. When a common carrier such as a railroad, trucking company, or airline transports the goods, the carrier prepares a freight bill in accord with the sales agreement.

Freight terms are expressed as either FOB shipping point or FOB destination. The letters FOB mean ***free on board***. Thus, **FOB shipping point** means that the seller places the goods free on board the carrier, and the buyer pays the freight costs. Conversely, **FOB destination** means that the seller places the goods free on board to the buyer's place of business, and the seller pays the freight. So, the purchaser sometimes may pay the costs of delivering the purchased merchandise to its address. In fact, transportation costs relating to the **acquisition** of inventory or any other **asset** are **not expenses** of the current accounting period; rather, these charges are considered **part of the cost of the asset** being obtained.

It is recognized that the ***cost*** of an asset includes all reasonable and necessary costs of getting the asset to an appropriate location and putting it into usable condition. Hence, if the purchaser is able to attach transportation costs to particular products, these costs should be **debited directly** to the inventory account as part of the **cost** of the merchandise. For example, if Computer World (the buyer) pays L.E.1,500 for freight charges, it will record the following entry in its books:

Inventory (or Purchases) a/c To Cash a/c To record payment of freight on goods purchased.	1,500	 1,500

Thus, any freight costs incurred by the buyer are part of the cost of merchandise purchased. The reason: Inventory cost should include any freight charges necessary to deliver the goods to the buyer.

Mostly, a variety of different products arrive in a single shipment. As such, it may be impractical for the purchaser to specify the amount of the total **transportation cost** applicable to each product. As a result, many enterprises follow the proper policy of debiting all transportation costs to an account entitled ***Transportation-in Account***. The pound amount of transportation-in usually is too small to present separately in the financial statements. Accordingly, this amount is merely included in the amount reported in the income statement as cost of goods sold.

4.5.2 Additional Transactions Related to Sales

As it was discussed and illustrated transactions related to purchases, credit terms and merchandise returns also influence the amount of sales revenue achieved by the seller. As long as the credit customers (buyers or debtors) take advantage of cash discounts or return merchandise for a refund, the seller's revenue is reduced. Hence, revenue presented in the **Income Statement** of a merchandising enterprise is usually called **<u>net sales</u>**. Thus, the term ***net-sales*** means that this figure represents total sales revenue **minus** sales **returns** and **allowances** and **minus sales discounts.**

4.5.2.1 Sales Returns and Allowances:

Normally, the majority of merchandising enterprises permit customers (buyers) to get a refund by returning any merchandise regarded to be unsatisfactory. Thus, if the merchandise has only slight defects, customers sometimes agree to keep the merchandise when an **allowance** (or reduction) in the sales price is given.

As such, under the **perpetual inventory approach,** two journal entries are required in order to record the sale of merchandise: the first of them is to recognize the revenue earned and the other is to transfer the cost of the merchandise from the **Inventory Account** to **Cost of Goods Sold.** So, if some of the merchandise is returned, both of these journal entries are **partially reversed.** Firstly, the journal entry to reduce sales revenue as the result of a sales **return** (**allowance**) may be shown as follows (for example):

By Sales Returns and Allowance a/c	2,000	
To Accounts Receivable (or Cash) a/c		2,000
Customer returned merchandise purchased on account for L.E.2,000. Allowed customer full credit for returned merchandise.		

In effect, **Sales Returns and Allowances** is considered a **contra-revenue account.** This is because it is deducted from gross sales revenue as a procedure to determine net sales. Moreover, the question that imposes itself is: why use a separate **Sales Returns and Allowances Account** rather than only debiting the **Sales Account**? The answer is that using a separate **contra-revenue account** may enable management to see both the total amount of sales in addition to the amount of sales returns. Also, the relationship between these amounts provides management with an indication of customer satisfaction with the merchandise.

Furthermore, if merchandise is returned by the customer, a **second** entry must be made to remove or deduct the cost of this merchandise from the **Cost of Goods Sold Account** and restore it to the **inventory records**, as shown below:

By Inventory a/c…………………	1,600	
To Cost of Goods Sold a/c……		1,600
To restore in the Inventory Account the cost of merchandise returned by a customer.		

