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Faculty of Commerce
Accounting Department

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Lectures in

Accounting For Financial Institutions

Collection

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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

إلي من قال:

- **فكر في واجبك ولا تفكر في حقك.**
- **اعمل طلباً للإتقان ولا تعمل طلباً للشهرة والجزاء.**
- **لا تطلب من الناس أكثر مما يطلبه الناس منك.**
- **الانسان بقيمته وليس بألقابه.**
- **يجب أن يكون للأدب والأديب قيمة في ذاته بغض النظر عن الألقاب والبرامج الدراسية.**

الأستاذ والمفكر: عباس محمود العقاد

Preface

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

Accounting performs an important role, not only on the business sector level, but also on the governmental and national one. It plays a major role in the planning and control of the governmental activities. The first part in this textbook is devoted to provide student with a very comprehensive introduction to Banking Accounting. The final part is devoted to the Accounting issues regarding Insurance companies. The splitting of this textbook between two parts 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 theoretical framework on the financial institutions.

PART ONE
ACCOUNTING FOR COMMERCIAL BANKS

Introduction:

In the real world, banks undertake commercial works in the same way as business organizations do. But, banks are considered service enterprises which provide specialized financial activities to public and business community. Commercial banks produce and supply professional management required for dealing with public funds. Furthermore, commercial banks perform fundamental functions and roles in the modern economies. Banks offer many services that are considered all of importance, which may include the following:

(1) Providing saving deposits' accounts.

(2) Offering current (checking or demand) deposits' accounts. Nowadays, this service has been extended beyond traditional activities to internet services and credit or smart cards, where

money can be spent electronically for purchasing of goods and services.

(3) Granting consumer and business loans.

(4) Supporting governmental activities with credit and purchasing government's bonds.

(5) Providing personal trust services to individuals and families and commercial trust services to business organizations and other organizations.

(6) Keeping and safeguarding of valuable properties such as gold, documents, securities and so on.

(7) Offering services related to currency exchanges.

(8) Discounting commercial notes.

(9) Offering financial advisory services.

(10) Providing financial lease services, in which the bank purchases the needed equipment and rents (leases) it to the business customers.

(11) Undertaking brokerage services regarding investment in securities.

(12) Managing mutual funds.

(13) Offering cash management services. The bank accepts to handle cash collections and payments for business enterprise and to invest any temporary cash surplus in short-term securities and loans.

Bank Accounting System:

Bank is a business firm; however, a bank accounting system is considered a specialized accounting system that differs in many aspects from an accounting system required for a merchandising, manufacturing and service business or other business. The basic causes of differences of bank accounting system may be traced by the following characteristics of banking industry:

First: The major product or commodity which is sold by banks is money. Accordingly, money cannot be placed in inventory waiting future sale.

In banks, assets must be managed so that funds are invested for providing a return that exceeds cost. On the other hand, the liquidity level necessary to meet customer withdrawals is maintained. As a result, bank accounting system must collect data and provide reports to support management in arranging the level, structure, and mixture of assets and liabilities.

Second: The accounting system of a bank must record transactions in details to help regulatory authorities to verify that a bank is following particular regulations such as lending limits.

Finally: The accounting system of a bank must provide sufficient data to allow bank management to overcome many of the cost and price problems. Such system helps management to take advantage of competitive situations and to price services in such a way as to remain competitive on services provided to customers.

This part of the textbook is intended to discuss some accounting issues regarding accounting for commercial banks, which may be subject to interest by senior students in the faculties of commerce. These issues may be discussed throughout the following chapters:

Chapter One: Bank Financial Statements.

Chapter Two: Accounting for cash and deposits due from banks transactions.

Chapter Three: Accounting for deposits.

Chapter Four: Accounting for nondeposit borrowings.

Chapter Five: Accounting for loans.

Chapter Six: Accounting for investment securities.

CHAPTER ONE
BANK FINANCIAL STATEMENTS

CHAPTER ONE

Bank Financial Statements

1.1 INTRODUCTION

Similar to business enterprises, banks are required to provide their users with information that can be submitted by financial statements. Practically, banks are required to prepare the following financial statements at the end of the fiscal period:

1. Balance Sheet.
2. Income Statement.
3. Statement of Changes in Stockholders' Equity.
4. Statement of Cash Flows

The following sections will introduce illustrative financial statements for a bank and a brief description of the items included in the statements.

1.2 THE BALANCE SHEET:

The balance sheet of a bank, or report of condition, lists the assets, liabilities, and stockholders' equity held by or invested in the bank on any given date.

Assets on the balance sheet include four major kinds of assets:

1. Cash in bank and deposits held at other institutions.

2. Government and private securities purchased in the open market.

3. Loans and lease financing made available to customers.

4. Miscellaneous (other) assets.

Liabilities include two major categories:

1. Deposits made by and owed to various customers.

2. Nondeposit borrowing of funds in the money and capital markets.

Owners' equity include:

1. Capital.

2. Additional paid-in capital.

3. Surplus (reserves).

4. Retained earnings.

The following is a balance sheet of a commercial bank as on December 31, 2021:

Alexandria Bank

Balance Sheet, December 31, 2021

Assets	L.E.
Cash and deposits at the Central Bank	90,000,000
Cash and deposits due from banks	137,000,000
Treasury bills	47,000,000
Interest-bearing deposits in banks	45,800,000
Central Bank certificate of deposits	36,200,000
Investment securities, available for sale	187,600,000
Investment securities, trading	67,400,000
Reserve funds sold and securities purchased under resale agreements	43,200,000
Loans, gross (including real estate, commercial, agricultural, financial institutions, customer loans and leases	490,800,000
Less: Allowance for loan losses	(11,600,000)
Unearned discount on loans	(6,400,000)
Loans, net	472,800,000
Investment security, held to maturity	62,000,000
Investment securities, in associates	56,800,000
Lease financing receivable (investment in leveraged leases)	20,000,000

Bank premises (plant and equipment) net	30,600,000
Customers' liability on acceptances	17,200,000
Other (miscellaneous) assets	22,600,000
goodwill	70,000,000
Total assets	1,406,200,000
Liabilities and stockholders' equity	L.E.
Liabilities	
Deposits	
Demand (noninterest-bearing) deposits	65,600,000
NOW accounts	77,100,000
Saving deposits	144,800,000
Money market deposits	56,000,000
Time deposits	220,200,000
Deposits due to domestic and foreign banks	49,200,000
Total deposits	612,900,000
Nondeposit borrowings:	
Reserve funds purchased and securities sold under repurchase agreements	63,600,000
Other short-term debt	67,200,000
Mortgage indebtedness	71,800,000
Subordinated notes and debenture	132,900,000
Other liabilities	
Acceptance outstanding	17,200,000
Miscellaneous liabilities	70,600,000
Total liabilities	1,036,200,000
Stockholders' equity	
Common stock, L.E.200 par value; 800,000 shares authorized and outstanding	160,000,000
Capital surplus	130,000,000
Retained earnings	90,000,000

Treasury stock *Total stockholders' equity*	(10,000,000) 370,000,000
Total liabilities and stockholders' equity	1,406,200,000

Description of the items included in the balance sheet:

A. Assets:

Cash and due from banks

These items are called cash assets. They represent the most liquid items. They are designated to meet the bank's need for liquidity to cover deposit withdrawals, customer demands for loans and other unexpected needs for cash. This item includes currency and coins held by tellers, cash held in the bank's treasury, any deposits the bank has placed with other banks (correspondent banks), cash items in the process of collection such as uncollected checks, and the bank's reserve account held with the Central Bank of Egypt (The Federal Reserve

Bank in the U.S.A), this item is often labeled primary reserves.

Normally, banks strive to keep the size of this account as low as possible, because cash balances earn little of interest income for the bank.

Reserve fund sold

Generally, banks are obliged (required) to deposit a specific percentage of customers' deposits in the Central Bank. This amount is called legal reserve. Of course, at any given time, some banks have excess reserves while others need reserves. Banks that have excess reserves sell (lend) them to banks in need of funds. Usually, these transactions are for short periods of time-overnight or during the weekend.

Investment in Egyptian Government Treasury Securities

Banks usually purchase government marketable debt obligations, which are called treasury bills, notes, or bonds. Treasury bills are issued for 91, 182 days and one year maturities, they are sold in L.E.10,000 denominations at weekly government actions. These bills are bought on a discount basis. Treasury notes and bonds are issued for a longer period of time (maturities of up to several years). Central Bank certificate of deposits are issued for 1,2,3,4 and 9 months maturities. **Security holdings** are a backup source of liquidity and provide another source of income.

Loans

Loans are granted principally to supply income. The bank can lend money for real estate purchase, for business development, and for customers as installment loans. Allowance for loan losses (or allowance for uncollectible accounts) and unearned discount on loans are deducted from gross loans in the balance sheet. Unearned discount represents the interest (discount) and other charges added to the amount advanced to the customer. The difference between the gross amount of the installment loan and the net amount paid (amount advanced to the customer) is called ***"unearned discount".*** This amount of interest and other charges are not earned yet. Unearned discount and allowance for loan losses are ***"contra-asset"*** accounts to loans.

Furthermore, there is another loan category called nonperforming loans, which are credits that not longer accrue interest income. Under current regulations, a loan is placed in the nonperforming category when any scheduled loan repayment is past due for more than 90 days. Once a loan is reclassified as nonperforming, any accrued interest but not collected yet, must be deducted from loan revenues.

Fixed Assets (property, plant, and equipment), net

Normally, fixed assets include buildings, office equipment, leasehold improvements, furniture, and land.

Miscellaneous assets and debit balances

This category includes assets owned by the bank as a settlement of a loan, prepaid expenses, and accrued revenues and so on.

Customers' liability on acceptances

In practice, banks often provide a form of credit for their customers. The amount of fund involved appears as an asset account labeled ***"customers' liability on acceptance outstanding".*** You must note that this term coincides (agrees) exactly with an item listed under bank liabilities, acceptances outstanding.

This dual pair of accounts increases each time a bank agrees to stand behind a customer's credit. Usually, a bank provides this credit to help that customer pay for imported goods from overseas. In this situation, the bank issues a signed letter of credit. This letter gives authorization to a third party (such as a foreign exporter of goods) to draw a draft against the issuing bank for a specified amount of money on a designated future date.

Accordingly, on or before the designated date, the customer that requested the acceptance must pay the bank in full. The bank that issued the acceptance, in turn, will honor the acceptance on its due date, paying the full amount of the draft to the current holder of the instrument.

Thus, bank's acceptance gives rise simultaneously to both an asset item (the customer's liability to the bank) and a liability item (the bank's promise to honor the acceptance draft on the date specified).

B. Liabilities:

Deposits

Deposits are the main source of funding for banks. There are 6 kinds of deposits:

1. Demand deposit accounts (DDA) represent customer deposits in regular checking accounts that do not pay interest.

2. NOW accounts (Negotiable order of Withdrawal accounts) represent checking accounts that pay interest.

3. Saving deposit accounts (SDA) represent the traditional passbook saving accounts.

4. Time deposit accounts (TDA) represent highly-yielding saving certificates offered by bank. They include certificate of deposits, golden accounts, platinum certificates, and other time deposits.

5. Money market deposit accounts (MMDA) can pay competitive interest and have limited check-writing privileges. Banks must reserve the right to require seven days notice before any withdrawals are made.

6. Deposits due to other banks, domestic and foreign.

Nondeposit borrowings

They represent the banks temporary borrowing in the money market, mainly from reserves loaned to the bank by the Central Bank in Egypt or the Federal Reserve Bank in the USA, or from securities sold under repurchase agreements. These transactions are carried out mainly to supplement deposits and provide the additional liquidity that cash assets and securities cannot provide.

One reason for bank borrowing from nondeposit funds sources is that there are no reserve requirements on most of these funds, which lowers the cost of nondeposit funding. Also, borrowing in the money market usually can be arranged in a few minutes and the funds wired immediately to the bank that needs them.

The most important nondeposit funding source for most banks is represented by reserve fund purchased and securities sold under agreements to repurchase. In these repurchase agreements the bank borrows funds collateralized by some of its own securities from another bank or large corporate customer.

Other short-term borrowings the bank may draw upon include borrowing reserves from the discount windows of the Central Banks.

C. Owners Equity

Equity capital or the shareholders' equity supplies the long-term and relatively stable base of financial support upon which the bank will rely to grow and to cover any extraordinary losses it incurs.

Liabilities and equity capital represent ***accumulated source of funds***, which provide the needed spending power for the bank to acquire its assets. On the other hand, a bank's assets represent the ***accumulated uses of funds***, which are made to generate income for shareholders, pay interest to depositors, and compensate the bank's employees, thus:

Accumulated uses of funds (assets) = Accumulated sources of funds (liabilities and equity capital)

1.3 THE INCOME STATEMENT:

The income statement, of course, is the report that measures the success of the bank operations for a given period of time, usually one year. Users of financial information use the income statement to determine profitability and investment value of the bank. It is also used to evaluate management's ability to manage the bank.

The income statement measures the flow of revenues and expenses, and from this flow users of financial information can predict the amounts, timing and uncertainty of future cash flows.

Revenue is defined as the inflow of assets received in exchange for services rendered or from interest earned, some examples of revenue items are as follows:

* Service fees, such as trust services, checking account services, collection of commercial papers for customers, and lockbox rental.

* Interest earned on commercial loans, consumer loans, real estate loans, and investment in debt and equity securities.

Bank expenses are defined as the outflow or using of assets in the earnings process. Some examples of expense items are as follows:

- Interest on deposits.
- Interest on nondeposit borrowing.
- Interest on bonds issued by the bank.
- Payment of services, such as salaries, building rental, and utilities expense.
- Depreciation of fixed assets.
- Provision for loan losses (bad debts expense).
- Tax expense.

The following is an income statement of a commercial bank as on December 31, 2021:

Alexandria Bank
Income Statement
For the Year Ended December 31, 2021
(amounts in thousands)

***Interest income:**	**L.E.**	**L.E.**	**L.E.**
.Interest and fees on loans	5,600		
.Interest on investment securities:			
Treasury securities	3,400		
Other securities	3,800		
.Interest on trading securities	2,360		
.Interest on reserve funds sold and securities purchased under resale agreements	1,600		
.Interest on deposits at other banks	240		
Total interest income		17,000	
***Interest expense:**			
.Interest on deposits	3,800		
.Interest on short-term debts	500		
.Interest on long-term debts	600		
.Interest on reserve funds purchased and securities sold under repurchase agreements	1,400		
.Interest on subordinated debentures	1,900		
Total interest expense		8,200	
Net interest income (Interest margin)		***8,800***	
Deduct: Provision for loan losses		340	
Net interest income after provision for loan losses			***8,460***
***Noninterest income (other income):**			
.Trust department income	1,270		

.Service fees (Charges on customer deposits)	430		
.Trading profits and commissions	200		
.Other operating income	800		
Total noninterest income		2,700	
***Noninterest expense (other expenses):**			
.Wages and salaries	1,300		
.Pensions and other employee benefits	460		
.Occupancy and equipment expenses (net)	640		
.Other operating expenses	500		
Total noninterest expense		2,900	
Net noninterest income (loss)			**(200)**
Income (loss) before income taxes			***8,260***
Applicable income taxes			340
Net income (loss) after income taxes			***7,920***
Add: Security gains (losses) net after taxes			348
Net income after taxes and securities gains (losses)			***8,268***

Earnings per share (net income or loss per share of common stock) = Net income after taxes and securities gains (losses) ÷ Average number of common shares of stock outstanding

= 8,268,000 ÷ 6,000,000 = L.E.1.378

Description of the items included in the income statement:

The income statement reports the revenues and expenses and the net income for a fiscal period. It indicates the profitability of the bank over the preceding year. The following is a brief description of income statement items:

(1) Interest income

Interest income includes interest and fees generated from loans, interest on investment securities, interest on trading securities, interest on reserve funds sold to other banks and securities purchased from other institutions under resale agreements, and interest on deposits in other banks.

The interest income for a bank represents the most important source of income.

(2) Interest expense

Interest expense includes interest on deposits which is considered the number-one expense item for a bank, interest on short-term and long-term debts, interest on reserve funds purchased from other banks and securities sold under repurchase agreements, and interest on subordinated debentures.

(3) Net interest income

It is the difference between total interest income and total interest expense. This important item is often referred to as the ***interest margin***. This item is the key determinant of bank profitability. When the net interest income falls, it means that the bank's net income after taxes and earnings per share will fall.

(4) Provision for loan losses

Provision for loan losses is considered a noncash expense equivalent to bad debts expense for a nonbanking enterprise. This provision account is treated by a simple journal entry, as below:

Provision for loan losses	xxx	
Allowance for loan losses		xxx

Allowance for loan losses is a contra-asset account (loans) and it is equivalent to allowance for doubtful accounts in a nonbanking enterprise. The balance in this account represents the estimated uncollectible account of loans included in the bank's loan portfolio. This amount is subtracted from the total amount of loans on the balance sheet.

(5) Noninterest income

This item represents the sources of income other than earnings from loans and securities. It includes fees earned from offering trust services, service charges on deposit accounts, and miscellaneous fees charges for other bank services. Nowadays, bankers consider noninterest income as a key source of future revenues. They sell services other than loans such as security brokerage, insurance, and trust services.

(6) Noninterest expense

Noninterest expense includes wages, salaries, and other personnel expenses, maintenance costs of properties and rental fees on office space, depreciation of buildings, equipment, and furniture, along with several small expense items including legal fees, utilities, office supplies, etc.

(7) Net noninterest income

It is the difference between total noninterest income and total noninterest expense.

(8) Income (loss) before income taxes

It is the total of net interest income and net noninterest income.

(9) Net income after income taxes

This is the net income before income taxes minus the applicable income taxes.

(10) Net income after income taxes and securities gains (losses)

It is calculated by adding securities gains or losses to net income after income taxes.

(11) Net income (loss) per share of common stock

It is calculated by dividing net income after income taxes and securities gains (losses) by the average number of common shares of stock outstanding during the year.

Reconciliation of Allowance for Loan Losses

When the bank calculates its provision for loan losses for the year, it is added to the balance of allowance for loan losses. Also, the bank must add any funds recovered on loans previously charged off as losses to the balance of allowance for loan losses.

