South Valley University
Faculty of Commerce
Accounting Department
©©©©©©©©©©©©©©©©

Lectures in

ACCOUNTING STUDIES IN ENGLISH

Prepared by

Dr. Ali Abdelkarim Rawy

Ph.D. in Accounting
Hull University-England

2023-2024

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

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

Preface

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

This textbook has been written to provide student with a very comprehensive introduction to accounting studies in English. In this textbook, many students will get all that they require to have a good idea about financial accounting and its applications in all forms of business organizations. Therefore, this textbook is divided into a variety of chapters intended to put the students, who study business, on the right way towards understanding financial accounting concerning sole proprietorships, partnerships, and corporations. Chapter one of this textbook covers the nature of accounting practice in different forms of business organizations. Chapter two introduces to the adjusting entries. Chapter three is entitled financial statement analysis and the statement of cash flows. Chapter four provides student a variety of tests which assess student's ability to solve practical problems.

CHAPTER ONE

FORMS OF BUSINESS ORGANIZATIONS

CHAPTER ONE

FORMS OF BUSINESS ORGANIZATIONS

1.1 Introduction:

Business organizations vary greatly in the nature of their operations, their needs for capital, the number of owners, and the legal form of the business organization.

In Egypt, like most of countries, there are three main forms of business organizations. They are sole proprietorship (traders), partnerships, and corporations. Accordingly, the risks incurred or borne both by equity investors and by creditors vary greatly depending upon the form of an organization. Practically, generally accepted accounting principles (GAAP) are adopted or applied to the financial statements of all three types of organizations. On the other hand, although these organizations use the same accounting principles,

the information contained in their financial statements should be interpreted differently.

1.2 Sole Proprietorships:

A ***sole proprietorship*** is an unincorporated business owned by one person. In practice, sole proprietorships are considered the most common form of business organizations because they are so easy to form and start. Often the owner also acts as the manager of the business.

Forming or creating a sole proprietorship requires no complicated authorization from any governmental authority or agency. In most cases, the business needs little or no investment of capital. For instance, youngster with certificate in law and consultant services has a *sole proprietorship.* On a large scale, sole proprietorships are widely used for firms, service business, small retail stores, restaurants, and professional practices, such as medicine, law, and public accounting.

From an accounting point of view, a sole proprietorship is regarded as a business entity *separate from the other affairs of its owner*. From a legal point of view, nevertheless, the business and its owner are not considered as separate entities. Accordingly, ***the owner is personally liable*** for the debts of the business. If the business becomes ***insolvent*** (معسر أو غير قادر علي السداد), creditors can force or oblige the owner to sell his or her personal assets to pay the business debts.

A sole proprietorship or an individual firm provides a good model for demonstrating accounting principles because it is the simplest form of business organization. However, in reality and in the business world, it will be hardly to see financial statements for these organizations. Most, if not all, sole proprietorships are relatively small business with few financial reporting obligations. Their needs for accounting information consist

basically of data used in daily business operations- the balance (الرصيد) in the firm's bank account and the amounts receivable and payable. In essence, most sole proprietorships do not prepare formal financial statements unless some special need emerges.

1.2.1 The Concept of the "Separate" Business Entity:

Generally accepted accounting principles require that a set of financial statements describe the affairs of a specific business entity. This concept is termed the ***Entity Principle or Concept*** (مبدأ أو مفهوم الشخصية المعنوية المستقلة-وحدة الأعمال). A ***business entity*** is an economic unit that engages in determined business activities.

For accounting purposes, every business organization- including sole proprietorship- is treated as an entity separate from the other activities of its owner. Such treatment enables

everyone to measure the performance of the business separately from the other financial affairs of its owners. On the other hand, and in the eyes of the law, a sole proprietorship is ***not*** an entity ***separate*** from its owner. According to the law, the proprietor is the ***"entity"***, and a sole proprietorship merely represents some of this individual's financial activities.