Form the above entry you will notice that it is based on the **cost** of the returned merchandise to the seller, ***not on its sales price*****.** Also, this entry is not necessary when a sales **allowance** is given to a customer who keeps the merchandise instead of returning it.

4.5.2.2 Sales Discounts (Discounts Allowed):

Previously, it has been discussed that sellers frequently offer **cash discounts**, for example, **2/10, n/30,** to encourage their customers (buyers) to make **early** payments for purchases on account (on credit). But sellers and buyers account for or treat **cash discounts** differently**.** For the seller, the **cost related to cash discounts** is not the discounts **lost** when payments are delayed, but rather the discounts **taken** by customers that pay within the discount period. Thus, sellers often design their accounting systems to measure the **sales discounts** *taken* by their customers. For accomplishing this objective, the seller records the sale and the related account receivable at the **gross** or full invoice price.

For example, suppose that **Computer World** sells merchandise to **Adam Nouh** for **L.E.5,000**, offering terms of **2/10, n/30.** The sales revenue is recorded at the full invoice price, as presented below:

By Accounts Receivable a/c (Adam Nouh)	5,000	
To Sales a/c………………		5,000

Sold merchandise on account. Invoice price, L.E.5,000; terms, 2/10, n/30.

Accordingly, if **Adam** pays after the discount period has expired, **Computer World** merely records the receipt of **L.E.5,000** cash in full payment of this account receivable. On the contrary, if **Adam** pays **within** the discount period, he will pay only **L.E.4,900** to settle his account. As such, **Computer World** will record the receipt of **Adam's** payment as shown below:

By sundries:
Cash a/c…………………… 4,900
Sales Discounts (or Disc. Allowed) a/c 100
To Accounts Receivable a/c (Adam Nouh) 5,000
Collected a L.E.5,000 account receivable from a customer who took a 2% discount for early payment.

Notice that **Sales Discounts (also called Discounts Allowed)** is also considered another **contra-revenue account.** Therefore, in computing **net sales**, **Sales Discounts** are deducted from **gross** sales along with any sales returns and allowances.

On the other hand **contra-revenue accounts** have much in common with **expense accounts;** both are deducted from gross revenue in determining **net income**, and both have **debit balances**.

4.5.2.3 Sales Delivery Expenses:

Sometimes the seller may pay for delivering merchandise to customers. If the seller incurs any costs in delivering merchandise to the customer, these costs are debited to an expense account which is entitled **Delivery Expense Account** (or Transportation-out Account / Freight-out Account). As such, in an income statement, delivery expense is classified as a **regular operating expense, <u>not</u>** as part of the cost of goods sold. For example, if the seller pays L.E.2,500 for freight charges, it will record the following entry in its books:

Freight-out a/c	2,500	
To Cash a/c		2,500
To record payment of freight on goods sold.		

4.5.3 Cash Discounts and the Three-column Cash Book:

4.5.3.1 Cash Discounts:

As it has been explained, it will be better if the enterprise's customers pay their accounts as quickly as possible. A business enterprise may accept a smaller sum in full settlement if payment is made within a certain period of time (discount period). As explained earlier, the amount of the reduction of the sum to be paid is termed ***Cash Discount.*** Thus, the term *cash discount* refers to the allowance given for prompt payment. The rate of cash discount is usually stated as a percentage, according to transaction terms, which are quoted on all sales documents by the selling firm.

4.5.3.2 Discounts Allowed and Discounts Received:

In effect, an enterprise may have two types of **cash discounts** in its books. These types are as follows:

1- **Discounts Allowed (or Sales Discounts).** Cash discounts allowed by a business enterprise to its customers (buyers or debtors) when they pay their accounts due promptly.

2- **Discounts Received (or purchase discounts).** This type of discounts is received by a business enterprise from its suppliers when it pays their accounts promptly.

4.5.3.3 Discount Columns in Cash Book:

Usually, the discounts allowed account and the discounts received account are in the **General Ledger** along with all the other revenue and expense accounts. In practice, every effort should be made to avoid too much reference to the **General Ledger.** Therefore, in the case of discounts this can be done by adding an additional column on each side of the cash book in which the amounts of discounts are entered. As such, **discounts received** are entered in the discounts column on the **credit side** of the cash book, while **discounts allowed** are entered in the discounts column on the **debit side** of the cash book. Accordingly, the cash book, taking the discounts into account, can be shown as explained in the following comprehensive illustration.