Bank's management decides about the amount of current loans as uncollectible and worthless this year. This amount of bad debts is subtracted from the balance of allowance for loan losses (charged to the allowance).

Illustration 1.1

Assume that Cairo Bank had an allowance for loan losses at January 1, 2021, L.E.6,800,000. During 2021, the bank recovers loans previously charged off, L.E.440,000. At the end of 2021, the bank's management decided to declare L.E.560,000 in current loans as uncollectible and worthless this year. The calculated amount of provision for loan losses for the year is L.E.760,000.

Instructions:

Calculate the balance of allowance for loan losses at the end of 2021.

Solution

Reconciliation of allowance for loan losses is prepared as follows:

	L.E.
Balance of allowance for loan losses, January 1, 2019	6,800,000
Add: Recoveries on loans previously charged off	440,000
Add: Current provision for loan losses	760,000

Subtotal	8,000,000
Deduct: Loans declared uncollectible during the year	560,000
Allowance for loan losses balance, at the end of 2019	7,440,000

Illustration 1.2

Assume the gross amount of loans at the end of 2021 is L.E.51,600,000.

Instructions:

Prepare a partial balance sheet to show the balance of loans and allowance for loan losses at the end of 2021.

Solution

Partial Balance Sheet

Assets	L.E.
Gross loans	51,600,000
Less: Allowance for loan losses	7,440,000
Net loans	44,160,000

1.4 Problems:

Problem 1.1:

The following information is for Alexandria Bank on December 31, 2021

Interest and fees on loans	L.E. 610,000
Interest and dividends on securities	120,000
Noninterest income and fees	70,000
Salaries, wages, and benefits	100,000
Overhead expense	50,000
Interest paid on deposits	490,000
Interest paid on nondeposit borrowings	60,000
provision for loan losses	20,000
other noninterest expenses	30,000
securities gains (losses)	10,000
income tax expense	10,000

Instructions:

Prepare an income statement arranged in the proper order.

Problem 1.2:

Bank of Misr submitted its balance sheet and income statement to the general assembly at the end of year of 2021 as follows:

Balance Sheet

Assets	**L.E.**
Cash and deposits due from banks	?
Investment securities, available for sale	16,400,000
Trading securities	2,400,000
Reserve funds sold	4,000,000
Loans (gross)	?
Allowance for loan losses	(3,000,000
Unearned discount on loans	(1,200,000)
Loans (net)	70,400,000
Plant and equipment	1,800,000
Customers' liability on acceptance	3,600,000
Miscellaneous assets	8,800,000
Total assets	**112,000,000**
Liabilities and Owners' Equity	**L.E.**
Demand deposits	22,600,000
Saving deposits and NOW accounts	?
Money market deposit accounts	9,200,000
Time deposits	44,600,000
Deposits due to foreign branches	5,000,000
Total deposits	**88,600,000**
Nondeposit borrowings	7,600,000
Other liabilities	5,800,000
Stockholders' Equity	?
Total liabilities and Owners' Equity	**112,000,000**

Income statement

Interest and fees on loans	?
Interest on investment securities	7,400,000
Other interest income	7,000,000
Total interest income	*56,000,000*
Total interest expense	*37,800,000*
Net interest income	**?**
Provision for loan losses	800,000
Service charges on customer deposits	?
Trust department income	3,600,000
Other operating income	4,000,000
Total noninterest income	*13,800,000*
Wages, salaries, and benefits	?
Net occupancy and equipment expense	1,400,000
Other expenses	1,000,000
Total noninterest expenses	*10,800,000*
Net noninterest income	**?**
Income taxes	400,000
Net income (loss) after taxes	**?**

Instructions:

Calculate the missing items from the statements shown above.

Problem 1.3:

From the following information, prepare an income statement for Egyptian African Bank for the year ended December 31, 2021. Be sure to arrange the figures in correct sequence to drive the bank's report of income.

Items	L.E.
Interest and fees on loans	3,120,000
Deposit interest costs	2,052,000
Provision for loan losses	1,020,000
Provision for income taxes	32,000
Service charges on customers deposits	196,000
Trust department income	164,000
Other operating noninterest income	476,000
Interest on short-term debt	404,000
Interest on long-term debt	120,000
Securities gains and losses	50,000
Wages and salaries and other benefits	520,000
Occupancy and equipment expenses	176,000
Other operating expenses	540,000
Other interest income	548,000
Interest on investment securities	664,000
Average number of shares outstanding	***354,000Sh.***

Problem 1.4:

For each item of the following, indicate whether it appears on a bank's balance sheet or a bank's income statement:

- Allowance for loan losses.
- Depreciation on plant and equipment.

- Commercial and industrial loans.
- Customer loans.
- Common stock.
- Repayment of credit card loans
- Securities gains or losses.
- Employee benefits.
- Provision for loan losses.
- Interest paid on money market deposits.
- Reserve funds sold.
- Retained earnings.
- Credit card loans.
- Utility expense.
- Cash on hand.
- Deposits due to banks.
- Leases of business equipment to customers.
- Interest received on credit card loans.
- Saving deposits.
- Customers’ liability on acceptances.
- Retained earnings.

- Mortgage owed on the bank’s buildings.
- Service charges on deposits.
- Trust department income.
- Provision for income taxes.
- Demand deposits.
- Investment securities.

CHAPTER TWO

Accounting for Cash and Deposits Due From Banks Transactions

CHAPTER TWO

ACCOUNTING FOR CASH AND DEPOSITS DUE FROM BANKS TRANSACTIONS

2.1 Introduction:

In this chapter, cash is defined as it is used in the real world of the banking system. Additionally, accounting policies and procedures will be illustrated for the transactions that include cash flows.

In effect, cash is intended to be the first item of assets that normally is listed on a bank's balance sheet under the heading "Cash and Deposits Due from Banks". Usually, the cash pool of a bank includes:

(1) ***Cash on Hand***: This item is considered the ultimate liquidity because it is held in the form of currency and coins. This item of cash is essential and necessary to facilitate the fluctuant

or uneven cash flows on a daily or weekly basis. Practically, cash is a nonearning or an unprofitable asset. As a result, it must be invested in some form to provide a source of income for paying bank charges such as salaries, debit interest, and other expenses. Accordingly, any excess in cash (currency and coins) are usually invested in earning assets to produce income.

(2) ***Balance at the Central Bank:*** Cash balance at the central banc consists of two types: (a) Legal Reserve which is required by regulating laws and may not be invested or converted into currency and coins. (b) Amounts in excess of required reserves that are available to the bank as a liquid optional reserve and are subject to be loaned overnight or over the weekend to other banks or financial institutions. The rate of interest on optional reserve funds transactions is

[redacted]. Like any other short-term interest rate, the interest rate is highly fluctuant (volatile) and changes frequently.

(3) ***<u>Balances at other Banks:</u>*** In addition to deposits at the Central Bank, there are deposits placed by bank with other banks to facilitate check clearings or as compensation for services rendered or for many other reasons. These deposits may take the form of demand or time deposits and thus provide different degrees of liquidity. Amounts due from banks provide a source of cash inflows, while amounts due to banks may require cash outflows at some time in the future.

(4) ***<u>Cash Items in the process of collections:</u>*** [redacted]

checks, redeemed government saving bonds, etc. these items are reimbursed or deposited to the bank within a very short period of time.

In effect, the above cash assets are considered the bank's first line of defense against changes in the volume of deposit withdrawals and the first source of funds to look to when a customer comes in with an unexpected loan request that the bank feels obliged or compelled to meet.

Usually, banks strive to keep the size of cash as low as possible, since cash balances earn little or no interest income for the bank.

2.2 Recording Cash Transactions:

Practically, there are many daily transactions that affect the components of bank's cash pool. But there are two types of changes that affect the cash pool.

1- Changes between components of the cash pool.

Actually, these changes affect the relative size of the various components but none of these types of transactions change the size of the total cash pool. For instance, collection of some balances at other banks will result in an increase in liquid cash and a decrease in balances at other banks. Transferring of liquid cash to the Central Bank will result in increase in the balance at the Central Bank and a decrease in the liquid cash. The journal entry needed to record the above changes in the cash pool will be as follows:

Currency and Coins (or Cash) Due from Banks-Bank X To record a collection of cash	xxx	 xxx

from other banks.		
Due from Banks-Central Bank Currency and Coins (or Cash) To record a transfer of cash to the Central Bank.	xxx	 xxx

We notice from the above that the cash pool is not changed. The final effect of these transactions is a reclassification of components within the cash pool. As a result of the first transaction, one item of the cash pool was increased (Currency and Coins) and another item was decreased (Due from Banks). Similarly, as a result of the second transaction, one item of the cash pool was increased (Due from Banks-Central Bank) and another item was decreased (Currency and Coins). However, there is no change in the total of assets and the total of liabilities.

2- *Changes in component of the cash pool:* Logically, these changes will affect the size of the cash pool. The amount in the cash pool will change if there is a transaction which affects a liability account or an asset account not considered as a component of the cash pool. For example, if a customer deposits L.E.10000 in currency to his/her current account the cash pool will increase, as shown from the following journal entry:

Currency and Coins (Cash) Current Account-Customer.. To record a deposit of cash by a customer in the current account.	10000	 10000

As a result of this transaction, the cash pool is increased by L.E.10000 and hence the total of assets is increased by the same amount. On the other hand, demand deposit account (customer's current account) is increased by L.E.10000 and hence the total of liabilities is increased by the same amount.

Illustrative Example:

In this example, the major types of transactions generated by the teller stations and external transactions that are originated outside the bank will be illustrated.

The National Bank of Egypt performed the following transactions during the month of January 2021:

Jan. 1 A customer opens a demand deposit account (current or checking account) and deposits L.E.40000 in currency and a check drawn on another bank in the amount of L.E.60000.

Jan. 2 L.E.140000 of cash is withdrawn from another bank in which this bank has a demand deposit account to increase the bank's liquid cash.

Jan. 5 Liquid cash in the amount of L.E.150000 is transferred from the main office to a branch office.

Jan. 8 A customer gives the bank an "on us" check in the amount of L.E.150000 for repayment of a loan.

Jan. 10 A customer transfers funds of L.E.96000 from a saving account to checking account.

Jan. 12 A customer cashes a certified check drawn on another bank in the amount of L.E.69000.

Jan. 14 A customer deposits a check drawn on another bank in the amount of L.E.172800 to a checking account.

Jan.16 The bank sells reserve funds overnight from its excess reserve funds at the Central Bank to another bank for the amount of L.E.1600000.

Jan. 18 Checks in the amount of L.E.2400000 are received from the Central Bank for in-clearing belong to checking accounts.

Jan. 31 Checks in the amount of L.E.3650000 are sent to the Central Bank for out-clearing belonging to checking accounts.

Instructions

Record the above transactions in the general journal.

Solution:

Date	Explanation	Dr. L.E.	Cr. L.E.
Jan. 1	Currency and Coins (Cash) Due from Banks Checking Account	40000 60000	 100000
2	Currency and Coins Due from banks	140000	 140000
5	No entry is required since nothing changed except the location of the cash. An entry would be made in the subsidiary records of the main office and the branch office to record the new location of the L.E.150000.		
8	Checking account…. loans	150000	 150000
10	Saving account…… Checking account….	96000	 96000

12	Due from banks….. Currency and Coins (Cash)	69000	69000
14	Due from banks….. Checking account…..	172800	172800
16	Reserve funds sold…. Due from banks-Central Bank (or Due to banks)	1600000	1600000
18	Checking accounts Due from banks (or due to banks)	2400000	2400000
31	Due from banks Checking accounts	3650000	3650000

2.3 Bank Control over Cash:

Cash is considered the most highly liquid asset and hence it is an easy target for theft and misuse. In order to safeguard cash, it is necessary for the bank to have a strong system of control over cash. In practice, there are a variety of procedures to control cash, the most important of which are:

First: Surprise Audit

In a surprise audit, the internal auditor takes charge or responsibility of a particular teller's station without any advance notification and then reconcile the activities and balances of that teller. Indeed, these surprise audits serve as a valuable tool in achieving control over cash and activities involving cash.

Second: Daily Reconciliation of Cash Pool:

Where important flows of cash occur every business day in the bank, each teller reconciles and verifies the cash inflows and outflows with beginning and ending balances of cash. As a result, errors are discovered and necessary actions are taken, if possible, to correct and rectify these errors.

Third: Separation of Duties:

Individuals responsible for handling cash should not have any access to the recording process. Accordingly, cash receipts and disbursements should be assigned to individuals without any access to the accounting records.

Fourth: Daily Reports:

In the financial institutions, such as banks, daily balance sheets and cash reports are prepared for management use. These reports provide information required to management for the control of liquidity and exposure to risk.

2.4 Exercises and Practical Problems:

Problem 2.1:

You are given the following transactions regarding Alexandria Bank, during the month of January 2021:

Jan. 1 A customer opens a current account (Demand Deposit Account) by depositing L.E.50000 cash to his/her checking account.

Jan. 4 A customer transfers amount of L.E.60000 from his/her checking account to a saving account.

Jan. 6 A customer pays his/her loan by L.E.70000 cash at teller window.

Jan. 8 A customer asks the teller to purchase a cashier’s check (cashier’s check is a check drawn on the bank and can be cashed by the beneficiary at the teller window any time and any place) by paying amount of L.E.28000 cash.

Jan. 15 A customer gives teller check in the amount of L.E.220000, drawn on another bank to be deposited to:

L.E.125000, saving account

L.E.95000, checking account

Jan. 22 A customer requests the bank to wire transfer funds to another bank by withdrawing L.E.75000 from his/her checking account.

Jan. 24 A customer makes loan payment for the amount of L.E.105000 with a check drawn on the bank (on us check) at teller window.

Jan. 28 A customer withdraws amount of L.E.90000 from a saving account and receives for L.E.35000 and a cashier's check for L.E.55000.

Jan. 31 A customer cashes "on us" check at teller window for the amount of L.E.34000.

Instructions:

Record the above transactions in the general journal of the bank.

Problem 2.2:

You are given the following transactions regarding Cairo Bank, during 2021:

1. The bank has an excess of funds and sells reserve funds at the Central Bank overnight for the amount of L.E.30000000. Agreed interest rate of 13%.

2. The reserve funds sold in the above transaction are returned to the bank on the next day.

3. The bank receives a wire transfer from another bank for the amount of L.E.925000, representing the proceeds of the sale of its investment in bonds.

4. The bank buys bonds for its own portfolio and pays for them with a cashier's check for the amount of L.E.1860000.

5. The bank ships excess currency to its correspondent bank for the amount of L.E.1225000.
6. The bank receives today's in-clearings from the Central Bank of L.E.1740000.
7. The bank sends today's out-clearings to the Central Bank of L.E.1592000.
8. The bank receives currency from its correspondent bank for the amount of L.E.684500.
9. The bank wire transfers funds from Alrajihy correspondent bank to Dubai correspondent bank for the amount of L.E.590000.
10. The bank sends redeemed saving bonds to the Central Bank of Egypt for the amount of L.E.7125000.

Instructions:

Record the above transactions in the general journal of the bank.

CHAPTER THREE

ACCOUNTING FOR DEPOSITS

CHAPTER THREE

Accounting for Deposits

3.1 Introduction:

Customers' deposits are considered the most important source of finance for banks. They represent the major liability of a bank. Deposits are financial claims or rights in the form of credit balances owed or outstanding to others, such as business organizations, individuals, and government. Accordingly, in the event a bank is liquidated, the proceeds from the sale of assets must first be used to pay off the claims of its depositors. Finally, other creditors and stockholders receive whatever funds remains. As a result, banks are considered highly levered enterprises because of the high percentage of liabilities, including deposits, in comparison to stockholders' equity.

3.2 Common Types of Deposits:

Types of deposits depend greatly upon the depositors' objectives of keeping their funds at banks. But, there are 3 major types of deposits, known in practice. These types will be highlighted in the following sections.

3.2.1 Demand Deposits Accounts (DDA):

These types of deposits are called "Demand Deposits Accounts" because they may be withdrawn on demand, without prior notice to the bank. The most common type of demand deposits is the regular checking account and the most common type of withdrawal instrument is the checks. Such accounts cannot pay any explicit (determined) interest rate. Examples of demand deposit accounts include:

- **Checking (Current) Accounts.**

- **Official Bank Checks: Such as certified checks, cashier's checks, and other checks issued by the bank (drawn on itself).**

3.2.2 Saving Deposit Accounts:

As their name include, these deposits allow depositors to save money over a period of time. In effect, saving deposit accounts have no maturity date compared with time deposits. In this type of accounts, the customer is allowed to add to or withdraw from his saving account without any limits or restrictions.

In this type of deposits, the principal objective of depositor is keeping funds in a safe place in addition to getting reasonable return. Since the depositors have unlimited freedom to add or withdraw from their saving accounts, these deposits generally bear or involve the lowest rate of interest offered to depositors by a bank. Interest on these accounts are usually added to the saving deposit account rather than paid in cash.

Common examples of saving deposit accounts may include:

- **Passbook (Bankbook) or statement saving accounts.**
- **NOW accounts (Negotiable Order of Withdrawal). These accounts can be held by individuals and not-for-profit making organizations, bear interest, and permit checks to be drawn against each account.**
- **Non-transaction accounts, which are commonly referred to as money market deposit accounts (MMDA). These deposits can earn interest offered by the bank and have limited check-writing privileges. The bank must deserve the right to require seven days' notice before any withdrawals are made.**

3.2.3 Time Deposit Accounts:

As there name includes, these accounts have a specific maturity date. As a result, the customer must wait until the maturity date or pay a penalty for early withdrawal (lose accrued interest). Time deposit accounts typically pay interest. The rate of interest usually varies with the term of the deposit.

Examples of time deposit accounts include:

- **Certificate of Deposits (CD). In this type of time deposits, the deposit is evidenced or documented by an instrument called a *Certificate*. Usually, the certificate of deposits carries a fixed maturity term and a stipulated interest rate.**
- **Time Deposit. Time deposit is evidenced in the form of a written contract rather than a certificate.**

3.3 Deposit Transactions:

In practice, the majority of deposit transactions into and out of these accounts are processed by tellers. Below are some illustrative examples of deposit account transactions.