The fact that a sole proprietorship and its owner legally are ***one and the same*** explains many of the distinctive characteristics of this form of organization.

1.2.2 Characteristics of a Sole Proprietorship:

The basic characteristics of sole proprietorships can be summarized as follows:

1. **Ease of formation.** As a result of the ease of formation, these forms of organizations are very common.

2. **Business assets actually belong to the proprietor.** Because the business is ***not a legal entity***, it can not own property. The *business assets* actually belong to the ***proprietor***, not to the business. Therefore, the proprietor may transfer assets in or out of the business.
3. **The business pays no income taxes.** In Egypt, the tax laws see net income of the sole proprietorship as an income of natural person. In other words, tax laws do not view a sole proprietorship as separate from the other financial activities of its owner. Accordingly, the proprietorship ***does not*** file or prepare an income tax return or pay income taxes. Instead, the ***proprietor or the owner*** must include the net income of the business in his or her **personal** income tax return (tax declaration).
4. **The business pays no *salary* to the proprietor.** The owner of a sole proprietorship is not

"working for salary". Instead, the owner's compensation consists of the entire net income (or net loss) of the business. Therefore, any money withdrawn from the business by its owner should be recorded by debiting the owner's ***Drawing*** Account, ***not*** recognized as salaries expense.

5. **The owner is personally liable for the debts of the business.** This concept is termed ***"Unlimited Personal Liability"*** and is very important to be treated as just one item in the characteristics. The owner of a sole proprietorship is ***personally responsible*** for all of the business' debts. Accordingly, unlimited personal liability is considered the greatest ***disadvantage*** to this form of organization. Other forms of business organization all provide owners with some means of limiting their

personal liability for business debts. But not the sole proprietorship.

1.2.3 Accounting Practice in Sole Proprietorships:

In the balance sheet of a sole proprietorship, total owner's equity is represented by the balance in the owner's ***Capital*** Account. Investments of assets by the owner are recorded by crediting this account, as follows:

Cash or any other asset a/c………	xxx	
Capital a/c……………………..		xxx

On the other hand, withdrawals of assets by the owner are recorded by debiting the owner's ***Drawing*** Account, as follows:

Drawing a/c………………………	xxx	
Cash, or any other asset a/c……		xxx

At the end of the accounting period, the drawing account, and also the Income Summary Account, is closed into the owner's capital account, as follows:

Capital a/c………………………..	xxx	
Drawing a/c……………………		xxx

A sole proprietorship is owned by only one person, therefore when reporting ownership equity in the balance sheet, the owner's equity (حق الملكية) section includes only on final item that is the equity of the owner. This can be illustrated as follows:

ABC ENTERPRISE
Balance Sheet as on December 31, 2020

Assets **Liabilities & Owner's Equity**

		Owner's Equity WXY, Capital	L.E. 450,000

The only financial reporting obligation of much sole proprietorship is the information that must be included in the owner's personal income tax return.

For this reason, much sole proprietorships base their accounting procedures on ***Income Tax Rules***, rather than generally accepted accounting principles. Also, the financial information that they develop usually is ***not*** audited.

1.2.4 Evaluating the Financial Statements of Sole Proprietorships:

(1) The Adequacy of Net Income:

Logically, sole proprietorships do not recognize any salary expense in relation to the owner or any interest expense on the capital that the owner has invested in his or her business. Therefore, if the business is to be considered ***successful***, its net income should at least provide the owner with reasonable compensation for any personal services and equity capital which the owner has provided to the business. Furthermore, the net income of a sole proprietorship should be adequate to compensate

the owner for taking or bearing reasonable risks. In practice, many small businesses do not succeed.

The owner of a sole proprietorship has ***unlimited personal liability*** for the debts of the business. Thus, if a sole proprietorship bears or sustains large losses, the owner can lose *much more* than the amount oh his or her equity investment. Accordingly, the net income of sole proprietorship should be sufficient or adequate to compensate the owner for these factors:

a. Personal services rendered or provided to the business.

b. Capital invested, and

c. The degree of financial risk which the owner is taking.