Comprehensive Illustration:

The following information appears in the books of **Happiness Firm** during May 2024 and you are required to prepare the Cash Book to record this information:

May 1 Balances brought down from April:

Cash Balance **L.E.2,900**, Bank Balance **L.E.65,400**. Debtors Accounts: Kamil **L.E.12,000**, Karima **L.E.28,000**, Shahinda **L.E.4,000**. Creditors Accounts: Basim **L.E.6,000,** Ahmed **L.E.44,000,** Lokman **L.E.10,000.**

May 2 Kamil pays by check, having deducted 2.5% cash discount **L.E.300, L.E.11,700.**

May 8 Paid Lokman his account by check, deducting 5% cash discount **L.E.500, L.E.9,500.**

May 11 Withdrawn **L.E.10,000** cash from the bank for business use.

May 16 Karima pays her account by cheque, deducting **2.5%** discount **L.E.700, L.E.27,300.**

May 25 Paid wages in cash, **L.E.9,200.**

May 28 Shahinda pays her account in cash after having deducted **5%** cash discount of **L.E.200**, **L.E.3,800.**

May 29 Paid Basim by check less **5%** cash discount of **L.E.300, L.E.5,700.**

May 30 Paid Ahmed by check less **2.5%** cash discount of **L.E.1,100, L.E42,900.**

Solution:

Receipts Cash Book Payments

Particulars	Discount	Cash	Bank	Particulars	Discount	Cash	Bank
May 1	L.E.	L.E.	L.E.	May 8	L.E.	L.E.	L.E.
Balance b/d		2900	65400	Lokman	500		9500
May 2				May 11			
Kamil	300		11700	Cash			10000
May 11				May 25			
Bank		10000		Wages		9200	
May 16				May 29			
Karima	700		27300	Basim	300		5700
May 28				May 30			
Shahinda	200	3800		Ahmed	1100		42900
				May 31			
				Balance c/d		7500	36300
	1200	16700	104400		1900	16700	104400
Jun 1							
Balance b/d		7500	36300				

4.6 Questions and Problems:

4.6.1 Questions:

1. Mohamed Ali Enterprise uses a **perpetual** inventory system. The firm sells merchandise (goods) costing **L.E.15,000** at a sales price of **L.E.21,500.** In recording this transaction, the accountant will make all of the following entries ***<u>except:</u>***

a. Credit Sales, **L.E.21,500.**

b. Credit Inventory, **L.E.21,500.**

c. Debit Cost of Goods Sold, **L.E.15,000.**

d. Credit Inventory, **L.E.15,000.**

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2. Fashion House Enterprise uses a **perpetual** inventory system. At the beginning of the year, inventory amounted to **L.E.50,000.** During the year, the firm purchased merchandise for **L.E.230,000,** and sold goods costing **L.E.245,000.**

The year-end balance in the firm's Inventory Account was:

a. L.E.31,000 **b. L.E.35,000**

c. L.E.50,000 **d.** Some other amount.

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3. Solid Hardware uses a **periodic** inventory system. Its inventory was **L.E.38,000** at the beginning of the year and **L.E.40,000** at the end. During the year, the firm made purchases of goods totaling **L.E.107,000**. Identify all of the correct answers:

a. To use this system, Solid must take a complete physical inventory twice each year.

b. Prior to making adjusting and closing entries at year-end, the balance in Solid's Inventory Account is **L.E.38,000.**

c. The cost of goods sold for the year is **L.E.109,000.**

d. As sales transactions occur, Solid makes no entries to update its inventory records or record the cost of goods sold.

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4. United Brothers, a retail store, bought 100 cassette sets from Telemisr Electronics on account at a cost of **L.E.1,000** each. Telemisr offers credit terms of **2/10, n/30.** United Brothers uses a perpetual inventory system and records purchases at **net cost**. United Brothers determines that 10 of these cassette sets are defective and returns them to Telemisr for full credit. In recording this return, United Brothers will:

a. Debit Sales Returns and Allowances.

b. Debit Accounts Payable **L.E.9,800.**

c. Debit Cost of Goods Sold, **L.E.9,800.**

d. Credit Inventory Account, **L.E.10,000.**

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5. Carriage inwards is charged to the trading account because:

a. It is an expense related to buying goods.

b. It should not go in the balance sheet.

c. It is not part of car expenses.

d. Carriage outwards goes in the profit and loss account.