Illustration 3.1:

The following transactions are occurred in a commercial bank during the month of January 2021:

(1) **Jan. 2** A customer deposits L.E.35000 currency and a check of L.E.15000, drawn on another bank, to his saving account.

(2) **Jan. 4** A customer buys an L.E.100000 certificate of deposit and pays for it as follows: L.E.40000 transfer from his/her saving account. L.E.60000 deposited in currency.

(3) **Jan. 6** A customer transfers L.E.20000 from his/her checking account to his saving account.

(4) Jan. 8 A customer buys a L.E.17500 cashier's check and pays for it as follows: L.E.10000 in currency. L.E.7500 with a check drawn on the bank.

(5) Jan. 10 A customer cashes the following: L.E.19000, check drawn on another bank, at a teller window. L.E.12000, check drawn on the bank (on us).

(6) Jan. 12 A customer requested the bank to wire transfer L.E.55000 to another bank and withdraw the money from his/her saving account. The bank wire transfers funds from its demand deposit account at the Central Bank.

(7) Jan. 14 A customer redeemed a government saving bond for L.E.5000. The amount was credited to the customer's NOW account.

(8) Jan. 16 Today's in-clearing received from the Central Bank of Egypt are as follows:

Customers' demand deposit accounts L.E.1500000

Customers' NOW accounts	1000000
Cashier's checks	750000
Total in-clearing	L.E.3250000

(9) Jan. 18 Interest of L.E.8000 on a certificate of deposit is payable. The amount is to be credited to the customer's checking account.

(10) Jan. 20 The bank receives a L.E.2500 government treasury note interest coupon from a customer. The bank credits the customer's checking account and charges him a L.E.35 service fee.

(11) Jan. 22 The bank sent the following items for collection from the Central Bank. After two days, the bank received notice of collection for these items:

Redeemed Egyptian Government saving bonds	L.E.6590
Interest coupons, Treasury note	2500
Total	L.E.9090

(12) Jan. 24 A customer has a certificate of deposit for L.E.500000 matures today. The customer requested the bank to distribute the proceeds from the certificate as follows:

Deposit to checking account	L.E. 50000
Purchase of a cashier's check	135000
Buy a new certificate of deposit	300000
Receive cash from the teller	15000
Total proceeds	L.E.500000

(13) Jan. 26 The bank certifies a L.E.125000 check at the request of the maker of the check.

(14) Jan. 28 The certified check in transaction **(13)** was received in the in-clearing from the Central Bank, along with L.E.3800000 of customers' DDA accounts.

Instructions:

Prepare the journal entries for the above transactions.

Solution

Date	Explanation	Dr. L.E.	Cr. L.E.
Jan. 2	Currency and Coins (Cash)	35000	
	Due from Banks-CB	15000	
	Saving deposit Account		50000
4	Saving deposit accounts	40000	

	Currency and Coins Certificate of deposits	60000	100000
6	Demand deposit accounts Saving deposit accounts	20000	20000
8	Currency and coins demand deposit accounts cashier's check	10000 7500	17500
10	Due from banks-CB Demand deposit accounts Currency and coins	19000 12000	31000
12	Saving deposit accounts Due from Banks-CB	55000	55000
14	Redeemed government saving bonds NOW accounts	5000	5000
16	Demand deposit accounts NOW accounts Cashier's checks Due from banks-Central Bank (or Due to banks)	1500000 1000000 750000	3250000
18	Interest expense certificate of deposit Interest payable-CD To record accrued interest on certificate of deposits.	8000	8000
18	Interest payable-CD Demand deposit account To record interest on CD	8000	8000
20	Redeemed interest coupon -customers Demand deposit account Collection fees	2500	2465 35
22	Due from banks-CB Redeemed government saving bonds Redeemed interest coupons-customers	9090	6590 2500

24	Certificate of deposit (old)	500000	
	Demand deposit account		50000
	Cashier's check		135000
	Certificate of deposit (new)		300000
	Currency and coins		15000
26	Checking accounts (DDA)	125000	
	Certified checks		125000
28	Demand deposit accounts	3800000	
	Certified checks	125000	
	Due from banks-CB		3925000

Notes

1- Transaction No. (8) These checks are drawn on the bank, and deposited by the payees to other banks, clearing through the banking system to the Central Bank and finally to this bank. The balance of bank's demand deposit account at the Central Bank is decreased by the total amount of in-clearing received of L.E3250000.

2- Transaction No. (10) The bank will be reimbursed when the interest coupon is forwarded for collection from the Central Bank.

3.4 Interest on Deposit Accounts:

Practically, interest expense on saving and time deposits should be recorded during the period of deposit. Interest is paid to the depositors periodically (monthly, quarterly, or semiannually) or at maturity date of the deposit.

Illustration 3.2:

A customer purchases a 3-month L.E.1000000 certificate of deposit on March 14, 2021 and the annual interest rate is 12%.

Instructions:

Prepare the journal entries to record the purchase of certificate, the accrual of interest during the deposit period, the maturity of certificate, and the payment of the certificate and the interest. The bank paid the interest to the customer by a check.

Solution

Date	Explanation	Dr. L.E.	Cr. L.E.
Mar. 14	Cash Certificate of deposit	1000000	 1000000
31	Interest expenses-CD Interest payable-CD	5918	 5918

	1000000 x 12% x 18/365 Accrued interest for March 2021		
Apr. 30	Interest expense-CD Interest payable-CD 1000000 x 12% x 30/365 Accrued interest for April 2021	9863	9863
May 31	Interest expense-CD Interest payable-CD 1000000 x 12% x 31/365 Accrued interest for May 2021	10192	10192
June 14	Interest expense-CD Interest payable-CD 1000000 x 12% x 13/365 Accrued interest for June 2021	4274	4274
14	Certificate of deposit Cash To record the maturity and payment of the certificate of deposit	1000000	1000000
14	Interest payable-CD CD interest checks 5918 + 9863 + 10192 + 4274 = 30247 To record disbursement of interest	30247	30247

Illustration 3.3:

Interest on saving deposit accounts is computed and recorded monthly. The interest is paid to the customer quarterly by adding the amount to customers' saving deposit accounts. The following are the amounts of interests accrued at the end of each month for the first quarter of 2021:

January 2021	L.E.1075150
February 2021	1185600
March 2021	1408000
Total	L.E.3668750

Instructions:

Journalize the accrual of interest on saving deposit accounts and the payment of interest to customers at the end of the first quarter.

Solution

Date	Explanation	Dr. L.E.	Cr. L.E.
Jan. 31	Interest expense-saving deposits Interest payable-saving D Accrual of interest on saving accounts for the month of January 2021.	1075150	 1075150
Feb. 28	Interest expense-saving deposits Interest payable-saving D Accrual of interest on saving accounts for the month of	1185600	 1185600

	February 2021.		
Mar. 31	Interest expense-saving deposits Interest payable-saving D Accrual of interest on saving accounts for the month of March 2021.	1408000	1408000
Mar. 31	Interest payable-saving deposits Saving deposit accounts To record payment of interest on saving deposits for quarter-year ended March 31, 2021 by crediting interest directly to saving deposit accounts.	3668750	3668750

3.5 Problems:

Problem 3.1:

National Bank of Egypt made the following transactions during January 2022:

(1) A customer deposits a L.E.70000 check, drawn on another bank and requested the bank to distribute the amount of the check to the following accounts:

Demand deposit account	L.E.20000
N OW account	10000
Saving account	40000
Total	L.E.70000

(2) A customer has a certificate of deposit for L.E.100,000 that matures today. The customer requests that the proceeds of the certificate and the interest check for L.E.5,000 to be rolled over (converted) into a new certificate of deposit.

(3) The received in-clearings list from the Central Bank is as follows:

Demand deposit accounts	L.E.1,300,000
NOW deposit accounts	360,700
Cashier' checks-loans	255,300
Total in-clearings	1,916,000

(4) The bank receives a note that a wire transfer, for the amount of L.E.252,000, into the bank's account at the Central Bank was made. The credit is to be given to the checking account of one of the bank's customers.

(5) A customer cashes L.E.42,000 check "on us" (a check drawn on Misr Bank) at the teller's window.

(6) a customer buys a L.E.160,000 cashier's check and pays for it as follows:

Currency	L.E. 40,000
A check drawn on the bank	120,000

(7) A customer deposits a check drawn on another bank for the amount of L.E.116,000. The customer wants to deposit L.E.100,000 to his saving account and receives L.E.16,000 in cash from the teller.

(8) A customer requests the bank to wire-transfer L.E.190,000 to another bank and withdraws the money from his checking account (L.E.30,000) and his saving account (L.E.160,000).

(9) The bank issued a certified check to a customer for the amount of L.E.95,000 and withdraws the money from the customer's checking account. After two days, the certified check was received in the in-clearings from the Central Bank along with L.E.16,992,000 of customers' demand deposit accounts.

Instructions:

Prepare the journal entries for the above transactions.

Problem 3.2:

A customer buys a one-month L.E.500,000 certificate of deposit on January 15, 2022. The certificate matures on February 15, 2022. The annual interest rate is 12%.

Instructions:

Prepare all the journal entries required from the date of issuing the certificate to the date of maturity.

Problem 3.3:

The following are selected transactions that were completed by Sinai Bank during April 2022:

1. A customer requests the bank to wire transfer funds to another bank and to withdraw L.E.130,000 from his checking account.
2. A customer makes loan payment for the amount of L.E.190,000 with a check drawn on the bank at teller window.
3. A customer withdraws L.E.160,000 from a saving account and receives cash for L.E.60,000 and a cashier's check for L.E.100,000.
4. The bank receives a wire transfer from another bank for the amount of L.E.3,700,000 for proceeds of the sale of its bonds investment.

5. The bank issued a certified check to a customer for the amount of L.E.100,000 and withdraws the money from the customer's checking account. After two days, the certified check was received in the in-clearing from the central Bank of Egypt along with L.E.4,248,000 of customers' demand deposit accounts.

Instructions:

Prepare the journal entries for the above transactions.

CHAPTER FOUR
ACCOUNTING FOR NONDEPOSIT BORROWINGS

CHAPTER FOUR

Accounting for Nondeposit Borrowings

4.1 Introduction:

The foregoing chapter (Chapter Three) discussed deposits, which considered the traditional source of bank funds. But the deposit volume and growth are sometimes inadequate to meat all the loans request.

Accordingly, in recent years banks have started to obtain an increasing percentage of their total funds through nondeposit borrowing. Such financing provide a bank an opportunity of raising substantial funds for short periods of time without restrictions on the amount of interest paid or requirements of reserve funds at the Central Bank.

Over years and through experience, bankers have learned that turning down a profitable loan request because the bank does not have enough deposits to support the loan is not well received by customers.

Refusing a loan request means immediate loss of a deposit and perhaps the loss of any future business from the disappointed customer as well. On the contrary, granting a loan request, even when deposits are inadequate, usually brings in both new deposits and the demand for other banking services as well. As a result, all loans and investments whose returns exceed their costs and whose quality meets the bank's credit standards should be made. If deposits are not immediately available to cover these loans, management of the bank should seek out the lowest-cost source of borrowed funds available to meet its customers' credit needs.

Practically, there are three basic sources of funds available to a bank to meet liquidity needs and to be used for revenue generating and other activities:

- Shareholders contributions.
- Deposits from customers.
- Funds derived from nondeposit borrowing.

This chapter will be devoted for discussing the various types of nondeposit borrowing, the accounting treatment for nondeposit borrowing transactions, and their impact on liquidity of a bank.

4.2 Types of Nondeposit Borrowings

Nondeposit borrowings include a variety of common methods. The following sections will introduce for the accounting treatment of such methods.

1. Borrowing from reserve funds at the Central Bank:

The reserve funds market is considered the most popular source of borrowed reserves. Originally, reserve funds consisted exclusively of deposits held by the Egyptian banks at the Central Bank. These deposits are owned by banks and are held at the Central Bank to satisfy legal reserve requirements, clearing checks, and pay for purchases of government securities. These reserve balances at the Central bank can be transferred from one bank to another in seconds through a wire transfer.

Bank deposit balances at the Central bank that is in excess of required reserve balances may be loaned overnight over the weekend to other banks or institutions. These balances are labelled (called) reserve funds at the Central Bank.

Actually, both lending and borrowing banks hold reserve deposits with the Central Bank of Egypt, the lending bank simply asks that bank (CBE) to transfer funds from its reserve account to the borrower's reserve account. The bookkeeping is achieved in seconds via computer. When the loan comes due, the funds are automatically transferred back to the lending institution's account. The interest owed may also be transferred at this time, or the borrower may simply send a check to the lender to cover any interest owed. The following ledger accounts in the books of the lending bank and the borrowing bank illustrate the mechanics of borrowing and lending reserve funds at the Central Bank.

<u>First Step:</u> Lending reserve funds at the Central Bank, for example 100 million pounds.

Balance sheet of the lending bank

Assets Liabilities & OE

Assets		Liabilities & OE	
Reserve funds sold (loaned)	+100		
Reserves on deposit at the Central Bank	-100		

Balance sheet of the borrowing bank

Assets Liabilities & OE

Assets		Liabilities & OE	
Reserves on deposit at the Central Bank	+100	Reserve funds purchased (borrowed)	+100

<u>Second Step:</u> Borrowing bank uses reserve funds it obtains to make loans.

Balance sheet of the borrowing bank

Assets Liabilities & OE

Assets		Liabilities & OE	
Reserves on deposit at the Central Bank	-100	Reserve funds purchased (borrowed)	+100
Loans	+100		

<u>Third Step:</u> Repaying the loan of the reserve funds.

Balance sheet of the lending bank

Assets Liabilities & OE

Reserve funds sold (loaned)	-100		
Reserves on deposit at the Central Bank	+100		

Balance sheet of the borrowing bank

Assets Liabilities & OE

Reserves on deposit at the Central Bank	-100	Reserve funds purchased (borrowed)	-100

<u>2. Repurchase agreements:</u>

Banks use repurchase agreements to settle for short-term deficits in the reserve position or for liquidity. A repurchase agreement is the sale of securities with the understanding that a bank will repurchase them in the near future at the sale price plus a specified interest rate. Actually, the securities sold are still listed as an asset by the borrowing bank. In effect, the bank has borrowed an amount of money using the securities as collateral (guarantee). Repurchase agreements are made for short time but for longer periods of time than borrowing from reserve funds at the Central Bank.

3. Borrowing from the Central Bank through the discount window:

Through this tool, the borrowing bank sells to the Central Bank its own customers' notes, drafts, and bills of exchange. The borrowing bank is liable to the Central Bank if the original maker defaults (delays) on the maturity date of the instrument.

4. Borrowing from commercial banks and other financial institutions.

5. Borrowing on property owned by the bank.

6. Borrowing from a parent bank holding company.

The following example will illustrate accounting treatment for nondeposit borrowing transactions.

Illustration 4.1:

(1) On March 1, 2021, Cairo Bank sells L.E.10,000,000 of reserve funds at the Central Bank for one day at interest rate of 12%. In this transaction, Cairo Bank grants a loan to another bank from excess reserves. On the following day, Cairo Bank is repaid the loan and the interest.

(2) On March 3, 2021, Cairo Bank borrows L.E.12,500,000 of reserve funds at the Central Bank for one day at interest rate of 12%. On March 4, 2021, Cairo Bank repays the loan and the interest.

(3) National Bank sells L.E.15,000,000 of Egyptian Government securities on April 1, 2021, with an agreement to repurchase them in 10 days. The interest rate is 12%. On April 11, 2021, the securities are returned to the bank.

Instructions:

Prepare journal entries for the above transactions.

Solution

Date	Explanation	Dr. L.E.	Cr. L.E.
Mar. 1	Reserve funds sold Due from banks-CB You will notice that the total assets or liquidity for Cairo Bank does not change. One liquid asset has been substituted for another. However, a nonearning asset has been exchanged for an earning asset, thus improving the bank profitability.	10000000	 10000000
2	Due from banks-CB Reserve funs sold Interest income 10000000 x 12% x 1/365= 3288 (round). Notice that total assets and liquidity of Cairo Bank increase by the amount of interest income.	10003288	 10000000 3288
3	Due from banks-CB Reserve funds purchased This transaction increases both an asset and a liability account. Such a transaction is usually made to satisfy a need for additional short-term liquidity.	12500000	 12500000
4	Reserve funds purchased Interest expense Due from banks-CB 12500000 x 12% x 1/365= 4110 (round).	12500000 4110	 12504110

	The net amount of assets has been reduced by the amount of interest expense.		
Apr. 1	Due from banks Securities sold under repurchase agreement Both an asset and a liability account are increased by L.E.15000000. The securities sold are still listed as an asset by the bank. In effect, the bank has borrowed 15 million pounds using the securities as collateral.	15000000	15000000
11	Securities sold under repurchase agreement Interest expense Due from banks 15000000 × 12% × 10/365 = 49315. The securities have been returned to the bank and the liability has been extinguished (paid) by the payment of cash.	15000000 49315	15049315

Of course, repurchase agreement is different from the reserve funds purchased because the reserve fund purchased is, in essence, an unsecured loan.

Both methods of Nondeposit borrowing increase the liquidity of the bank.

Illustration 4.2:

On April 10, Misr Bank discounts L.E.10000000 of customer notes at the Central Bank of Egypt at a discount rate of 12%. The note matures in 30 days.

Instructions:

Prepare the journal entries for discounting the notes at the Central Bank and the collection of the notes on May 10, 2021.

Solution

Date	Explanation	Dr. L.E.	Cr. L.E.
Apr. 10	Due from banks-CB	9901370	
	Interest expense	98630	
	Customers notes discounted		10000000
	10000000 × 12% × 30/365 = 98630 (round).		
May 10	Customer notes discounted	10000000	
	Customer notes		10000000
	Collection of customer notes.		

The effect of the first entry is to record a contra asset account “Customer Notes Discounted” until the notes are collected, then the contra asset account and the original asset account “Customer Notes” are cancelled.

4.3 Problems:

Problem 4.1

Egyptian African Bank performed the following transactions during August and September 2021.