(2) Evaluating Solvency (المقدرة علي السداد):

As it will be discussed later, for a business organized as a *corporation*, creditors often base

their lending decisions upon the relationships between assets and liabilities in the corporation's balance sheet. However, if the business is organized as a sole proprietorship, the balance sheet will be less useful to creditors. As it was explained, the assets listed in the balance sheet are owned by the ***owner or proprietor***, not by the business. The owner can transfer assets in and out of the business **at will**. In addition, it is the ***proprietor*** who is financially responsible for the firm's debts. Therefore, the ability of a sole proprietorship to pay its debts depends on ***solvency of the owner***, not on the relationships among the assets and liabilities appearing in the firm's balance sheet.

Actually, the ***solvency*** of a sole proprietorship may be affected by many things which ***do not appear*** in the financial statements of the business. The owner may have great personal wealth or

overwhelming (غامرة أو ساحقة) personal debts. To sum up, creditors of a sole proprietorship should look past the balance sheet of the business. The real issue is the debt-paying ability of the ***owner.*** Therefore, creditors of the business may ask the ***owner*** to supply ***personal*** financial information. They also may investigate the owner's credit history.

1.3 Partnerships:

A ***Partnership*** can be defined as an unincorporated (مشروع أو شركة غير محدودة) business owned by two or more ***partners***. A ***partner*** may be either an individual person or a corporation. A partnership often is referred to as a ***firm*** (company). Partnerships are the *least* common form of business organization, probably because they often result in ***too many bosses.*** Nevertheless, they are widely used for professional practices (المشروعات أو الممارسات المهنية), such as medicine, law, and public accounting. They also are used for many small businesses, especially those which are family-owned.

For accounting purposes, like sole proprietorship, a partnership is viewed as an entity separate from the other activities of its owners. But, under the point of view of the law, the partnership is ***"not separate"*** from its owners. In

addition, the law regards the partners as ***personally*** and ***jointly*** responsible for the activities of the business.

As such, the assets of a partnership ***do not*** belong to the business; they belong ***jointly*** to all of the partners. Unless special provisions or agreements are made, each partner has ***unlimited personal liability*** for the debts of the business.

Legally, partnerships have ***limited lives.*** From a legal standpoint, a partnership ends upon the withdrawal or death of an existing partner. Admission of a new partner terminates or ends the ***old*** partnership and creates a ***new*** legal entity. However, this is only a legal distinction. Most, if not all, partnerships have ***continuity of existence*** extending beyond the participation of individual partners. Partnership agreements often have provisions that make the retirement of existing partners and the admission of new partners'

routine events that do not affect the operations of the business (Meigs, et al., 1996).

1.3.1 Types of Partnerships:

Practically and in order to satisfy the various needs of different groups of investors interested in the investment fields, different types of partnerships have been developed. The term ***partnership*** actually includes three distinct types of organizations: *general partnerships, limited partnerships, and limited liability partnerships* (Meigs, 1996; Larsen, 2000; and Baker, Lembke, and King, 2005).

1.3.1.1 General Partnerships:

The *general partnership* (شركة التضامن) is the traditional form of partnership, in which ***all*** partners have unlimited personal liability for unpaid debts of the partnership. In a **general partnership**, each partner has rights and

responsibilities similar to those of a sole proprietor. For instance, each ***general partner*** (شريك متضامن) can withdraw cash and many other assets from the business at will, except real estate, as title to real estate is held in the name of the partnership and, accordingly, cannot be sold or withdrawn by any partner at will.

Furthermore, each partner has the full ***"authority of an owner"*** to negotiate contracts binding upon the business. This concept is called *mutual agency* (الوكالة أو المسئولية المشتركة أو التبادلية). Hence, every partner also has ***unlimited personal liability*** (مسئولية شخصية غير محدودة) for the debts of the firm.