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6. Given figures showing: Sales **L.E.82,000;** Opening stock **L.E.13,000;** Closing stock **L.E.9,000;** purchases **L.E.64,000;** Carriage inwards **L.E.2,000,** the cost of goods sold figure is

a. L.E.68,000 **b. L.E.62,000**

c. L.E.70,000 **d.** Another figure.

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7. A debit balance of **L.E.10,000** in a cash account shows that:

a. There was **L.E.10,000** cash in hand

b. Cash has been overspent by **L.E.10,000**

c. L.E.10,000 was the total of cash paid out

d. The total of cash received was less than **L.E.10,000.**

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8. **L.E.5,000** cash taken from the cash till and banked is entered:

a. Debit cash column **L.E.5,000:** Credit bank column **L.E.5,000**

b. Debit bank column **L.E.5,000:** Credit cash column **L.E.5,000**

c. Debit cash column **L.E.5,000:** Credit cash column **L.E.5,000**

d. Debit bank column **L.E.5,000:** Credit bank column **L.E.5,000.**

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9. A credit balance of **L.E.20,000** on the cash columns of the cash book mean

a. We have spent **L.E.20,000** more than we have received.

b. We have **L.E.20,000** cash in hand

c. The bookkeeper has made a mistake

d. Someone has stolen **L.E.20,000.**

Answers to multiple choice questions:

1. b **2.** b **3.** b, d **4.** b **5.** a **6.** a 7**.** a **8.** b **9.** c

4.6.2 Problems:

1. Nile-Sat sells satellite tracking systems for receiving television broadcasts from communications satellites in space. At December 31, 2024, the firm's inventory amounted to **L.E.44,000.** During the first week in January 2024, Nile-Sat made only one purchase and one sale. These transactions were as follows:

- Jan. 3 Sold a tracking system to the National Sporting Club for **L.E.20,000** cash. The system consisted of 7 different devices, which had a total cost to Nile-Sat of **L.E.11,200.**

- Jan. 7 purchased 2 Model 400 and 4 Model 800 satellite dishes from Telemisr Corp. The total cost of this purchase amounted to **L.E.10,000;** terms **2/10, n/30.**

Nile-Sat records purchases of merchandise at net cost. The enterprise has fulltime accounting personnel and uses a manual accounting system.

***Required*:**

a. Briefly describe the operating cycle of a merchandising enterprise.

b. Prepare journal entries to record these transactions assuming that Nile-Sat uses a perpetual inventory system.

c. Compute the balance in the **Inventory Controlling Account** at Jan. 7.

d. Prepare journal entries to record the two transactions, supposing that Nile-Sat uses a **periodic** inventory system.

e. Compute the cost of goods sold for the first week of January, assuming use of the periodic system. As the amount of ending inventory, use your answer to part **c.**

***Solution*:**

a. The operating cycle of a merchandising enterprise consists of purchasing merchandise, selling that merchandise to customers (cash or on account), and collecting the sales proceeds from credit customers. In such cycle, the enterprise converts cash into inventory, the inventory into accounts receivable (debtors), and the accounts receivable into cash.

b. Journal entries assuming use of a **perpetual** inventory system.

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Date	Account Titles and Explanation	Debit	Credit
2025 Jan. 3	By Cash a/c………… To Sales a/c…………… Sold tracking system to National Sporting Club.	20,000	 20,000
3	By Cost of Goods Sold a/c… To Inventory a/c………… To record cost of goods sold.	11,200	 11,200
7	By Inventory a/c ………… To Accounts payable Purchased merchandise, Terms 2/10, n/30; net cost, L.E.9,800 (L.E.10,000, minus 2%).	9,800	 9,800

c. L.E.42,600 (L.E.44,000 beginning balance, less **L.E.11,200,** plus **L.E.9,800).**

d. Journal entries assuming use of a **periodic** inventory system.