Aug. 1 The ban sold L.E.15,000,000 of reserve funds at the Central Bank of Egypt to another bank for one day at interest rate of 12%.

Aug. 12 The bank purchased (borrowed) L.E.20,000,000 of reserve funds for 2 days at an interest rate of 12%.

Aug. 22 The bank sold L.E.10,000,000 of securities under a 15 days repurchase agreement at an interest rate of 12%.

Aug. 31 The bank accrued any interest for the month of August.

Sept. 6 The bank purchased the L.E.10,000,000 of securities sold on August 22.

Instructions:

Prepare the journal entries for the above transactions.

Problem 4.2:

On March 10, 2022, the National Bank discounts L.E.5,000,000 of customer notes at the Central Bank of Egypt at a discount rate of 12%. The notes mature in 45 days.

Instructions:

Prepare the journal entries for the following:

1. Discounting of the notes at the Central Bank.
2. Collection of the notes at maturity date.

Problem 4.3:

Presented below are several transactions for the National Bank of Egypt during May 2022:

May 1 The bank sold L.E.20,000,000 of its reserve funds at the Central Bank to Alexandria Bank for 2 days at interest rate of 10%.

May 3 The bank is repaid the loan and the interest.

May 7 The bank sold L.E.15,000,000 of securities under a 14 days repurchase agreement at an interest rate of 13%.

May 21 The bank repurchased the L.E.15,000,000 of securities sold on May 7.

May 25 The bank discounted L.E.10,000,000 of customer notes at the Central Bank at a discount rate of 11%. The notes mature on July 17.

Instructions:

Journalize the above transactions and the collection of the customer notes at maturity date.

CHAPTER FIVE
ACCOUNTING FOR LOANS

CHAPTER FIVE

Accounting for Loans

5.1 INTRODUCTION

Loans are considered the most important tool for investment to banks. Accordingly, loans represent the largest asset item and they generally account for fifty to seventy five percent of all bank assets. In addition, loans are the largest source of revenue to a bank.

In practice, there are various kinds of loans granted by banks. Each type of loans differs from the others based on some characteristics, such as:

(1) Duration of loan which varies from one month to 25 years.

(2) Purpose of borrowing which can be for the purchase of real estate, financing business operations, financing consumer and household expenditures, and so on.

(3) Method of repayment-periodic payment, repayment in full, and renewal of the loan at the maturity date.

(4) Collateral (guarantee). Accordingly, a loan may be collateralized by the property purchased with the proceeds of the loan. For instance, equipment would be the collateral for a loan used to buy that equipment, merchandise inventory may be used as collateral for a loan used to buy that merchandise, and a factory building would be the collateral for a real estate loan used to buy the building. A loan may be unsecured, where no property is used to collateralize the loan.

5.2 ACCOUNTING TREATMENT FOR LOANS:

In the real world, there are four types of transactions recorded in the accounting books with the granting of loans:

1) Payment of loan proceeds to the borrower.
2) Repayment of the loan by the borrower.
3) Journalizing monthly accrued interest (interest earned).
4) Collection of interest.

When a loan or a portion of the loan balance deemed uncollectible, it must be written off (bad loans). Any previously accrued interest receivable would also be written off.

Of course, the net amount of loans shown on the balance sheet should be stated at estimated cash value. This net amount equals the gross loans minus the allowance for possible loan losses (All). The Allowance for Loan Losses, which is considered a contra-asset account, represents an accumulated reserve against which loans declared to be uncollectible can be charged off. Three types of loans will be discussed in the following sections.

First: Commercial loans:

Commercial loans are granted to finance business operations. A variety of these loans are made for working capital purposes, that is, to purchase merchandise inventory. As a result, commercial loans are usually short term-vary from 3 to 6 months- some loans may be granted for longer periods of time.

Illustration 5.1:

The Star Company borrowed L.E.400,000 on March 11, 2021, repayable on June 11, 2021. The loan agreement includes a provision for renewal of the loan on the maturity date in the amount of L.E.200,000 and a final maturity date of September 11, 2021. The annual interest rate is 12%.

The bank records interest income using a simple interest method on the last day of each month, except the month in which the loan matures. In that case, interest income is recorded on the maturity date of the loan for the number of days interest earned in that month.

Instructions:

Journalize the loan transactions from March 11, to September 11, 2021.

Solution

Date	Explanation	Dr. L.E.	Cr. L.E.
2021 Mar.11	Commercial loans Cashier's checks-loans	400,000	400,000
Mar.31	Interest receivable Interest income 400,000 x 12% x 21/365= 2,762 (round).	2,762	2,762
Apr.30	Interest receivable Interest income 400,000 x 12% x 30/365= 3,945 (round).	3,945	3,945
May31	Interest receivable Interest income 400,000 x 12% x 31/365= 4,077 (round).	4,077	4,077
June11	Interest receivable Interest income 400,000 x 12% x 10/365=	1,315	1,315

	1,315 (round).		
June11	Cash Commercial loan (new) Interest receivable Commercial loan (old) To record maturity of old loan (L.E.400,000), renewal of loan (L.E.200,000), and collection of an interest for the period, from March 11 to June 11. Interest = 2,762 + 3,945 + 4,077 + 1,315 = L.E.12,099.	212,099 200,000	 12,099 400,000
June30	Interest receivable Interest income 200,000 x 12% x 20/365= 1,315 (round).	1,315	 1,315
July31	Interest receivable Interest income 200,000 x 12% x 31/365= 2,038 (round).	2,038	 2,038
Aug31	Interest receivable Interest income	2,038	 2,038
Sept11	Interest receivable Interest income 200,000 x 12% x 10/365= 658 (round).	658	 658
Sept11	Cash Interest receivable Commercial loan To record maturity and repayment of loan and collection of an interest for 3 months. Interest = 1,315 + 2,038 + 2,038 + 658 = L.E.6,049.	206,049	 6,049 200,000

At the end of the year, the balance of interest income account is closed to the income summary of the bank, along with other revenues as follows:

Interest income	18,148	
Income summary		18,148

(L.E.12,099 + 6,049 = L.E.18,148).

Second: Real Estate Loans:

This type of loans is secured by liens on real estate. The most common kind of real estate loans are the **Construction Loans**. These loans are made to finance the construction of a building. The bank determines a maximum amount of lending limit for the construction loan. The builder submits the bills received from subcontractors to the bank and the bank pays directly to the subcontractors. Interest earned is calculated and recorded at the end of every month. When the building is completed and sold, the borrower will repay the loan from the sales proceeds.

Illustration 5.2:

The Arab Contractors Company commenced the construction of a building. The company borrowed a construction loan from the National Bank. The bank will allow the company to borrow a maximum of L.E.30,000,000 for construction. The annual interest rate is 13%. The bank made the following disbursements to subcontractors.

1. L.E.700,000 to Mansour Company on May 10, 2021.
2. L.E.1,000,000 to Mokhtar Company on May 16, 2021.

Instructions:

Calculate the due interest for May 2021 and prepare the appropriate journal entry.

Solution

Due interest is calculated as follows:

- Interest on L.E.700,000 for 6 days (May10 to May 15) and

- Interest on L.E.1,700,000 for 16 days (May 16 to May 31).

Interest = 700,000 × 13% × 6/365 + 1,700,000 × 13% × 16/365 = 1,496 + 9,688 = L.E.11,184.

Or = 700,000 × 13% × 22/365 + 1,000,000 × 13% × 16/365 = 5,485 + 5,699 = L.E.11,184

The journal entry at the end of May would be as follows:

Interest Receivable.	11,184	
Interest Income		11,184

<u>Third: Installment Loans:</u>

Installment loans are provided to individuals (consumer loans) to purchase an automobile, house appliances, or a ticket for vacation, and to businesses (business loans) to purchase equipment, truck, and so on.

The difference between the gross amount of installment loan and the net amount paid (advanced) to the customer is called "**Unearned**

Discount". Unearned discount is a ***contra-asset*** balance sheet account.

Illustration 5.3:

Victory Company borrowed L.E.700,000 on August 1, 2021, for 12-month period. Interest (finance charge) on the borrowing was L.E.70,400. According to the above information, total amount to be paid by Victory Co. to the bank (principal loan add interest) is:

Borrowed amount	L.E.700,000
Add: Finance charge	70,400
Total	L.E.770,400

Monthly payment = $\frac{\text{Total amount}}{\text{Period}}$

= 770,400 ÷12 months = L.E.64,200 per month.

The bank records the following journal entry at the time the loan is disbursed to the borrower:

Installment loans	770,400	
Unearned discount		70,400
Cashier's checks		700,000

For computing the amount of interest to be recorded each month, the sum of the months’ digits will be used.

The sum of the months’ digits = 12 + 11 +10 + 9 + 8 + 7 + 6 + 5 + 4 + 3 + 2 + 1 = 78.

Interest per digit = 70,400 ÷78 = L.E.902.56

Interest or finance charge to be amortized every month is calculated as follows:

First payment (month) = 902.56 ×12 = 10,830.72.

Second payment (month) = 902.56 ×11 = 9,928.16.

Third payment (month) = 902.56 ×10 = 9,025.6.

Accordingly, two entries are recorded each month. They are:

1- Loan repayment by the borrower.

2- Amortization of unearned discount by transferring amounts to interest income.

2021 Sep1	Cash Installment loans	64,200	64,200
	Unearned discount Interest income	10,830.72	10,830.72
Oct1	Cash Installment loan	64,200	64,200
	Unearned discount Interest income	9,928.16	9,928.16
Nov1	Cash Installment loan	64,200	64,200
	Unearned discount Interest income	9,025.60	9,025.60

The ledger accounts relating installment loans would be shown as below:

Installment Loans Account

1/8 Unearned discount	70,400	1/9 Cash	64,200
Cash	700,000	1/10 Cash	64,200
		1/11 Cash	64,200
		30/11 Balance c/d	577,800
	770,400		770,400

Unearned Discount Account

1/9 Interest income	10,830.72	1/8 Install. Loans	70,400.00
1/10 Interest income	9,928.16		
1/11 Interest income	9,025.60		
30/11 Balance c/d	40,615.52		
	70,400.00		70,400.00

On November 30, 2021, Installment Loans will be presented on the balance sheet as below:

Balance Sheet, November 30, 2021

Installment loans	577,800.00		
Less: Unearned discount	40,615.52		
	537,184.48		

Allowance For Loan Losses (ALL):

As explained in the preceding sections, allowance for loan losses (ALL) is a contra asset balance sheet account, represents an accumulated reserve against which loans declared to be uncollectible can be charged of (written down).

Total loans shown on the balance sheet should be reduced by the estimated amount of uncollectible loans (ALL). Thus, loans are stated on the balance sheet at the ***estimated cash value*** amount (net loans).

The balance in allowance for loan losses account is based on management's judgment based on quality of loan portfolio, past-due loss experience, and current economic conditions that may affect the borrowers' ability to repay the loans. On the other hand, the allowance for loan losses is built up gradually over time by annual charge to expenses. The annual charge appears on the income statement as a non-cash expense item called **"Provision for Loan Losses" (PLL).**

Illustration 5.4:

Assume that the balance in the allowance for loan losses account is L.E.1,500,000 before adjustments at the end of December 2021.

Additional information:

(1) L.E.80,000, loans declared uncollectible and should be written off (commercial loans).

(2) L.E.65,000, received as a recovery of a prior year's write off of loans (commercial loans).

(3) Allowance for loan losses must be increased by L.E.175,000.

Instructions:

Record the above transactions.

Solutions

2021 Dec. 31	Allowance for loan losses Commercial loans	80,000	80,000
	Commercial loans Allowance for loan losses	65,000	65,000
	Cash Commercial loans	65,000	65,000
	Provision for loan losses Allowance for loan losses	175,000	175,000

Allowance for Loan Losses Account

31/12 Commercial loans	80,000	31/12/021 Balance	1,500,000
31/12 Balance	1,660,000	Commercial loans	65,000
		Provision for loan losses	175,000
	1,740,000		1,740,000

On December 31, 2021, Loans will be presented on the balance sheet as below:

Balance Sheet, December 31, 2021

Assets	L.E.		
Commercial loans	17,000,000		
Construction loans	4,200,000		
Installment loans	4,050,000		
Total loans	25,250,000		
Less: Unearned discount	(1,350,000)		
	23,900,000		
Less: Allowance for loan losses	(1,660,000)		
Net loans	22,240,000		

Uncollectible Interest Receivable:

When a loan is deemed uncollectible and written off, any uncollectible interest receivable applicable to the uncollectible loan should also be written off. Nevertheless, the write off of interest of uncollectible interest receivable is made against Interest Income. This means that the entry which was recorded before should be reversed.

Illustration 5.5:

Assume that a loan balance of L.E.125,000 of a customer is deemed uncollectible and must be written off. Assume also that the unpaid balance of interest receivable on the loan is L.E.13,500. The required journal entries are as follows:

Allowance for loan losses Commercial loans To write off the uncollectible loan balance.	125,000	125,000
Interest income-Commercial loans Interest receivable-commercial loans To write off the balance of interest receivable on the loan.	13,500	13,500

Illustration 5.6:

Assume that the Stars Company's installment loan balance, deemed uncollectible, has the following balances:

Installment loan	L.E.	75,000
Less: Unearned discount		(13,250)
Net loan	L.E.	61750

The journal entry required to write off the loan will be as follows:

Allowance for loan losses	61,750	
Unearned discount-installment loans	13,250	
Installment loans		75,000
To write off the uncollectible installment loan balance of the Stars Company.		

5.3 Problems:

Problem 5.1:

The Alexandria company borrowed L.E.2,000,000 on April 26, 2021, with interest at 12% annually. The loan agreement specifies that the maturity date is June 26, 2021.

Instructions:

Prepare the journal entries for the following:

(1) Disbursement (granting) of the loan on April 26, 2021.

(2) Accrual of interest at the end of April, May, and June, 29.

(3) Collection of interest and the principal at maturity date.

(4) Transfer the interest income to the Income Summary at the end of June 2021.

Problem 5.2:

Arab Contractors Company negotiated an agreement with National Bank to borrow a construction loan. The bank will allow the

Company to borrow at a maximum of L.E.10,000,000. Interest rate will be 12%.

The bank made the following disbursements:

1. L.E.1,400,000 to the Victory Company on May 10, 2021.
2. L.E.300,000 to the South Valley Company on May 20, 2021.

Instructions:

a) Calculate the interest receivable on the loan during May 2021.

b) Provide the journal entry to record the interest at the end of May 2021.

Problem 5.3:

A customer borrowed L.E.175,000 from Egyptian African Bank for a period of 3 years to purchase a flat (an apartment) on January 1, 2021. Equal monthly payments are made that include principal and interest. The monthly payment is L.E.5,812.50. (Tip: The sum of months' digits = 666).

Instructions:

a. Prepare an amortization schedule for the first three loan repayments.

b. Prepare the journal entries for the disbursement of the loan and the first two months' loan repayment.

Problem 5.4:

On January 1, 2021, Qena Company borrowed L.E.60,000 for 12 months on an installment loan basis. The interest (finance charge) on the loan was L.E.5,800. The borrower will make loan repayments in equal monthly amounts at the beginning of each month.

Instructions:

a. Record the disbursement of the loan.

b. Record the entries for the first two months' loan repayment.

Problem 5.5:

The Arab African Bank has the following loans that are deemed uncollectible at December 31, 2021:

1. A company has a commercial loan with a balance of L.E.115,000. The uncollectible interest receivable of L.E.6,400 should be also written off.

2. Another company has an installment loan with balances as of December 31, 2021: Installment loans L.E.38,000, Unearned discount-installment loans L.E.4,250.

Instructions:

Pass journal entries for the above events.

Problem 5.6:

The balance of allowance for loan losses account in the books of the National Bank at December 31, 2021 before adjustments is L.E.1,085,000. Additionally, the following information is given:

1) The bank received a check for the amount of L.E.49,000 as a recovery of a prior year's write off of a loan.

2) The bank determined that L.E.65,000 of loans deemed uncollectible and must be written off.

3) Allowance for loan losses must be increased to be L.E.1,350,000.

Instructions:

a. Prepare journal entries to record the above events in the books of the bank at the end of December 2021.

b. Assume the balance of gross loans is L.E.18,575,000, show the balance sheet presentation for the loans.

Solution

2021	Loans	49,000	
Dec.	Allowance for loan losses		49,000
31	Cash	49,000	
1)	Loans		49,000
	Recoveries of prior years write off.		
2)	Commercial loans	65,000	
	Allowance for loan losses		65,000

	Cash Commercial loans	175,000	 175,000
	Provision for loan losses Allowance for loan losses		

CHAPTER SIX
ACCOUNTING FOR INVESTMENT SECURITIES

CHAPTER SIX

Accounting for Investment Securities

6.1 INTRODUCTION:

Practically, three types of investment securities are found. They are:

1. Government Treasury Securities:

This type of securities is issued by the treasury (Ministry of Finance). It includes the following securities:

a. ***Treasury Bills:*** Treasury bills are issued for a period of one year or less. In effect, treasury bills are sold at a discount. In other words, interest to be earned by the bank (the investor) is the amount of discount (the difference between the face amount and the original purchase price).

b. ***Treasury Notes:*** Treasury notes are issued for a period of one year but not more than 10 years. Cash interest is received by the bank on the interest payment date (usually every 6 months).

c. ***Treasury Bonds:*** Treasury bonds are issued for a period of more than 10 years. Interest is received by the bank on the interest payment date (usually every 6 months).

2. Bonds issued by other Government Agencies and Corporations:

3. Other Securities issued by major Business Corporations:

This type of securities includes interest-bearing securities and trading securities, available for sale securities, held to maturity securities, and mutual funds certificates.

In terms of ***liquidity***, investment securities are divided into two portions. The ***liquid portion;*** which is considered as a *second line of defense* to meet demands for cash and serves as a quick source of funds. This portion is often called ***secondary reserves***. These securities include short-term government securities and money market securities including interest-bearing time deposits held with other banks and commercial papers.

Commonly, secondary reserves occupy the middle ground between cash assets and loans, earning some income but held mainly for the ease with which they can be converted into cash or short notes.

Of course, bonds, notes, and other securities held by the bank primarily for their expected rate of return or yield is the ***income-generating portion*** of investment securities.