Aggregating the characteristics of unlimited personal liability and mutual agency makes a *general partnership* a potentially dangerous form of business organization. For example, assume that you enter into a general partnership with Said

Ahmed. You agree to split (distribute) profits and losses ***"50-50"***. While you are on vacation, Said commits the partnership to a contract that it simply does not have the resources to complete. Your firm's failure to complete the contract causes large financial losses to the customer. The customer sues or appeals (يقاضي أو يرفع دعوة) your firm and is awarded a judgment of L.E.5,000,000 by the court.

Said has few financial resources and declares personal bankruptcy (إفلاس). The holder of the judgment against your firm can hold ***you personally liable for the whole L.E.5,000,000.*** The fact that you and Said agreed to appropriate everything ***"50-50"*** does *not* lessen or minimize your personal liability to your firm's creditors. You may have a legal claim against Said for his half of the debt, but so what? Said is bankrupt.

To sum up, general partnerships involve the same unlimited personal liability as sole

proprietorships. Such risk is intensified, however, because you may be held financially responsible for your partner's actions, as well as for your own.

1.3.1.2 Partnerships That Limit Personal Liability:

The modified forms of partnerships include ***"limited"*** partnerships and ***"limited liability"*** partnerships. The purpose of these modified forms of partnerships is to ***place limits*** upon the potential liability of individual partners.

1.3.1.2.1 Limited Partnerships:

A ***limited partnership*** (***شركة التوصية البسيطة***) has one or more *"general partners"*, and also one or more *"limited partners"*. The general partners are partners in the traditional sense or meaning, with unlimited personal liability for the debts of the business, and also the right to make managerial decisions.

The **limited partners** are basically *"passive or silent partners"*. Silent or passive partners (الشركاء الموصون) share in the profits of the business, but they don't participate actively in management and are ***not*** personally liable fore debts of the business. Thus, if the firm *"goes under"* or sinks, the losses incurred by the limited partners are ***"limited"*** to the amounts they have invested in the business.

For example, Pyramids, the professional football team, is organized as a publicly owned limited partnership. This means you can easily purchase a partnership interest in the team. As one of the limited partners, you can participate in all distributions of the team's profits. But you can not make management decisions: You can't hire players, send in plays, or fire the head coach. On the other hand, if the Pyramids can not pay their bills, the team's creditors won't come after you.

In the past, limited partnerships were widely used for various *"investment ventures"* (الاستثمارات المغامرة أو الاستثمار بالمضاربة) such as drilling for oil, developing real estate, or making a motion picture. These businesses often lost money-at least in the early years; if they were profitable, the profits come in later years. For such ventures, the limited partnership concept had great appeal to investors. Limited partners' financial risk was limited to the amount of their equity investment.

1.3.1.2.2 Limited Liability Partnerships:

A ***limited liability partnership*** ***شركة أشخاص محدودة*** is a relatively new form of business organization. Over the years, many professional partnerships have grown in size. Several public accounting firms, for example, now have thousands of partners and operate in countries all over the world. Also, lawsuits against professional firms have increased greatly in number and in pound amount. To

prevent these lawsuits from bankrupting *'innocent'* partners, the concept of the limited liability partnership has emerged. In this type of partnerships, each partner has unlimited personal liability for his or her ***own*** professional activities, but not for the actions of other partners. Unlike a limited partnership, all of the partners in a limited liability partnership may participate in management of the firm.

Many public accounting and other professional services now have the letters ***LLP*** after the name of their partnership. The ***LLP*** means that the partnership is a ***limited liability partnership***. The limited liability partnership provides that the partners are not personally liable for any debt, obligation, or liability that chargeable to the partnership. Also, the partners are still liable up to the amount of their capital accounts, but their

personal assets are protected from the partnership's creditors.

1.3.2 Accounting Practices in Partnerships:

In the majority of respects, partnership accounting is similar to that in a sole proprietorship-except there are more owners. As a result, a separate capital account, drawing account and current account is maintained for each partner. Like sole proprietorships, partnerships recognize no salaries expense for services provided to the organization by the partners. Amounts paid to partners are recorded by debiting the partners' drawings accounts.