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Date	Descriptions	Debit	Credit
2025	By Cash a/c………	20,000	
Jan. 3	To Sales a/c…………		20,000
	Sold tracking system to National Sporting Club.		
7	By Purchases a/c ………	9,800	
	To Accounts payable		9,800
	Purchased merchandise, Terms 2/10, n/30; net cost, L.E.9,800 (L.E.10,000, minus 2%).		

e. Computation of the cost of goods sold:

Inventory, January 1 ………………	L.E.	44,000
Add: Purchases ……………………		9,800
Cost of goods available for sale………		53,800
Less: Inventory, January 7 (per part c)		42,600
Cost of goods sold …………………		11,200

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2. Upper Egypt enterprise uses a perpetual inventory system. On January 1 the Inventory

Account had a balance of **L.E.93,500.** During the first few days of January, the following transactions happened:

Jan. 2 Purchased merchandise on credit from Victory Co. for **L.E.6,300.**

Jan. 3 Sold merchandise for cash, **L.E.19,000.** The cost of these goods was **L.E.12,500.**

Required:

a. Prepare entries in general journal form to record the above transactions.

b. What was the balance of the Inventory Account?

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3. Commercial Bookshop returned certain merchandise which it had purchased from Dar-Elmaarif. Dar-Elmaarif allowed the bookshop full credit for this return against the account receivable (debtors) from the bookshop. The returned goods had been purchased by Commercial Bookshop for **L.E.70,000,** terms **2/30, n/90.** Commercial

Bookshop records purchases of merchandise **<u>net</u>** of any available cash discounts.

<u>Required</u>

Prepare journal entries to record the return of this merchandise in the accounting records of (a) Commercial Bookshop and (b) Dar-Elmaarif. (Assume that the cost of the goods to Dar-Elmaarif had been **L.E.56,000**.)

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4. Modern Office sells facsimile machines, copiers, and other types of office equipment. On May 10, the firm purchased for the first time a new **plain-paper** fax manufactured by Xerox Company. Transactions relating to this product during May and June were as follows:

May 10 Purchased five P-500 facsimile machines on account from Xerox Co., at a cost of **L.E.5,600** each. Payment is due in 30 days.

May 23 Sold four P-500 facsimile machines on account to Elhoda Stockbrokers; sales price, **L.E.9,000** per machine, payment due in 30 days.

May 24 Purchased an additional seven P-500 facsimile machines on account from Xerox. Cost, **L.E.5,600** per machine; payment due in 30 days.

June 9 Paid **L.E.28,000** cash to Xerox Co. for the facsimile machines purchased on May 10.

June 19 Sold two P-500 facsimile machines to MOHM for cash. Sales price, **L.E.9,500** per machine.

June 22 Collected **L.E.36,000** from Elhoda Stockbrokers in full settlement of the credit sale on May 23.

***Required*:**

a. Prepare journal entries to record these transactions in the accounting records of Modern Office. (The firm uses a perpetual inventory system.)

b. Post the appropriate information from these journal entries to an inventory subsidiary ledger account.

c. How many Xerox P-500 facsimile machines were in inventory on May 31?

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5. Appeared below is a series of related transactions between Egypt Wholesale Corp. and Star Fish, a chain of retail stores:

Feb. 9 Egypt Wholesale sold Star Fish 100 pairs of boots on account, terms 1/10, n/30. The cost of these boots to Egypt Wholesale was **L.E.160** per pair, and the sales price was **L.E.250** per pair.

Feb. 12 United Express charged **L.E.810** for delivering this merchandise to Star Fish. These charges were split evenly between the buyer and seller, and were paid immediately in cash.

Feb. 13 Star Fish returned ten pairs of boots to Egypt Wholesale because they were the wrong style. Egypt Wholesale allowed Star Fish full credit for this return.

Feb. 19 Star Fish paid the remaining balance due to Egypt Wholesale within the discount period.

Both companies use a perpetual inventory system.

***Required*:**

a. Record this series of transactions in the general journal of Egypt Wholesale Corp. (The company records sales at gross sales price.)

b. Record this series of transactions in the general journal of Star Fish. (The firm records purchases of goods at **net cost** and uses a Transportation-in account in recording transportation charges on inwards shipments.)