6.2 ACCOUNTING FOR INVESTMENT SECURITIES:

In the real world, all investments in ***debt*** securities and ***equity*** securities that have readily determinable fair values (except those for which the equity method or consolidation is appropriate) are classified in one of three categories and accounted for differently depending on the classification as shown below:

Reporting Category	Classification Criteria
1. Held-to-maturity	Debt securities for which the bank has the positive intent an ability to hold to maturity.
2. Trading securities	Debt or equity securities held for immediate resale.
3. Securities available for sale	Debt or equity securities not classified as either security held to maturity or trading securities (typically securities whose sale depends on market factors and

	financial conditions of the bank).

For all three categories, the bank includes the determination of income any ***realized*** gains and losses; those that arise when securities are sold. Similarly, the bank includes investment income (dividends and interest) in the determination of earnings for all three categories.

The differences in accounting treatment among the categories of securities emerge with respect to **unrealized** gains and losses, those that arise from holding securities during a period when their market value change. The unrealized gains and losses are treated as follows:

Category	**Valuation**	**Unrealized holding gains and losses**
1. Held-to-maturity	Amortization cost	Not recognized
2. Trading securities	Fair value	Recognized in net income

3. Available-for-sale	Fair value	Recognized as other comprehensive income and as a separate component of stockholders' equity

6.3 SECURITY TRANSACTIONS:

There are four security transactions:

1) Purchase of security.
2) Interest earned and subsequently collected in cash.
3) The redemption at the maturity date, the bank receives the face amount of security in cash.
4) Sale of a security before the maturity date. A gain or loss may result from the sale of security.

Notice that government treasury bills do not pay interest periodically. The bank earns interest income on treasury bills by purchasing the bills at a discount and holds them until maturity. The difference between the purchase price and the face amount is the discount

1. Purchase of Security:

Debt securities may be purchased at the face amount (par amount), where the purchase price is equal to the par value; purchased at a premium, where the purchase price is greater than the face amount; or purchased at a discount, where the purchase price is less than the face value.

Illustration 6.1, Held-to-maturity securities

Cairo Bank purchased the following securities on January 1, 2021:

1. Government bonds, face amount L.E.1,200,000, 10% coupon interest, matures December 31, 2023, coupon due June 30 and December 31. Purchase price, L.E.1,200,000.

2. Government bonds, face amount L.E.1,500,000, 12% coupon interest, matures December 31, 2024, coupon due June 30 and December 31. Purchase price, L.E.1,620,000.

3. Government bonds, face amount L.E.500,000, 9% coupon interest, matures December 31, 2025, coupon due June 30 and December 31. Purchase price, L.E.489,500.

4. Egyptian Government treasury bills, L.E.1,250,000 face amount, to mature on September 30, 2021. Purchase price, L.E.1,137,500.

Instructions:

Record the above transactions in the journal.

Solution

2021 Jan.1 (1)	Investment in Egyptian Government bonds Cashier's checks	1,200,000	 1,200,000
(2)	Investment in Egyptian Government bonds Premium on bonds investment Cashier's checks	1,500,000 120,000	 1,620,000
(3)	Investment in Egyptian Government bonds Cashier's checks Discount on bonds investment	500,000	 489,500 10,500
(4)	Investment in Egyptian Government treasury bills- cost Cashier's checks	1,137,500	 1,137,500

2. Interest Earned:

According to banks' accounting system, interest earned is recorded monthly. Coupon interest and amortization of premium (and accretion of discount) and the collection of interest on payment date are recorded.

Again, treasury bills do not pay interest periodically with coupons or interest checks. Interest to be earned is totally from the ***"discount"*** or the difference between the face amount of the bill and the purchase price. Interest income, recorded monthly on the straight-line method, is the pro-rata portion of the discount allocated over the period of time from the purchase date to the maturity date. The following formula is used to calculate the amount of monthly interest:

Monthly interest = Face amount-purchase price ÷ Number of months to maturity

The bank would record the monthly accrual of interest earned as follows:

Treasury bills	xxx	
Interest income-treasury bills		xxx

When the face amount of the treasury bills is redeemed at maturity, the following journal entry would be made when the cash is received:

Cash or Due from banks	xxx	
Treasury bills		xxx

Amortization of Premium and discount:

Held to maturity securities are recorded at cost and reported in the financial statements (valued) at the amortized cost. Amortized cost is the acquisition cost adjusted by the amortization of the premium or the discount. Holding gains or losses from market price changes are ignored.

The original premium or discount recorded from the purchase transaction would be periodically reduced to zero over the remaining life of the bond. At the maturity date of the security, the amount of premium or discount would be zero.

Amortization of premium:

In the previous illustration (Illustration 6.1), the bank purchased the ponds (transaction No. 2) at a premium of L.E.120,000. The maturity date of the bonds is December 31, 2024. The remaining life of the bonds is 4 years or 48 months (4 × 12 = 48).

Monthly amortization of the premium using the straight-line method =

Premium ÷ Number of months to maturity

= 120,000 ÷ 48 months = L.E.2,500.

The following journal entry would be made to amortize the premium and record the interest income every month.

Interest receivable- investment securities	15,000	
Interest income		12,500
Premium on bond investment		2,500

(1,500,000 × 12% × 1/12 = 15,000).		

The amortized cost of the investment on January 31, 2021, will be as follows:

1,500,000 + (120,000 - 2,500) = 1,617,500.

Accordingly, the investment is reported in the balance sheet at that date as follows:

Balance Sheet, January 31, 2021

Investment in bonds	1,500,000		
Add: Premium on bond investment	117,500		
	1,617,500		

Amortization of discount:

In the previous illustration (Illustration 6.1), the bank purchased the ponds (transaction No. 3) at a discount of L.E.10,500. The maturity date of the bonds is December 31, 2025. The remaining life of the bonds is 5 years or 60 months (5 × 12 = 60).

Monthly amortization of the discount using the straight-line method =

Discount ÷ Number of months to maturity

= 10,500 ÷ 60 months = L.E.175.

The following journal entry would be made to amortize the discount and record the interest income every month.

Interest receivable	3,750	
Discount on bond investment	175	
Interest income		3,925
(500,000 × 9% × 1/12 = 3,750).		

The amortized cost of the investment on January 31, 2021, will be as follows:

500,000 - (10,500 - 175) = 489,675.

Calculation of coupon interest:

Transaction no. 1, monthly interest =

1,200,000 × 10% × 1/12 = L.E.10,000.

Transaction no. 2, monthly interest =

1,500,000 × 12% × 1/12 = L.E.15,000.

Transaction no. 3, monthly interest =

500,000 × 9% × 1/12 = L.E.3,750.

Transaction no. 4, monthly interest =

1,250,000 - 1,137,500 =

112,500 ÷ 9 months = L.E.12,500.

Thus, journal entries for monthly interest earned on investment securities will be as follows:

2021 Jan.31 (1)	Interest receivable- investment securities	10,000	
	Interest income, treasury bonds		10,000
(2)	Interest receivable- investment securities	15,000	
	Interest income, treasury bonds		12,500
	Premium on bond investment		2,500
(3)	Interest receivable- investment securities	3,750	
	Discount on bond investment	175	
	Interest income, treasury bonds		3,925
(4)	Treasury bills	12,500	
	Interest income, treasury bills		12,500

On the maturity date of September 30, 2019, the balance in the investment securities-treasury bills will be as follows:

1,137,500 + 9 months × 12,500 = L.E.1,250,000

Thus, when the face amount of a treasury bill is redeemed on maturity date, the bank records the cash received as bellow:

2021 Sep. 31	Cash (Due from banks) Government treasury bills	1,250,000	1,250,000

Furthermore, when the bank collects the accrued interest receivable at the payment dates on June 30 and December 31, the journal entry would be as follows for the first three security transactions (for example, on June 30, 2021):

2021 June 30	Cash (Due from banks) Interest receivable-investment securities (10,000 + 15,000 + 3,750) × 6 months = 28,750 × 6 = L.E.172,500.	172,500	172,500

3. Maturity of a Security:

The face amount of a security becomes due on the maturity date. So, the bank receives the face amount from the issuer. The following journal entry would be recorded by the bank on December 31, 2023, when the face amount of L.E.1,200,000 is received for the maturity of the government bonds (transaction no. 1):

2023 Dec. 31	Cash (Due from banks) Egyptian Government Bonds	1,200,000	
			1,200,000

4. Sale of Security before maturity date:

When a security is sold before the maturity date, a gain or loss may result. For instance, assume that the government bonds (transaction no. 1) were sold on November 1, 2023, two months before maturity, for L.E.1,275,000 (plus interest from June 30 to November 1, 2023).

- What would be the amount received by the bank?
- Prepare the appropriate journal entry.

According to the above information, the amount which would be received by the bank is calculated as follows:

* Selling price = L.E.1,275,000.

* Interest for 4 months = 10,000 × 4 = L.E.40,000.

Total amount = 1,275,000 + 40,000 = L.E.1,315,000.

* Gain or loss on sale of security will be computed as follows:

Received amount *less* (−) (cost of security + accrued interest for 4 months).

= 1,315,000 - (1,200,000 + 40,000) = L.E.75,000.

Thus, the journal entry will be as follows:

2023 Nov. 1	Cash (Due from banks)	1,315,000	
	Egyptian Government Bonds		1,200,000
	Interest receivable		40,000
	Securities gains & losses		75,000

Assume, also, that the treasury bills purchased on January 1, 2021, were sold on August 31, 2021 (one month before maturity date), for L.E.1,245,000. The difference between the book value and the sale price of securities is calculated as follows:

*Original cost on January 1, 2021: L.E.1,137,500	
*Add: 8 months' interest (8 × 12,500) =	
	100,000
@ Book value on August 31	1,237,500
Sale price on August 31, 2021	1,245,000
Excess of sale price over book value	
(Interest income)	L.E. 7,500

Thus, the journal entry will be as follows:

2021 Aug. 31	Cash (Due from banks) Treasury bills Interest income, treasury bills (or securities gains and losses)	1,245,000	 1,237,500 7,500

<u>Illustration 6.2, Available for sale and trading securities:</u>

Misr Bank buys and sells debt and equity securities as investments. The following transactions were completed during 2021. the bank's fiscal year-end is December 31.

Oct. 1 Purchased Cairo Corporation 10% bonds for L.E.30 million (face amount).

Oct. 31 Received cash interest of L.E.250,000 on the investment in Cairo Corporation bonds, calculated as 30 million × 10% × 1/12.

Nov. 1 Sold Cairo Corporation bonds for L.E.30,750,000.

Dec. 22 Acquired two new investments costing: Qena Company Shares L.E.12,500,000. Aswan Company Shares L.E.10,000,000.

Dec. 31 The market prices of the investment are: Qena Co. L.E.14,000,000. Aswan Co. L.E.9,500,000.

<u>Instructions:</u>

Journalize the above transactions and events assuming:

1. The investment is classified as available for sale.

2. The investment is classified as trading securities.

Solution

1. The investment is classified as available for sale

Date	Explanation	Dr. L.E.	Cr. L.E.
2021 Oct.1	Investment in Cairo Corporation bonds	30,000,000	
	Cashier's checks (cash)		30,000,000
Oct.31	Due from banks (cash)	250,000	
	Interest income		250,000
	30,000,000 x 10% x 1/12= 250,000.		
Nov.1	Due from banks (cash)	30,750,000	
	Investment in Cairo Corporation bonds		30,000,000
	Gain on sale of securities		750,000
Dec.22	Investment in Qena Company shares	12,500,000	
	Investment in Aswan Company shares	10,000,000	
	Cash or due from banks		22,500,000

<u>Adjusting investments to fair value:</u>

Security	***Cost***	***Fair value***	***Unrealized holding gains (losses)***
1. Qena Co.	12,500,000	14,000,000	1,500,000
2. Aswan Co.	10,000,000	9,500,000	(500,000)
Totals	***22,500,000***	***23,500,000***	***1,000,000***

December 31, 2021, adjusting journal entry

2021 Dec. 31	Fair value adjustment Net unrealized holding gains (losses).	1,000,000	1,000,000

On December 31, 2021, the investment is reported in the balance sheet as follows:

Balance Sheet, December 31, 2021(Assets)

Securities available for sale	22,500,000		
Add: Fair vale adjustment	1,000,000		
	23,500,000		

Balance Sheet, December 31, 2021 (Stockholders' equity)

		Accumulated other comprehensive income: Net unrealized holding gains (losses)	1,000,000

2. The investment is classified as trading securities

The first four journal entries are the same for available for sale and trading securities.

Adjusting investments to fair value:

2021 Dec. 31	Investment in Qena Company Unrealized holding gains on investments	1,500,000	1,500,000
	Unrealized holding losses on investments investment in Aswan Company	500,000	500,000

The ledger accounts relating investment securities would be shown as below:

Investment in Qena Shares

Dec.22 Cash	12,500,000	Dec.31 Balance c/d	14,000,000
Dec.31 Unrealized holding gains	1,500,000		
	14,000,000		14,000,000

Investment in Aswan Shares

Dec.22 Cash	10,000,000	Dec.31 Unrealized holding losses	500,000
		Dec.31 Balance c/d	9,500,000
	10,000,000		10,000,000

The security investment is reported in the balance sheet as follows:

Balance Sheet, December 31, 2021 (Assets)

Trading securities at fair value (cost L.E.22.5 million)	23,500,000		

Notice that the change in fair value (L.E.1,000,000) is recorded directly to the security investment accounts. Also, the net unrealized holding gains is reported in the income statement in other incomes (revenues) like the interest income (L.E.250,000) and the gain on sale of securities (L.E.750,000).

6.4 Problems:

Problem 6.1:

Alexandria Bank purchased Treasury Bonds on January 1, 2021, L.E.1,000,000 face amount, with interest coupon at 12%, matures December 31, 2022, coupon due June 30 and December 31. Purchase price, L.E.1,000,000. And a treasury note, L.E.2,000,000 face amount, 9% coupon interest, matures December 31, 2023, coupon due June 30 and December 31, purchase price L.E.1,850,000. Assume that security is classified as held to maturity.

Instructions:

(1) Record the purchase of securities on January 1, 2021. Payment was by cashier's checks.

(2) Record the interest earned at the end of January 2021.

(3) Record the collection of interest on June 30, 2021. Payment was made directly to the bank's

demand deposit account at the Egyptian Central Bank.

(4) Record the redemption of the treasury bonds on December 31, 2022. Payment was made directly to the bank's demand deposit account at the Egyptian Central Bank.

Solution

Date	Explanation	Dr. L.E.	Cr. L.E.
2021 Jan. 1	Investment in treasury bonds	1,000,000	
	Cashier's checks		1,000,000
	Investment in treasury notes	2,000,000	
	Cashier's checks		1,850,000
	Discount on treasury notes		150,000
Jan.31	Interest receivable	10,000	
	Interest income		10,000
	1,000,000 x 12% x 1/12= 10,000.		
	Interest receivable	15,000	
	Discount on treasury notes	4,167	
	Interest income		19,167
	2,000,000 × 9% × 1/12 = 15,000.		
	Amortization of discount = 150,000 ÷ 36 months = 4,167 (round).		
June. 30	Due from banks-CB	150,000	
	Interest receivable		150,000
	(10,000 + 15,000) × 6 months = L.E.150,000.		
Dec.31	Due from banks- CB	1,000,000	

2020	Investment in treasury bonds		1,000,000

Problem 6.2:

Assume That the treasury note in problem 6.1 above was sold on September 1, 2023 for L.E.2,075,000 plus accrued interest.

Instructions:

a) Calculate the gain or loss on the sale of the Treasury note.

b) Provide the journal entry to record the sale of the note. The bank received payment by wire transfer to its demand deposit account at Cairo Bank.

Solution

(1) * Discount on Treasury note = L.E.150000.

* Remaining life of the Treasury note is 3 years or 36 months.

* Monthly amortization of discount =

$\frac{150,000}{36 months}$ = L.E.4166.6667.

* Book value of the note (amortization cost) at the date of sale (Sept. 1, 2023) = 1,850,000 + amortization of the discount (from Jan. 1, 2019 to Sept. 1, 2023) for 32 months.

= 1,850,000 + (4166.6667 × 32 months).

= 1,850,000 + 133,333 = L.E.1,983,333.

Or = 2,000,000 - (4166.6667 × 4 months) = 2,000,000 - 16,667 = L.E.1,983,333.

* Gain on sale = 2,075,000 - 1,983,333 = L.E.91,667.

(2) Journal entry to record the sale of the Treasury note:

Collected amount = sale price + accrued interest (interest earned from June 30 to September 1, 2021) = 2,075,000 + (2,000,000 $\times \frac{9}{100} \times \frac{2}{12} =$ 30000) = L.E.2,105,000.

2023 Sep. 1	Due from banks- Cairo Bank Discount on the note Treasury note Interest Receivable	2105000 16667	 2000000 30000

	Gain on sale of the note		91667

Problem 6.3:

The National Bank of Egypt purchased a treasury bill for L.E.3,700,000 on March 31, 2021, to mature on January 31, 2022, face amount L.E.4,000,000.

Instructions:

a. Record the purchase of the Treasury bill on March 31, 2021. Payment was made by a cashier's check.

b. Record the interest earned on the treasury bills at the end of April 2021.

c. If the bill was sold on November 30, 2021 for L.E.3,920,000, pass the journal entry to record the sale of the bill.

Problem 6.4:

On January 1, 2021, Cairo Bank purchased the following investments:

1) Treasury bonds, L.E.500,000 face amount, 12% coupon interest, and matures December 31, 2022. Interest due March 31 and September 30. Purchase price, L.E.476,000 plus accrued interest.

2) Treasury bills for L.E.4,720,000 to mature on September 1, 2021, face amount, L.E.5,000,000.

Instructions:

a. Record the purchase of securities on January 1, 2021, payment was made by a cashier's check.

b. Record the interest earned at the end of January, 2021 and the collection of interest on March 31, 2021.

c. Record the sale of the treasury bonds on June 1, 2021 for L.E.482,500 plus the accrued interest.

d. Record the sale of the treasury bills on July 1, 2021 for L.E.4,945,000.