1.3.2.1 Opening the Accounts of a New Partnership:

A chief advantage of the partnership form of entity is ease of formation. Accordingly, the agreement to form a partnership may be as informal as a handshake or as formal as a several-paged

agreement typically termed the ***articles of co-partnership***. Each partner must agree to the formation agreement, and partners are strongly advised to have a formal written agreement to avoid potential problems that may arise or emerge during the operation of the business (Larsen, 2000; Baker, Lembke and King, 2005).

In the real world, when a partner contributes his or her capital share, he/she may introduce cash amount, cash and other assets, or a sole proprietorship (both assets and liabilities).

As discussed previously, accounting in a partnership is similar to that in a sole proprietorship, except that separate capital accounts are maintained for each partner. These capital accounts show for each partner the amounts invested, the amounts withdrawn, and the appropriate share of partnership net income.

Hence, each partner is provided with a history of his or her equity in the firm.

Separate drawing accounts also are maintained for each partner. These drawing accounts are debited to record all withdrawals of cash or other assets including the use of partnership funds to pay a partner's personal debts.

Illustration 1.1:

To illustrate the opening entries for a newly formed partnership, assume that on January 1, 2020, Bodair and Khodair, who operate competing retail stores, decide to form a partnership by consolidating their business two businesses. A capital account will be opened for each partner and credited with the agreed valuation of the ***net assets*** (total assets less total liabilities) that the partner contributes. The journal entries to open the accounts of the partnership of Bodair and Khodair, are as follows.

Journal entries:

Date	Description	Dr.	Cr.
2020	Cash……………………..	80000	
Jan. 1	Accounts Receivable……	120000	
	Inventory………………..	180000	
	Accounts Payable………..		60000
	Bodair, Capital…………..		320000
	To record the investment by Bodair in the partnership of Bodair and Khodair.		
	Cash…………………..	20000	
	Inventory……………..	120000	
Jan. 1	Land…………………..	120000	
	Building………………	200000	
	Accounts Payable……………..		140000
	Khodair Capital………………..		320000
	To record the investment by Khodair in the partnership of Bodair and Khodair.		

1.3.2.2 Additional Investments:

Assume that after five months of operation, the organization is in need of more cash, and the partners make additional investments of L.E.20,000 each on June 1. These additional investments are credited to the capital accounts as presented below:

2020 June 1	Cash…………… Bodair, Capital…… Khodair, Capital…… To record additional investments.	40000	 20000 20000

1.3.2.3 Closing Partnership's Accounts at Year-End:

Like sole proprietorship, at the end of the accounting period, the balance in the **Income Summary Account** of the partnership is closed into partners' capital accounts. The profits or losses of a partnership may be appropriated among the partners in ***any manner agreed upon*** by the partners. Partners have great freedom in deciding how to allocate the partnership's net income among them. In the absence of prior agreement, prevailing laws and conventions generally provide for an ***equal split (allocation)*** among the partners, but this rarely happens. Partners usually agree well in advance how the firm's net income will be allocated.

Actually, every partnership requires a carefully written ***partnership-contract***, prepared before the firm starts operations. This contract is an ***agreement among the partners*** as to their rights and responsibilities. It determines the responsibilities of individual partners, how net income (or loss) will be allocated, and the amounts of assets that partners are allowed to withdraw.

On the other hand, a partnership contract or agreement ***does not*** prevent disputes from arising among the partners, but it does, however, provide a contractual base for their resolution.

Practically, a distinct feature of a partnership is the need to ***divide (allocate or appropriate)*** the firm's net income among its partners. Allocating partnership net income (or loss) means computing each partner's ***share*** of total net income (or loss) and crediting (or debiting) this amount to the partner's capital account. The dividing of

partnership net result is simply a journal entry made in the books and it ***does not*** involve any distributions of cash or other assets to the partners.