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6. Era Fashions, a wholesaler, regularly sells goods on account to Caroline's, a chain of retail stores. Among the transactions between these two enterprises are the following:

Mar. 3 Sold 1,000 cashmere sweaters to Caroline's on account, terms, 2/10, n/30. These sweaters had cost Era Fashions **L.E.320** each; the sales price to Caroline's was **L.E.500** per sweater.

Mar. 5 Caroline's returned 100 of the sweaters because they were the wrong colour. Era Fashions always allows such returns.

Mar. 13 Caroline's paid within the discount period the remaining amount owed to Era Fashions, after allowing for the purchase return on Mar. 5.

Both enterprises uses perpetual inventory systems. Caroline's records purchases of merchandise at **net cost**.

***Required*:**

a. Prepare journal entries to record these transactions in the accounting records of Era Fashions.

b. Prepare journal entries to record these transactions in the accounting records of Caroline’s.

c. Assume that Caroline’s had not paid the remaining balance of its account payable to Era Fashions until April 2. Record this payment after the discount period in both of the accounting records of Era Fashions and Caroline’s.

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7. Running Hero deals in a wide variety of low-priced merchandise and uses a periodic inventory system. The firm’s accounting polices call for recording credit sales at the gross invoice price, but recording purchases at net cost. Presented below is a partial list of the transactions occurring during May:

May 2 Purchased goods (running shoes) on credit from Gold-Man Shoes, **L.E.95,000.** Terms, 2/10, n/30.

May 3 Paid freight charges of **L.E.450** on the shipment of merchandise purchased from Gold-Man Shoes.

May 4 Upon unpacking the shipment from Gold-Man, discovered that some of the shoes were the wrong style. Returned these shoes, which had a gross invoice price of **L.E.4,000** (**L.E.3,920** net cost) to Gold-Man and received full credit.

May 9 Sold goods on account to Mountain Hotel, **L.E.41,000.** Terms, 2/10, n/30.

May 11 Paid **L.E.220** freight charges on the outbound (outwards) shipment to Mountain Hotel.

May 12 Paid Gold-Man Shoes within the discount period the remaining amount owed for the May 2 purchase, after allowing for the purchase return on May 4.

May 16 Sold goods on account to Season Sportswear, **L.E.27,550,** terms, 2/10, n/30.

May 19 Received check from Mountain Hotel within the discount period in full settlement of the May 9 sale.

May 21 Season Sportswear returned **L.E.6,500** of the merchandise it had bought on May 16. Running Hero has a policy of accepting all merchandise returns within 30 days of the date of sale without question. Full credit was given to Season for the returned goods.

***Required*:**

Prepare journal entries to record each of these transactions in the accounting records of Running Hero. Give a written explanation for each journal entry.

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8. From the following details, prepare a two-column cash book and balance off as at the end of the month:

May 1 Started business with capital in cash **L.E.10,000.**

May 2 Paid rent by cash **L.E.1,000.**

May 3 Cairo Bank lent us **L.E.50,000,** paid by check.

May 4 Paid Ahmed by check **L.E.6,500.**

May 5 Cash sales **L.E.9,800.**

May 7 Collected from Mike by check **L.E.6,200.**

May 9 Paid Basim in cash **L.E.2,200.**

May 11 Cash sales paid direct into the bank **L.E.5,300.**

May 15 Collected from Mido in cash **6,500.**

May 16 L.E.5,000 was taken out of the cash till and paid into bank account.

May 19 Repaid Cairo Bank by check **L.E.10,000.**

May 22 Cash sales paid direct into the bank **L.E.6,600.**

May 26 Paid motor expenses by check **L.E.1,200.**

May 30 Withdrew **L.E.10,000** cash from the bank for business use.

May 31 Paid wages in cash **L.E.9,700.**

9. From the following details, prepare a two-column cash book and balance off as at the end of the month:

Mar 1 Balances brought down from last month: Cash in hand **L.E.560:** Cash in Bank **L.E.23,560.**

Mar 2 Paid rates (taxes) by check **L.E.1,560.**

Mar 3 Paid for postage stamps in cash **L.E.50.**

Mar 5 Cash sales **L.E.740.**

Mar 7 Cash paid into bank **L.E.600.**

Mar 8 Paid to Amir by check **L.E.750:** paid to Esmail in cash **L.E.20.**

Mar 12 Collected from Mohamed **L.E.1,500, L.E.500** being in cash and **L.E.1,000** by check.