Problem 6.5:

Cairo Bank has the following portfolio of investment securities at October 31, 2021, its last reporting date:

Security	Cost L.E.	Fair Value L.E.
1.Arab Contractors Corp. (10,000 shares)	150,000	146,000
2.Egyptian Corp. (8,000 shares)	200,000	220,000
3.Peace Corp. (6,000 shares)	180,000	178,000

On November 15, 2021, the Arab Contractors shares were sold at a price of L.E.18 per share and 4000 shares of Misr Sugar Co. were purchased for L.E.75 per share.

On December 31, 2021, fair values were: Egyptian Corp. L.E.32, Misr Sugar Co. L.E.92.

Instructions:

a. Prepare the journal entries to record the sale, purchase, and adjusting entries assuming that all securities are classified as trading.

b. Show how would the entries in (***a.***) change if the securities were classified as available for sale.

Problem 6.6:

The National Bank of Egypt undertook the following transactions during 2021:

(A) On January 1, the bank acquired a treasury note of L.E.1,000,000 face amount, 10% coupon interest, mature December 31, 2023. Coupon due June 30 and December 31, purchase price L.E.950,000.

Instructions:

1. Record the purchase of the note.

2. Record the interest earned at the end of January 2021.

3. Record the collection of interest on July 1, 2021. Payment was made directly to the bank's demand account at the Central Bank.

(B) On March 1, the bank purchased a treasury bill for L.E.1,940,000 to mature on May 31, 2021, face amount L.E.2,000,000. The bank sold the bill on May 1, 2021 for L.E.1,970,000.

Instructions:

1. Record the purchase of the Treasury bill. Payment was made by a cashier's check.

2. Record the interest earned on the treasury bills at the end of March 2021.

3. Record the sale of the bills on May 1, 2021.

PART TWO
ACCOUNTING FOR INSURANCE COMPANIES

Introduction:

Banks and insurance companies are considered as the most important financial institutions for any economy. They represent the principal sources of financing and granting credit. This part of the book provides primarily the accounting procedures, practices and financial reporting in the area of insurance companies.

In practice, the general concepts and principles of financial accounting adopted by commercial companies are equally applicable to insurance companies. The differences, if any, of accounting in the field of insurance companies may emerge because the business activities and financial reporting of such sector are highly regulated and controlled and also because the products sold by insurance companies are assessed on estimates of future revenues and costs.

Common Types of Insurance Products:

The organizational structure and the insurance products of such sector are briefly presented as bellow:

(1) Life Insurance Companies: Such companies may sell life insurance policies, annuities, accident and health insurances, and disability income protection.

Life insurance is based on the principle that the past loss experience of a large group is reasonable basis for anticipating or predicting the life expectancy of a new policyholder from the date on which the insurance policy is issued. Similarly, the premiums paid by each of the policyholders are expected to cover the cost of issuing the policy, the expenses of continuing the policy in force, and the liabilities for the benefits promised.

Current benefit costs or claims are financed by the amounts reserved for such liabilities in addition to the current premiums and revenues from investments. Excess funds over required claims are kept for financing unexpected losses, company expansion, and dividends in favour of stockholders or policyholders.

The most common forms of life insurance are:

a) ***Partial life insurance*** policies are prepared for a limited period and are normally renewable until a specified age. In such form of policies, the premium charged cover the risk that related to the insured person life during the policy period in addition to the expenses of issuing and maintaining the policy in force, plus the expected profits or margins for the services provided by the company. Such amounts are discounted for the time value of money received in advance.

b) ***Whole life insurance*** includes all of the elements of term life insurance except the premium is calculated to be paid over life-time of the insured person.

c) ***A mature whole life policy*** is a form of a whole life which requires the payment of cash value as a result of surrender or giving up of the policy.

d) ***Accident and health insurance*** in which the insurance protection that is offered for economic losses due to injury or poor health is classified as accident and health insurance. Such a policy is arranged for a short period of time and is generally renewable on an annual basis. The premiums for such policies are computed by using morbidity or disease tables that estimate the expected claims for individuals or groups of policyholders having common age and health experience.

e) ***Disability income insurance*** which provides income benefits for a period of years or life should the policyholder become disabled.

Disability income protection is often purchased in connection with a wage continuation plan.

f) ***Annuities:*** The common two types of annuities are ***immediate*** and ***deferred***. **Immediate annuity** is usually issued against single premium that provides a monthly or annual benefit over a determined future period or for life. Premiums are calculated similar to those of whole life insurance policy. Life annuity benefits terminates when the policyholder dies. On the other hand, **deferred annuity** is similar to a saving account until converted to a life annuity. Deferred annuity premiums are collected on a periodic basis to accumulate funds that will provide benefits at some time in the future, after a retirement.

(2) Property and Liability Insurance Companies:

In contrast to life insurance, which their coverage is subject to the long-term risks of mortality and investments, property and liability coverage is more subject to the risks of short-term losses.

Property and liability insurance is generally arranged on a year-to-year basis. Property and liability insurance is subject to greeter risk of loss from natural occurrences and accidents in addition to carelessness or negligence by policyholders of insured properties. Such insurance covers a variety of risks such as fire, water damage, theft, personal injury liability, aircraft, marine, lightning, windstorm and tornadoes, earthquakes, collapse of buildings, etc.

(3) Reinsurance: Insurance activity is the process in which an insurance company accepts the risk of losses for people's property insured by the policyholder. Such insurance protects the policyholder from the burden of losses and expenses that he/she should have to bear.

When the insurance company's risk from hazard of loss exceeds its reserves and surplus capacity, it looks for another company to share its risks. Such risk sharing of original insurance contracts is termed as ***"Reinsurance".*** In the light of reinsurance, the originating company remains responsible for the losses incurred but has the right to claim reimbursement from the other companies with whom it has shared the insurance premiums.

According to reinsurance activity, the company that issues the policy is called the *ceding or reinsured company*, and the other company is called the *accepting or reinsurer company.* Reinsurance transactions represent an important part of the operation of any direct arranging company. A reinsurer may specialize in reinsurance or be a direct writing (arranging) company.

In practice, the reinsured company first determines the amount of risk that it will accept and the amount that it will retain. A direct writing company will choose to retain a significant part of the risk because, if the business is profitable, any reinsurance arrangement will require the company to give up or cede part of the profits it would otherwise earn on the business. Nevertheless, the cost of reinsurance can also be considered as a premium paid to avoid exposure to losses that could adversely affect the company's financial condition.

This part of the textbook is intended to discuss some accounting issues regarding accounting for insurance companies, which may be subject to interest by senior students in the faculties of commerce. These issues may be discussed throughout the following chapters, which are mainly devoted to life insurance activities:

Chapter Seven: Recording Life Insurance Transactions.

Chapter Eight: Life Insurance Financial Statements.

CHAPTER SEVEN
RECORDING LIFE INSURANCE TRANSACTIONS

CHAPTER SEVEN

Recording Life Insurance Transactions

7.1 INTRODUCTION:

Similar to business enterprises and in accordance with the Egyptian laws which govern insurance activities; insurance companies are required to maintain some registers for each insurance branch.

For instance, **Policies Register** must include all polices concluded and their details such as policyholder name and address, issuing date and number of the policy, the insurance premium, and so on. Total amounts in this register are journalized periodically in the general journal. **Claims Register** in which all insurance claims are recorded, including all required details. Total amounts of this register are recorded in the general journal.

Mediators and Agents Register which is assigned for recording all data belonging the middlepersons who mediate in conducting insurance transactions. **Agreements and Treaties Register** which includes information about the reinsurance transactions accepted from other companies and reinsurance transactions ceded to other companies.

General Cash Journal is devoted for recording all cash receipts and payments. Also, totals of subsidiary cash registers are recorded periodically in addition to other payments and receipts that do not relate to a specific type of insurance business. **The General Journal**, in which all subsidiary journal totals are recorded periodically in addition to the transactions that do not relate to specific subsidiary journal. **The General Ledger** includes assets, liability, revenues, expenses, and equity accounts. Of course, the financial statements of the life insurance branch are prepared from this book.

7.2 THE INSURANCE PREMIUMS:

Life insurance policy is a contract between the insurance company (the insurer) and a determined person (the insured). On payment of premium, the insurance company is obliged or liable to pay to that person or anyone else known as the beneficiary, at a specific date or on the insured's death date, a certain amount of money.

On the other hand, the consideration paid by the policyholder (the insured person) to the life insurance company is termed the ***'premium'*.** Insurance premiums represent the basic source of revenues to the insurance company.

As discussed previously, the insurance companies are obliged to cede or give up a certain percentage of their premiums to the **Egyptian Reinsurance Company**. Additionally, they can optionally cede another percentage of their premiums to other companies, whether local or foreign companies.

On the same time, the insurance companies often accept reinsurance premiums from other companies. Accordingly, insurance premiums take the following classifications.

7.2.1 Direct premiums:

Direct premiums are premiums which are obtained from the company's direct customers. The company records the following journal entries regarding direct premiums:

a) **When the premiums are accrued, the following journal entry is passed:**

Premiums receivable-life	xxx	
Direct premiums-life (net)		xxx
Issue fees		xxx
Supervision fees		xxx

b) **When the premiums are collected, the following journal entry is recorded:**

Cash	xxx	
Premiums receivable-life		xxx

For example, the amount of direct premiums is L.E.500,000. In addition, issue fees and supervision fees amounted L.E.5,000 and L.E.2,500, respectively. The following journal entries are passed:

Premiums receivable-life	507,500	
Direct premiums-life (net)		500,000
Issue fees		5,000
Supervision fees		2,500
Cash	507,500	
Premiums receivable-life		507,500

7.2.2 Reinsurance premiums accepted:

An insurance company receives reinsurance transactions from other insurance companies. The company will get premiums revenues from such other companies, thus the company is obliged to cover a certain percentage of claims paid by such other companies, which represents an expense for the company. Furthermore, an insurance company must pay its share in the commissions paid by such reinsurance companies that also represent an expense for the company.

Reinsurance process includes three types of reinsurance transactions.

(1) Compulsory (obligatory) reinsurance:
In this type of reinsurance transactions, the insurance company is obligated to reinsure certain percentage of its direct insurance transactions in Egypt to another insurance company

(2) Treaty reinsurance:
According to this type, reinsurance transactions are made between insurance companies on the basis of agreements (treaties) among them. The agreement or treaty is effective for a given period. such contracts provide an arrangement whereby a certain class or type of business written is covered

on an agreed percentage of each outstanding policy.

(3) Facultative (optional) reinsurance:

As its name means, the insurance company is free or has its right to choose the preferable or appropriate kind of risks and the company for reinsurance transactions.

The company records the following journal entries regarding reinsurance premiums accepted:

a) **When the reinsurance premiums accepted are accrued, the following journal entry is passed:**

Egyptian reinsurance company	xxx	
Treaty reinsurance company	xxx	
Facultative reinsurance company	xxx	
Reinsurance premiums accepted-life		xxx

b) **When the reinsurance premiums accepted are collected, the following journal entry is recorded:**

Cash	xxx	
Egyptian reinsurance company		xxx
Treaty reinsurance company		xxx
Facultative reinsurance company		xxx

7.2.3 Reinsurance premiums ceded:

An insurance company cedes insurance transactions to other reinsurance companies. The company will leave premiums revenues to such other companies, thus the company is qualified to receive a certain percentage of claims which have been paid by it from other reinsurance companies, which represents retrievable expenses for the company. Furthermore, other reinsurance companies must pay their share in the commissions paid by the company that also represent a retrievable expense for the company.

The company records the following journal entries regarding reinsurance premiums ceded:

a) **When the reinsurance premiums ceded are accrued, the following journal entry is recorded:**

Reinsurance premiums ceded-life	xxx	
Egyptian reinsurance company		xxx
Treaty reinsurance company		xxx
Facultative reinsurance company		xxx

b) **When reinsurance premiums ceded are paid, the following journal entry is recorded:**

Egyptian reinsurance company	xxx	
Treaty reinsurance company	xxx	
Facultative reinsurance company	xxx	
Cash		xxx

7.3 PRODUCTION COSTS:

The major product for insurance company is the insurance policies. Hence, the production costs include the commission of the producers and agents in addition to their salaries and other expenses incurred in the production department.

Usually, commissions are calculated at a determined percentage of the premiums of the first three years of the policy for life insurance. Journalizing the production commission is done as follows:

(1) **At the time of recording the accrual of direct premiums, the commissions become due and the following journal entry is made:**

Direct production commission	xxx	
Production commission payable		xxx

(2) **When the premiums are collected and recorded, the calculated commissions are**

credited to the producers' and agents' current accounts as follows:

Production commission payable	xxx	
Producers' and Agents' Accounts		xxx

(3) **When the commission is paid, the following journal entry is done:**

Producers' and Agents' Accounts	xxx	
Cash		xxx

7.4 REINSURANCE COMMISSION ON PREMIUMS ACCEPTED:

As the insurance company receives revenues of premiums accepted from other insurance companies, it must pay commission to reinsurance companies on premiums accepted from these companies. In such a situation, the insurance company is regarded as a reinsurance company and the other company is considered the originating company.

The following journal entries are recorded with respect to such commissions:

(1) **When reinsurance commission on premiums accepted from other companies is accrued, the following journal entry is passed:**

Reinsurance commission on premiums accepted-life	xxx	
Egyptian reinsurance company		xxx
Treaty reinsurance company		xxx
Facultative reinsurance company		xxx

(2) **On payment of commission, the following journal entry is prepared:**

Egyptian reinsurance company	xxx	
Treaty reinsurance company	xxx	
Facultative reinsurance company	xxx	
Cash		xxx

7.5 REINSURANCE COMMISSION ON PREMIUMS CEDED:

As the company cedes the premiums revenues to other reinsurance companies, it qualifies and has the right to receive commission from the reinsurance companies on premiums ceded. The following journal entries are recorded:

(1) **When the reinsurance commission on premiums ceded is accrued, the following journal entry is made:**

Egyptian reinsurance company	xxx	
Treaty reinsurance company	xxx	
Facultative reinsurance company	xxx	
Reinsurance commission on premiums ceded-life		xxx

(2) **Upon collection of commission, the following journal entry is done:**

Cash	xxx	
Egyptian reinsurance company		xxx
Treaty reinsurance company		xxx
Facultative reinsurance company		xxx

7.6 INSURANCE CLAIMS:

The most important item of expenditure of the insurance company is insurance claims (compensations or remunerations). On basis of terms the life insurance contracts, claims for insured amounts are due in the following cases:

1. Death of the insured person.

2. Maturity of the policy.

3. Surrender (giving up or liquidation) of the policy.

Also, claims may take other form such as in case of pensions, annuities and prizes that must be granted to policy holders.

In all insurance businesses, claims are considered the most important type of expenditure element incurred by insurance companies. The most common types of insurance claims are:

a) Direct claims that are submitted directly by policyholders to the insurance company.

b) Reinsurance claims on premiums accepted which are submitted by the ceding companies to the insurance company regarding the reinsurance transactions accepted.

c) Reinsurance claims on premiums ceded that are submitted by the insurance company to reinsurance companies with respect to the reinsurance transactions ceded.

Such types of claims are treated as follows:

***1)* Direct Claims:**

All due claims are recorded in claim register. The total amounts of claims are recorded on a periodical basis in the general journal. For example, if the due claims for a given period were as follows (amounts in millions L.E.): 50 by death, 30 by maturity, 10 by surrender, 7 pension and annuities, and 3 in the form of prizes. The following general journal is made:

Claims-life	100	
By death 50		
By maturity 30		
By surrender 10		
Pension & annuities 7		
Prizes 3		
Claims payable-life Or		
Current accounts of insured persons		100
Accrual of claims.		

On paying claims, the insurance company deducts from the claims the amount of uncollected premiums, loans and their interests. For instance, if the following deductions are accrued: 10 millions premiums, 8 millions loans, and 2 millions interests on loans, the journal entry for paying of claims is as below:

Claims payable-life	100	
(or insured persons' accounts)		
Premiums receivable		10
Loans receivable		8
Interest receivable		2
Cash (net amount)		80

2) Reinsurance Claims on Premiums Accepted:

Reinsurance claims on premiums accepted may be recorded by the insurance company using one journal entry at the payment of claims or two journal entries, one when the claims are accrued and the other at payment of claims. Using one journal entry will be as follows:

Reinsurance claims on premiums accepted-life	xxx	
Cash		xxx

3) Reinsurance Claims on Premiums Ceded:

Reinsurance claims on premiums ceded is recorded by the insurance company using two journal entries, one when the claims are accrued and the other on collection of the claims. Accrual of reinsurance claims on premiums ceded is recorded as follows:

Egyptian Reinsurance company	xxx	
Treaty Reinsurance company	xxx	
Facultative Reinsurance company	xxx	
Reinsurance claims on premiums ceded-life		xxx

Collection of reinsurance claims on premiums ceded is recorded as follows:

Cash	xxx	
Egyptian Reinsurance company		xxx
Treaty Reinsurance company		xxx
Facultative Reinsurance company		xxx

7.7 REVENUES FROM INVESTMENTS:

Like other business institutions, insurance companies undertake investments transactions. As a result, revenues yielded from such activity are considered the second most important source of income for the life insurance company after the premiums.

These sources of revenues are in the form of:

* Dividends on equity investments.
* Interest on bonds, loans, and bank deposits.
* Rental revenues of real estates, and
* Other revenues.

Practically, revenues from investments are recorded as usual (accrual and collection). On the other hand, any expense related to investments, such as real estates expenses, is also recorded as usual. Every insurance company prepares an account named ***"Net Income from Investments"*** at year-end. Such account takes the following pro forma account:

XXX Insurance Company
Net Income from Investments (Life Branch)
For the Year Ended Dec. 31, 2021

Real estate expenses: maintenance, taxes, depreciation, etc.	xxx	-Securities revenues	xxx
		-Interest revenues on loans	xxx
		-Real estate revenues	xxx
		-Interest on bank deposits	xxx
Net income from investments	***xxx***	-Revenues on amounts invested against the Reserve Fund for purchasing of Governmental Bonds	xxx
	xxx		xxx

7.8 PROFIT COMMISSION ON REINSURANCE TRANSACTIONS:

In practice, insurance agreements between the insurance company and other companies regarding reinsurance transactions usually include that the ceding company is entitled to receive a particular percentage of the profits achieved by the reinsurance company. Profit commissions include two types as follows:

1- Profit Commission on Transactions of Reinsurance Ceded:

In this type of profit commission, the insurance company cedes part of its insurance transactions to the reinsurance company. Accordingly, profit commission is considered as revenue for the ceding company. The accrual of profit commission on reinsurance ceded is recorded as follows:

Egyptian Reinsurance company	xxx	
Treaty Reinsurance company	xxx	
Facultative Reinsurance company	xxx	
Profit Commission on reinsurance transactions ceded		xxx

Upon collection of profit commission, the following journal entry is made:

Cash	xxx	
Egyptian Reinsurance company		xxx
Treaty Reinsurance company		xxx
Facultative Reinsurance company		xxx

2- Profit Commission on Transactions of Reinsurance Accepted:

In this type of profit commission, the insurance company accepts percentage of insurance transactions from other insurance companies. Accordingly, profit commission is considered as an expense for the accepting company. The accrual of profit commission on reinsurance accepted is recorded as follows:

Profit Commission on reinsurance transactions accepted	xxx	
Egyptian Reinsurance company		xxx
Treaty Reinsurance company		xxx
Facultative Reinsurance company		xxx

On payment of profit commission, the following journal entry is made:

Egyptian Reinsurance company	xxx	
Treaty Reinsurance company	xxx	
Facultative Reinsurance company	xxx	
Cash		xxx

7.9 INTEREST ON RESERVE FUND OF REINSURANCE TRANSACTIONS:

Reinsurance agreements made among insurance companies may involve provision stating that the ceding company has the right to withhold or keep a certain percentage of the premiums ceded to the reinsurance company. Such withheld amounts are called ***"Reserve Fund of Reinsurance transactions"***.

In effect, this reserve is intended to provide a guarantee against the payment of accrued claims. Accordingly, interest at an agreed upon rate is due on the withheld reserve fund. In the real world, the reserve fund of reinsurance transactions withheld from the premiums ceded is taken into account only for the foreign reinsurance companies.

Interest on reserve fund of reinsurance transactions is as follows:

1) Interest expense on reserve fund of reinsurance transactions ceded:

The original insurance company records the following journal entries:

***** At the time of withholding or deducting the reserve fund from the amount of reinsurance premiums ceded and accrued to the foreign companies, the following journal entry is recorded at the payment to the foreign companies:

Foreign Insurance Companies	xxx	
Reserve Fund of Reinsurance Transactions Ceded		xxx
Cash		xxx

***** Accrual of interest on reserve fund:

Interest Expense on Reserve Fund of Reinsurance Transactions Ceded	xxx	
Foreign Insurance Companies		xxx

***** Payment of interest expense on reserve fund:

Foreign Insurance Companies	xxx	
Cash		xxx

2) Interest revenue on reserve fund of reinsurance transactions accepted:

In such case, foreign reinsurance companies withhold the reserve fund. So, the Egyptian company is considered as a reinsurance company in regard to the foreign company. At the collection of the premiums accepted from the foreign companies, the Egyptian reinsurance company records the following journal entry:

Reserve Fund of Reinsurance Transactions Accepted	xxx	
Cash	xxx	
Foreign Insurance Companies		xxx

On accrual of interest revenue on reserve fund of reinsurance transactions accepted, the following journal entry is done:

Foreign Insurance Companies	xxx	
Interest revenue on Reserve Fund of Reinsurance Transactions accepted		xxx

When interest revenue on reserve fund is collected, the following journal entry is passed:

Cash	xxx	
Foreign Insurance Companies		xxx

General Example:

The following transactions are done by Cairo Insurance Company- life insurance branch, during the month of May 2022:

Cairo Insurance Company has an agreement with Alexandria Insurance to reinsure 25% of its life policies with Alexandria Co. The following information is provided:

(1) The net premiums for policies concluded during the month totaled L.E.4,000,000. Issue fees were L.E.20,000 and supervision fees amounted L.E.15,000.

(2) Reinsurance premiums accepted totaled L.E.1,500,000.

(3) Production commission due agents and producers on direct premiums amounted L.E.350,000. Reinsurance commission on premiums ceded to Alexandria Co. totaled L.E.100,000. Reinsurance commission on premiums accepted from ceding companies totaled L.E.140,000.

(4) The net premiums for renewed polices during the month amounted L.E.1,000,000.

(5) Direct premiums collected from the new and renewed polices during the month totaled L.E.4,750,000.

(6) Commission paid to agents and producers during the month totaled L.E.325,000.

(7) Direct claims during the month reached L.E.1,210,000, as follows (L.E.): 600,000 by death, 380,000 by maturity, 80,000 by surrender, 100,000 pension and annuities, and 50,000 prizes.

Reinsurance claims on premiums ceded represents 25% of the direct claims. Reinsurance claims on premiums accepted from ceding companies totaled L.E.410,000, as follows (L.E.): 150,000 by death, 125,000 by maturity, 50,000 by surrender, 60,000 pension and annuities, and 10,000 prizes.

(8) Total claims paid of L.E.1,050,000.

(9) Profit commission on reinsurance transactions accepted during the month amounted L.E.37,500.

(10) Profit commission on reinsurance transactions ceded during the month amounted L.E.32,500.

(11) Interest on reserve fund withheld on reinsurance transactions ceded of L.E.7,000.

(12) Interest on reserve fund withheld by the foreign companies on reinsurance transactions accepted was L.E.6,500.

Instructions:

Prepare journal entries for the above transactions.

Solution

No.	Description	L.E.	L.E.
(1)	Premiums Receivable-life Direct premiums-life (net) Issue fees Supervision fees	4,035,000	 4,000,000 20,000 15,000
	Reinsurance premiums ceded Reinsurance companies 4,000,000 × 25%	1,000,000	 1,000,000
(2)	Reinsurance companies Reinsurance premiums accepted	1,500,000	 1,500,000
(3)	Direct production commission Production commission payables	350,000	 350,000
	Reinsurance companies Reinsurance commission on premiums ceded	100,000	 100,000
	Reinsurance commission on premiums accepted Reinsurance companies	140,000	 140,000
(4)	Premiums receivable-life Direct premiums-life Premiums on renewed polices	1,000,000	 1,000,000
	Reinsurance premiums ceded Reinsurance companies 25% of renewed polices	250,000	 250,000
(5)	Cash Premiums receivable-life	4,750,000	 4,750,000
(6)	Production commission payable Cash	325,000	 325,000
(7)	Direct claims: By death 600,000 By maturity 380,000 By surrender 80,000	1,210,000	

	Pension and annuities 100,000 Prizes 50,000 Claims payable		1,210,000
	Reinsurance companies Reinsurance claims on premiums ceded 25% of direct claims.	302,500	302,500
	Reinsurance claims on premiums accepted: By death 150,000 By maturity 125,000 By surrender 50,000 Pension and annuities 60,000 Prizes 25,000 Reinsurance companies	410,000	410,000
(8)	Claims payable Cash	1,050,000	1,050,000
(9)	Profit commission on reinsurance transactions accepted Reinsurance companies	37,500	37,500
(10)	Reinsurance companies Profit commission on reinsurance transactions ceded	32,500	32,500
(11)	Interest expense on reserve fund of reinsurance transactions ceded Foreign insurance companies	7,000	7,000
(12)	Foreign insurance companies Interest revenue on reserve fund of reinsurance transactions accepted	6,500	6,500

CHAPTER EIGHT
FINAL ACCOUNTS
FOR LIFE INSURANCE BRANCHES

CHAPTER EIGHT

Final Accounts for Life Insurance Branches

8.1 INTRODUCTION:

Like all business enterprises, insurance companies prepare final accounts or financial statements at year end to provide their users with appropriate information needed for decision making process. So, all users of financial statements are assumed that they will require similar classification and valuation processes for reporting the final results of business enterprises.

The regulative authorities of insurance companies obtain their needs of financial data which is prepared according to accounting practices that concentrate on liquidity as a basic measurement of the reporting process. Their objective is to guarantee that adequate funds are provided to pay all obligations of insurance company emerged from its insurance activities.

On the other hand, policyholders are considered one of the users of the financial statements prepared by insurance companies. Of course, they are entitled to obtain financial information required for investigating or evaluating the financial strength of the company that insures their risks. Insurance companies are obliged by law to maintain sufficient reserves for paying policyholders' claims. Such requirement provides policyholders with an appropriate comfort regarding their insurance transactions.

Practically, insurance companies prepare final accounts at the end of the accounting period. According to the Egyptian Insurance Laws and Regulations, insurance companies must provide the Egyptian Insurance Supervisory Authority (الهيئة

المصرية للإشراف علي التأمين) with the following statements and accounts every year:

- **The balance sheet.**
- **Income statement for the company.**
- **A statement or account of revenues and expenses for each insurance department or branch.**
- **Statement of cash flows.**

Insurance activity is considered one of the most important activities of business. Hence, financial reporting of insurance companies is highly regulated. As a result, the financial statements or final accounts of such companies must be prepared in accordance with the forms provided in the executive regulations of the insurance law.

The discussion in this chapter will be interested in the statement or account of revenues and expenses of life insurance, as it will be explained in the following section.

8.2 REVENUES AND EXPENSES ACCOUNT FOR LIFE INSURANCE BRANCH:

Insurance activities cover a variety of insurance departments or branches. Accordingly, there are two stages in determining the results of operations for the insurance company, as follows:

1) A statement or account of revenues and expenses for each insurance department or branch, which is prepared in order to determine the ***surplus*** or ***deficit*** for each branch.

2) An income statement which is prepared for the whole insurance company. All the surpluses (or deficits) of insurance departments or branches are transferred to the company's income statement. The income statement encompasses also the un-appropriated revenues and expenses (general and administrative expenses) on the level of the insurance company as a whole.

The statement or account of revenues and expenses for life insurance branch includes all adjusted revenues and expenses related to this branch of insurance only. It is prepared in accordance with generally accepted accounting principles and prevailing standards in the accounting domain, like all business organizations. However, there are some items, called technical provisions, which require to be specially highlighted, as follows:

1. Reserve Fund:

This account is regarded as one of the obligations or liabilities accounts in the insurance company’s balance sheet. The amount of reserve fund required is evaluated or assessed at the year-end by a statistician (an actuary). Such amount is estimated to meet or match the obligation of the insurance company toward policyholders’ claims in the future.

2. Provision for Outstanding Claims:

Provision for outstanding claims is also estimated at year-end to meet or cover claims occurred during the year and that have been submitted by policyholders, but not yet admitted or approved for payment. These claims represent the unsettled ones. This provision is also created to cover claims for losses incurred before the balance sheet date but submitted to insurance company for settlement after that date.

Adjustments of the Technical Provision Accounts at the Year-end:

On determining the amount of the reserve fund required at the end of the year by the actuary to meet the obligation of the insurance company toward policyholders' claims in the future, and estimating the amount of the provision for outstanding claims to cover the claims that have been submitted to the insurance company during the year but still unsettled yet, the following journal entry is recorded in the general journal:

Revenues and Expenses Account-life branch	xxx	
Reserve Fund Account		xxx
Outstanding Claims Account		xxx

Such journal entry represents an adjusting entry to charge the revenues and expenses account of the amount of reserve fund and the amount of outstanding claims required to meet the obligation of the insurance company toward policyholders as an expense.

At the start of the following year, the balances of the reserve fund account and the outstanding claims account are closed to the revenues and expenses account of that year by preparing the following journal entry:

Reserve Fund Account	xxx	
Outstanding Claims Account	xxx	
Revenues and Expenses Account-life branch		xxx

Comprehensive Illustration (1):

The following balances appear in the books of Misr Insurance Company at December 31, 2021 for life insurance branch (amounts in L.E.):

Description	L.E.
Direct insurance premiums	1,200,000
Direct claims	440,000
Agents and producers' wages	32,000
Reinsurance premiums ceded	300,000
Reinsurance premiums accepted	500,000
Reinsurance claims on premiums ceded	110,000
Reinsurance claims on premiums accepted	140,000
Direct commission to producers	120,000
Reinsurance commission on premiums ceded	36,000
Reinsurance commission on premiums accepted	50,000
Production expenses	84,000
Interest on reserve fund withheld on reinsurance transactions ceded	2,400
Interest on reserve fund withheld by foreign companies on reinsurance transactions accepted	2,200
Interest revenue on loans	27,000
Interest revenue on bank deposits	15,000
Real estate rental revenues	32,000
Real estate expenses	15,600
Revenues on amounts invested against the reserve fund for the purchase of government bonds	9,000
Reserve fund	360,000
Provision for outstanding claims	90,000
Revenues from investment securities	101,000

Other revenues	77,400
Other expenses	119,400
Computer center expenses	15,200
Loss on sale of securities	71,800

Other data:

a. Reserve fund as on December 31, 2021 is assessed to be of L.E.570,000.

b. Outstanding claims as on December 31, 2021 amounted L.E.150,000.

c. Depreciation expenses of fixed assets used in life insurance branch for the year totaled L.E.9,600.

Instructions:

1) Prepare the Net Income from Investments Account.

2) Prepare the Revenues and Expenses Account of life insurance branch for the year ended December 31, 2021.

3) Prepare the Statement of Revenues and Expenses of life insurance branch for the year ended December 31, 2021.

Solution

1) Net Income from Investments Account

Real estate expenses	15,600	Revenues from securities	101,000
Loss on sale of securities	71,800	Interest revenues on loans	27,000
		Real estate rental revenues	32,000
		Interest revenue on bank deposits	15,000
Net income from investments	***96,600***	Revenue on amounts invested against reserve fund for purchasing government bonds	9,000
	184,000		**194,000**

Misr Insurance Company

2) Revenues and Expenses Account (Life Branch)

For the year ended December 31, 1021

Direct claims	440000		<u>Technical provisions</u>		
+ Reinsurance accepted claims	140000		Beg. of the year:		
Total	*580000*		Reserve fund	360000	
- Reinsurance ceded claims	(110000)		Outstanding claims	90000	450000
Net claims		*470000*	Direct premiums	1200000	
Direct commission	120000		+ Reinsurance premiums accepted	500000	
+ Reinsurance accepted commission	50000		*Total*	*1700000*	
Total	*170000*		- Reinsurance premiums ceded	(300000)	
- Reinsurance ceded commission	(36000)		*Net premiums*		*1400000*

Net commission		*134000*	Net income from investments		96600
Production expenses		84000			
Agents & producers wages		32000	Interest revenue on reserve fund of reinsurance accepted		2200
Computer center Exp.		15200	Other revenues		77400
Interest expense on reserve fund of reinsurance ceded		2400			
Depreciation expenses		9600			
Other expenses		119400			
Technical provisions:					
End of the year:					
Reserve fund	570000				
Outstanding claims	150000	720000			
Surplus		***439600***			
		2026200			**2026200**

Misr Insurance Company
3) Statement of Revenues and Expenses (Life Branch)
For the year ended December 31, 1021

Description	**L.E.**	**L.E.**
Revenues:		
Direct premiums	1200000	
+ Reinsurance premiums accepted	500000	
Total premiums	1700000	
- Reinsurance premiums ceded	(300000)	
Net premiums		1400000
Change in reserve funds:		
Reserve fund at the beginning of the year	360000	
Reserve fund at the end of the year	(570000)	(210000)
Reinsurance commission on premiums ceded		36000
Net income from investments		96600
Interest revenue on reserve fund of reinsurance accepted		2200
Other revenues		77400

Total revenues		***1402200***
Expenses:		
Direct claims	440000	
+ Reinsurance accepted claims	140000	
Total claims	*580000*	
- Reinsurance ceded claims	(110000)	
Net claims		*470000*
Change in outstanding claims:		
Outstanding claims at the end of the year	150000	
Outstanding claims at the beginning of the year	(90000)	60000
Direct commission	120000	
Reinsurance commission on premiums accepted	50000	
Total commission expenses		*170000*
Production expenses		84000
Agents and producers' wages		32000
Computer center expenses		15200
Interest expense of reserve fund of reinsurance transactions ceded		2400
Depreciation expenses		9600
Other expenses		119400
Total expenses		***962600***
Surplus (deficit) of life insurance activities		***439600***

Comprehensive Illustration (2):

The following balances appear in the books of National Insurance Company at December 31, 2021 for life insurance branch (amounts in L.E.):

Description	L.E.
Direct insurance premiums	800,000
Direct claims	320,000
Agents and producers' wages	37,000

Direct commission to producers	104,000
Reinsurance premiums ceded	208,000
Reinsurance claims on premiums ceded	96,000
Reinsurance premiums accepted	344,000
Reinsurance claims on premiums accepted	120,000
Reinsurance commission on premiums ceded	28,000
Reinsurance commission on premiums accepted	41,600
Interest on reserve fund withheld on reinsurance transactions ceded	4,400
Interest income on loans	20,400
Interest income on bank deposits	11,000
Real estate rental revenues	28,800
Real estate maintenance expenses	8,600
Revenues from investment securities	104,000
Other revenues	71,000
Gain on sale of securities	12,800
Reserve fund	304,000
Provision for outstanding claims	77,200

Other Information:

1. Reserve fund as on December 31, 2021 is assessed to be of L.E.586,000.
2. Outstanding claims as on December 31, 2021 amounted L.E.130,000.
3. Depreciation expenses of fixed assets used in life insurance branch for the year totaled L.E.10,400.

Instructions:

a. Prepare the Net Income from Investments Account.

b. Prepare the Revenues and Expenses Account of life insurance branch for the year ended December 31, 2021.

c. Prepare the Statement of Revenues and Expenses of life insurance branch for the year ended December 31, 2021.

d. Prepare the closing entry at the beginning of January 2021 and the adjusting entry at the end of December 2021, for the technical reserves.