Mar 17 Cash drawings by proprietor **L.E.200.**

Mar 20 Collected from John by check **L.E.790.**

Mar 22 Withdrew **L.E.200** from the bank for business use.

Mar 24 Bought a new equipment for **L.E.1,950** cash.

Mar 28 Paid rent by check **L.E.400.**

Mar 31 Cash sales paid direct into the bank **L.E.1,050.**

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10. From the following details, prepare a two-column cash book and balance off as at the end of the month:

Nov 1 Balances brought forward from last month: Cash L.E.1,050: Bank L.E.21,640.

Nov 2 Cash sales L.E.6,050.

Nov 3 Collected from Metwalli by check L.E.2,170.

Nov 4 L.E.5,000 was taken out from the cash till and paid into the bank.

Nov 5 Paid for postage stamps in cash L.E.600.

Nov 6 Purchased office equipment by check L.E.1,890.

Nov 7 Paid to Usama by check L.E.500.

Nov 9 Received rates refund by check L.E.720.

Nov 11 Withdrew L.E.2,500 from the bank for business use

Nov 12 Paid wages in cash L.E.2,390.

Nov 14 Paid motor expenses by check L.E.570.

Nov 16 Misr Bank lent us L.E.2,000 in cash.

Nov 20 Collected from Maha by check L.E.1,120.

Nov 28 Paid general expenses in cash L.E.220.

Nov 30 Paid insurance by check L.E.740.

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11. From the following details, enter up a three-column cash book. Balance off at the end of the month, and show the relevant discount accounts as they would appear in the general ledger.

May 1 Started business with L.E.60,000 in the bank.

May 1 Purchased fixtures paying by check L.E.9,500.

May 2 Purchased goods paying by check L.E.12,400.

May 3 Cash sales L.E.4,070.

May 4 Paid rent in cash L.E.2,000.

May 5 Collected from Mai her account of L.E.2,200 by a check for L.E.2,100, allowing her L.E.100 discount.

May 7 Paid Manar & Co L.E.800 owing to them by means of a check L.E.760, they allowed us L.E.40 discount.

May 9 We received a check for L.E.3,800 from Yaser, discount having been allowed L.E.200.

May 12 Paid rates by check L.E.4,100.

May 14 Walid pays us a check for L.E.1,150.

May 16 Paid Mahmoud his account of L.E.1,200 by cash L.E.1,140, having deducted L.E.60 cash discount.

May 20 Islam pays us a check for L.E.780, having deducted L.E.20 cash discount.

May 31 Cash sales paid direct into the bank L.E.880.

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12. From the following information, a three-column cash book is to be written up, balanced off and the relevant discount accounts in the general ledger shown.

Mar 1 Balances brought forward: Cash L.E.2,300; Bank L.E.47,560.

Mar 2 The following paid their accounts by check, in each case deducting 5% cash discounts; Accounts: Ahmed L.E.1,400; Tamer L.E.2,200; Hani L.E.3,000.

Mar 4 Paid rent by check L.E.1,200.

Mar 6 Cairo Bank lent us L.E.10,000 paying by check.

Mar 8 We paid the following accounts by check in each case deducting a 2.5 per cent cash discount; Badry L.E.3,600; George L.E.4,800: Rami L.E.8,000.

Mar 10 Paid motor expenses in cash L.E.440.

Mar 12 Hani pays his account of L.E.770 by check L.E.740, deducting L.E.30 cash discount.

Mar 15 Paid wages in cash L.E.1,600.

Mar 18 The following paid their accounts by check, in each case deducting 5 per cent cash discount: Accounts: Wasil L.E.2,600; Wilson L.E.3,400; Wahbi L.E.4,600.

Mar 21 Cash withdrawn from the bank L.E.3,500 for business use.

Mar 24 Cash drawings L.E.1,200.

Mar 25 Paid Basma her account of L.E.1,400, by cash L.E.1,330, having deducted L.E.70 cash discount.

Mar 29 Purchased fixtures paying by check L.E.6,500.

Mar 31 Received commission by check L.E.880.

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