Solution

a. Net Income from Investments Account

Real estate maintenance expenses	8,600	Interest income on loans	20,400
		Interest income on bank deposits	11,000
		Real estate revenues	28,800
		Revenues from investment securities	104,000
Net income from investments	***168,400***	Gain on sale of securities	12,800
	177,000		**177,000**

National Insurance Company

b. Revenues and Expenses Account (Life Branch)

For the year ended December 31, 1021

Direct claims	320000		Technical provisions		
+ Reinsurance accepted claims	120000		Beg. of the year:		
Total	*440000*		Reserve fund	304000	
- Reinsurance ceded claims	(96000)		Outstanding claims	77200	381200
Net claims		*344000*	Direct premiums	800000	
Direct commission	104000		+ Reinsurance premiums accepted	344000	
+ Reinsurance accepted commission	41600		*Total*	*1144000*	
Total	*145600*		- Reinsurance premiums ceded	(208000)	
- Reinsurance ceded commission	(28000)		*Net premiums*		*936000*
Net commission		*117600*	Net income from investments		168400
Agents & producers wages		37000	Other revenues		71000
Interest expense on reserve fund of reinsurance ceded		4400			
Depreciation expenses		10400			
Technical provisions:					
End of the year:					
Reserve fund	586000				
Outstanding claims	130000	716000			
Surplus		***327200***			
		1556600			**1556600**

National Insurance Company
c. Statement of Revenues and Expenses (Life Branch)
For the year ended December 31, 1021

Description	L.E.	L.E.
Revenues:		
Direct premiums	800000	
+ Reinsurance premiums accepted	344000	
Total premiums	1144000	
- Reinsurance premiums ceded	(208000)	
Net premiums		936000
Change in reserve funds:		
Reserve fund at the beginning of the year	304000	
Reserve fund at the end of the year	(586000)	(282000)
Reinsurance commission on premiums ceded		28000
Net income from investments		168400
Other revenues		71000
Total revenues		***921400***
Expenses:		
Direct claims	320000	
+ Reinsurance accepted claims	120000	
Total claims	*440000*	
- Reinsurance ceded claims	(96000)	
Net claims		*344000*
Change in outstanding claims:		
Outstanding claims at the end of the year	130000	
Outstanding claims at the beginning of the year	(77200)	52800
Direct commission	104000	
Reinsurance commission on premiums accepted	41600	
Total commission expenses		*145600*
Agents and producers' wages		37000
Interest expense of reserve fund of reinsurance transactions ceded		4400
Depreciation expenses		10400

Total expenses		***594200***
Surplus (deficit) of life insurance activities		***327200***

d. Closing and Adjusting Journal Entries:

Description	L.E.	L.E.
Reserve Fund Account Provision for Outstanding Claims Account Revenues and Expenses Account To close the old balances of reserve fund and provision for outstanding claims accounts (Jan. 1, 2021).	304000 77200	 381200
Revenues and Expenses Account Reserve Fund account Provision for Outstanding Claims Account To charge the revenues and expenses account for the amount of reserve fund and provision for outstanding claims estimated at the end of the year (Dec. 31, 2021).	716000	 586000 130000

8.3 FINANCIAL STATEMENTS AT THE LEVEL OF INSURANCE COMPANY AS A WHOLE:

Like any business organization, insurance company prepares its financial statements, such as income statement which portrays the operating result for all insurance activities of the company as a whole. Also, insurance company prepares balance sheet that shows the financial position of the company at a given date, usually at the end of every financial period.

The Balance Sheet:

Like any balance sheet for a given business, the balance sheet of insurance company reports the assets, liabilities, and stockholders' equity of a business enterprise at a specific date. The balance sheet provides basic information for computing rates of returns and evaluating the capital structure of the company.

The regulative authorities of insurance activities require financial data from insurance companies that is prepared on a set of accounting practices that ascertain or emphasize liquidity as the primary measurement of the reporting process. The final objective of such requirement is to ascertain that there are sufficient funds to meet the insurance and other liabilities incurred by insurance companies from the insurance activities that they practice.

On the other hand, the policyholders need to receive financial information required to investigate the financial strength of the company which insures their risks. They take comfort in knowing that the insurance company is obliged by the law to maintain adequate reserves for the payment of policyholders' claims. Policyholders' interests in financial statements are assumed to be satisfied by adherence with statutory accounting practices.

The Income Statement:

The income statement of the insurance company represents the second stage in the process of determining the results of operations for an insurance company. In the first or preliminary stage, insurance company prepares a statement of revenues and expenses for each insurance branch, such as life, marine, fire, accidents, etc.

In the second or final stage, insurance company prepares an income statement for the company as a whole. Accordingly, the result of each revenues and expenses statement for the different branches of insurance activity (whether surplus or deficit) is transferred to the company’s income statement. Also, the un-appropriated (general) revenues and un-appropriated expenses of the company are transferred to this income statement. The following is a pro forma or model of an income statement of an insurance company:

CAIRO INSURANCE COMPANY
Income Statement
For the year ended December 31, 2021

Description	**2021**	**2020**
Surplus (deficit) of insurance activities:	L.E.	L.E.
*Life insurance	xxx	xxx
*Fire insurance	xxx	xxx
*Accidents and liability insurance	xxx	xxx
Total	*xxx*	*xxx*
*Net income from un-appropriated investments	xxx	xxx
*Other revenues	xxx	xxx
Total revenues	*xxx*	*xxx*
*Depreciation of un-appropriated fixed assets	xxx	xxx
*Other provisions or allowances	xxx	xxx
*Miscellaneous expenses	xxx	xxx
Total expenses	*xxx*	*xxx*
***Net income (loss) before extraordinary items**	**xxx**	**xxx**
*Profit (loss) from extraordinary items	xxx	xxx
***Net income before income taxes**	**xxx**	**xxx**
*Income taxes for the year	xxx	xxx
Net income (loss) after income taxes	***xxx***	***xxx***
Earnings per common share	xx	xx

<u>Comprehensive Illustration (3):</u>

The following balances were obtained from the accounting records of Cairo Insurance Company at December 31, 2021 for life insurance branch (amounts in L.E.):

Description	L.E.
Direct insurance premiums	1,400,000
Reinsurance premiums accepted	240,000
Reinsurance premiums ceded	380,000
Direct commission to producers	140,000
Reinsurance commission on premiums accepted	24,000
Reinsurance commission on premiums ceded	38,000
Production costs	96,000
Net income from investments	592,000
Other revenues	422,000
Direct claims	858,000
Reinsurance claims on premiums accepted	168,000
Reinsurance claims on premiums ceded	226,000
General and administrative expenses	426,000
Depreciation expenses	26,000
Agents and producers' salaries	78,000
Reserve fund	570,000
Provision for outstanding claims	266,000

Other Information:

1. Reserve fund as on December 31, 2021 is estimated to be of L.E.550,000.

2. Outstanding claims as on December 31, 2021 totaled L.E.284,000.

3. The following are un-appropriated revenues and expenses (L.E.):

-Depreciation of fixed assets 35,000

-Interest expense	79,000
-Net income from investments	439,000
-Loss from sale of securities	57,000
-Miscellaneous revenues	354,000
-Interest revenue	178,000
-General and administrative expenses	780,000
-Other expenses	82,000

4. Surplus (deficit) of other insurance branches:

*Fire	866,000
*Accident and liability	(222,000)
*Transportation	234,000
*Marine and aviation	(199,000)
*Motor Vehicle	122,000

Instructions:

a. Prepare the Revenues and Expenses Account of life insurance branch for the year ended December 31, 2021.

b. Prepare the Statement of Revenues and Expenses of life insurance branch for the year ended December 31, 2021.

c. Prepare an income statement for the year ended December 31, 2021.

Solution

Cairo Insurance Company

a. Revenues and Expenses Account (Life Branch)

For the year ended December 31, 1021

Direct claims	858000		Technical provisions		
+ Reinsurance accepted claims	168000		Beg. of the year:		
Total	*1026000*		Reserve fund	570000	
- Reinsurance ceded claims	(226000)		Outstanding claims	266000	836000
Net claims		*800000*	Direct premiums	1400000	
Direct commission	140000		+ Reinsurance premiums accepted	240000	
+ Reinsurance accepted commission	24000		*Total*	*1640000*	
Total	*164000*		- Reinsurance premiums ceded	(380000)	
- Reinsurance ceded commission	(38000)		*Net premiums*		*1260000*
Net commission		*126000*	Net income from investments		592000
Production costs		96000			
Agents & producers salaries		78000	Other revenues		422000
Depreciation expenses		26000			
General & Adm. Exp.		426000			
Technical provisions:					
End of the year:					
Reserve fund	550000				
Outstanding claims	284000	834000			
Surplus		***724000***			
		3110000			**3110000**

Cairo Insurance Company

b. Statement of Revenues and Expenses (Life Branch)

For the year Ended December 31, 1021

Description	L.E.	L.E.
Revenues:		
Direct premiums	1400000	
+ Reinsurance premiums accepted	240000	
Total premiums	1640000	
- Reinsurance premiums ceded	(380000)	
Net premiums		1260000
Change in reserve funds:		
Reserve fund at the beginning of the year	570000	
Reserve fund at the end of the year	(550000)	20000
Reinsurance commission on premiums ceded		38000
Net income from investments		592000
Other revenues		422000
Total revenues		***2332000***
Expenses:		
Direct claims	858000	
+ Reinsurance accepted claims	168000	
Total claims	*1026000*	
- Reinsurance ceded claims	(226000)	
Net claims		*800000*
Change in outstanding claims:		
Outstanding claims at the end of the year	284000	
Outstanding claims at the beginning of the year	(26600)	18000
Direct commission	140000	
Reinsurance commission on premiums accepted	24000	
Total commission expenses		*164000*
Production costs		96000
Agents and producers' salaries		78000
Depreciation expenses		26000
General & administrative expenses		426000

Total expenses		***1608000***
Surplus (deficit) of life insurance activities		***724000***

Cairo Insurance Company
c. Income Statement
For the year ended December 31, 1021

Description	L.E.	L.E.
Surplus (deficit) of insurance activities:		
-Life insurance	724000	
-Fire insurance	866000	
-Accident and liability insurance	(222000)	
-Transportation insurance	234000	
-Marine and aviation insurance	(199000)	
-Motor vehicle insurance	122000	
Total		*1525000*
-Net income from un-appropriated investments (439000-57000)		382000
-Miscellaneous revenues		354000
-Interest revenues		178000
Total revenues		***2439000***
-Depreciation of fixed assets	35000	
-Interest expense	79000	
-Other expenses	82000	
-General and administrative expenses	780000	
Total expenses		***976000***
****Net income (loss)***		***1463000***

8.4 Problems:

Problem 8.1:

The following transactions are performed by National Insurance Company during the month of June 2022, regarding life insurance branch:

1. The national Insurance Company signed an agreement with Suez Insurance Company to reinsure 25% of its life polices with Suez.

2. The net premiums for polices concluded during the month amounted L.E.1,600,000, issue fees, L.E.8,000, and supervision fees, L.E.50,000.

3. Reinsurance premiums accepted totaled L.E.600,000.

4. Production commissions due to agents and producers on direct premiums amounted L.E.140,000. Reinsurance commissions on premiums accepted from ceding companies amounted L.E.56,000.

5. The net premiums for renewed polices during the month was L.E.400,000.

6. Direct premiums collected from the new and renewed polices during the month were L.E.1,900,000.

7. Commissions paid to agents and producers during the month totaled L.E.132,000.

8. Direct claims during the month were L.E.484,000.

9. Reinsurance claims on premiums ceded represents 25% of the direct claims and the reinsurance claims on premiums accepted from ceding companies totaled L.E.164,000.

10. Total claims paid L.E.420,000.

11. Profit commission on reinsurance transactions accepted during the month was L.E.15,200.

12. Profit commission on reinsurance transactions ceded during the month was L.E.12,800.

13. Interest on reserve fund withheld on reinsurance transactions ceded was L.E.2,800.

Instructions:

Prepare the general journal entries for the above transactions.

Problem 8.2:

The following balances are extracted from the accounting records of Alexandria Insurance Company for life insurance branch, for the year ended December 31, 2022:

Description	L.E.
Direct insurance premiums	1,000,000
Direct claims	400,000
Agents and producers' wages	44,000
Direct commission to producers	130,000
Reinsurance premiums ceded	260,000
Reinsurance premiums accepted	430,000
Reinsurance claims on premiums ceded	120,000
Reinsurance claims on premiums accepted	150,000
Reinsurance commission on premiums ceded	40,000
Reinsurance commission on premiums accepted	52,000

Interest on reserve fund withheld on reinsurance transactions ceded	5,200
Interest on reserve fund withheld by foreign companies on reinsurance transactions accepted	3,000
Interest income on loans	28,000
Interest income on bank deposits	13,600
Real estate rental revenues	31,200
Real estate maintenance expenses	10,800
Reserve fund	380,000
Provision for outstanding claims	96,000
Revenues from investment securities	107,000
Other revenues	88,800
Other expenses	55,800
Gain on sale of securities	15,600

Additional data:

a. Reserve fund as on December 31, 2022 is assessed to be of L.E.732,000.

b. Outstanding claims as on December 31, 2022 amounted L.E.160,000.

c. Depreciation expenses of fixed assets used in life insurance branch for the year totaled L.E.13,000.

Instructions:

1. Prepare the Net Income from Investments Account.

2. Prepare the Revenues and Expenses Account of life insurance branch for the year ended December 31, 2022.

3. Prepare the Statement of Revenues and Expenses of life insurance branch for the year ended December 31, 2022.

Problem 8.3:

The following balances were obtained from the accounting records of Qena Insurance Company at December 31, 2022 for life insurance branch (amounts in L.E.):

Description	L.E.
Direct insurance premiums accrued (including fees of L.E.96,000)	696,000
Reinsurance premiums accepted	80,000
Reinsurance premiums ceded	150,000
Claims (accrued)	260,000
Reinsurance claims on premiums accepted	30,000
Reinsurance claims on premiums ceded	50,000
Direct commission to producers and agents	70,000

Reinsurance commission on premiums accepted	12,000
Reinsurance commission on premiums ceded	18,000
Miscellaneous expenses	42,000
General and administrative expenses	150,000
Net income from investments	570,000
Gain on sale of investments	66,000
Managers incentives	58,000
Miscellaneous revenues	75,000
Reserve fund	1,000,000

Other Information:

1. Reserve fund as on December 31, 2022 is estimated to be of L.E.1,260,000.
2. The following are un-appropriated revenues and expenses (L.E.):

-Depreciation of fixed assets	57,000
-Income tax expense	105,000
-Net income from investments	177,000
-Incentives to top management	390,000
-Miscellaneous expenses	55,800
-Interest revenue on loans	434,000
-General and administrative expenses	224,000

Instructions:

(1) Prepare the Revenues and Expenses Account of life insurance branch for the year ended December 31, 2022.

(2) Prepare the Statement of Revenues and Expenses of life insurance branch for the year ended December 31, 2022.

(3) Prepare the income statement of the company for the year ended December 31, 2022.

Problem 8.4:

The following are the transactions performed by National Insurance Company (Life Insurance Branch) during the year ended December 31, 2022, noting that the company has an agreement with Tanta insurance company to reinsure 25% of its life policies with it.

1- The net premiums for policies concluded during the month totaled L.E.1,000,000.

2- Reinsurance premiums accepted totaled L.E.400,000.

3- Production commission due to agents and producers on direct premiums totaled 10%. Reinsurance commission on premiums accepted totaled 10%. Reinsurance commission on premiums ceded totaled 10%.

4- The net premiums for renewed policies during the year totaled L.E.200,000.

5- Direct premiums collected from the new and renewed policies during the year totaled L.E.900,000.

6- Commission paid to agents and producers during the year totaled 80% of the due commission.

7- Direct claims during the year totaled L.E.260,000

8- Reinsurance claims on premiums ceded represents 25% of the direct claims and the reinsurance claims on premiums accepted from ceding companies totaled L.E.90,000.

9- Total claims paid L.E.250,000.

10- Reinsurance commission on premiums ceded L.E.30,000 and reinsurance commission on premiums accepted L.E.20,000.

11- Interest on reserve fund withheld on reinsurance transactions ceded L.E.3,000 and accepted L.E.5,000.

Instructions:

(1) Prepare the general journal entries for the above transactions.

(2) Using the information provided in the above transactions and the additional information provided below, prepare the Revenues and Expenses Account for the year ended December 31, 2022, life insurance branch.

Additional information:

Agents and producers wages L.E.25,000, Production expenses L.E.45,000 Interest income on loans L.E.20,000, Interest income on bank deposits L.E.10,000, Real estate rental revenue L.E.30,000, Real estate expenses L.E.8,000, Revenue from investment securities L.E.55,000, Other revenues L.E.45,000, Other expenses L.E.60,000, Loss on sale of securities L.E.40,000, Computer center expenses L.E.12,000, Reserve Fund (beginning of year L.E.300,000 and ending of year L.E.250,000), Provision for outstanding claims (beginning of year L.E.50,000 and ending of year L.E.100,000), and Depreciation expenses of fixed assets for the year L.E.10,000.

Problem 8.5:

The following are accounting balances from the books of Alexandria Insurance Company at

December 31, 2022 for the Life Insurance Branch (L.E.):

-Direct insurance premiums (600,000)

-Direct Claims (220,000)

-Reserve fund (200,000)

-Provision for outstanding claims (55,000)

-Producers' wages and production expenses (65,600)

-Direct commission to producers (10%)

-Reinsurance premiums accepted (250,000)

-Reinsurance premiums ceded (25%)

-Reinsurance commission on premiums accepted (10%)

-Reinsurance claims on premiums accepted (70,000)

-Reinsurance claims on premiums ceded (55,000)

-Reinsurance commission on premiums ceded (12%)

-Interest on reserve fund withheld on reinsurance ceded (1,200)

-Interest on reserve fund withheld on reinsurance accepted (1,100)

-Interest income on loans (13,500)

-Interest income on bank deposits (7,500)

-Real estate rental revenue (16,200)

-Real estate expenses (7,800)

-Revenues from investment securities (55,000)

-Other revenues (38,000)

-Other expenses (59,000)

-Loss on sale of securities (35,900)

Additional information:

Provisions at year end (L.E.): Reserve fund (285,000), Depreciation expense of fixed assets for the year (4,800), outstanding claims (75,000).

Instructions:

1- Determine the net Surplus (Deficit) of life insurance branch for the year ended December 31, 2022.

2- Prepare the Net Income from Investment Account for that year.

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TABLE OF CONTENTS