The amount that an individual partner ***withdraws*** during the year may ***differ*** greatly from the amount of partnership net income allocated to that partner.

Illustration 1.2:

Assume that Bodair and Khodair have agreed to share profits equally. Assuming that the partnership gains net income of L.E.120,000 in the first year of operations, the journal entry to close the Income Summary account is as below:

2020 Dec. 31	Income Summary……………. Bodair, Capital…………… Khodair, Capital………….. To allocate net income for the in accordance with partnership agreement to share profits equally.	120,000	 60,000 60,000

The next procedure in closing partnerships' accounts is to transfer the balance of each partner's drawing account to his capital account.

Illustration 1.3:

Assume that withdrawals of partners during the year amounted to L.E.48,000 for Bodair and L.E.32,000 for Khodair. The journal entry at December 31 to close the drawing accounts is as follows:

2020 Dec. 31	Bodair, Capital…………… Khodair, Capital…………... Bodair, Drawing………... Khodair, Drawing……… To transfer debit balances in partners' drawing accounts to their respective capital accounts.	48,000 32,000	 48,000 32,000

1.3.2.4 Income Statement for a Partnership:

The income statement for a partnership differs from that of a sole proprietorship in only one respect that is a final section may be added to show the division of the net income between the

partners, as appears below for the enterprise of Bodair and Khodair. The income statement of a partnership is consistent with that of a sole proprietorship in showing no salaries relating to services rendered by partners.

BODAIR AND KHODAIR
Income Statement
For the Year Ended December 31, 2020

Sales……………………………..		1200000
Cost of goods sold……………….		800000
Gross profit on sales……………		***400000***
Operating expenses:		
Selling expenses………………...	200000	
General & administrative expenses	80000	280000
Net income……………………...		***120000***
Division of net income:		
To Bodair (50%)……………….	60000	
To Khodair (50%)…………….	60000	120000

1.3.2.5 Statement of Partners' Equity:

In a partnership, the partners will usually want an explanation of the changes in their capital accounts from one year-end to the next. Accordingly, for a partnership, the ***statement of owner's equity***,

which is prepared by a sole proprietorship, is replaced by a ***statement of partners' equity.*** It shows separately the changes in each partner's capital account. The statement of partners' equity for Bodair and Khodair appears below:

BODAIR AND KHODAIR
Statement of Partners' Equity
For the Year Ended December 31, 2020

Description	Bodair	Khodair	Total
Balances, Jan. 1, 2010………………	320000	320000	640000
Add: Additional investments…………	20000	20000	40000
Net income for the year…………	60000	60000	120000
Subtotals……………………………	400000	400000	800000
Less: Drawings……………………………	48000	32000	80000
Balances, Dec. 31, 2020…………….	***352000***	***368000***	***720000***

The balance sheet of Bodair and Khodair would show the capital balance for each partner, as well as the total equity of L.E.720,000, as follows:

BODAIR AND KHODAIR
Balance Sheet as on December 31, 2020

Assets		Liabilities & Partners' Equity	
		Partners' Equity	
		Bodair, Capital 352,000	
		Khodair, Capital 368,000	
		Total partners' equity	720,000

1.3.3 Evaluating the Financial Statements of a Partnership:

(1) The Adequacy of Net Income: In essence, the net income of a partnership is similar to that of a sole proprietorship. The net income represents the partners' compensation for such things, including: ***a)*** Personal services, ***b)*** invested capital, and ***c)*** the risks of ownership. Additionally, the reported net income is an income after income tax (according to recent amendments of Income Tax Law No. 91/2005).

The services and capital provided by individual partners may vary, as may the degree of financial risk assumed or born. Thus, it will be difficult to evaluate the income of a partnership regarded as a whole. Instead, the individual partners must separately evaluate their ***respective shares*** of the partnership net income in light of their personal contributions to the firm. As a result, some partners

may find the partnership quite rewarding, while others may consider their share of the partnership net income inadequate.

(2) Evaluating Solvency: The balance sheet of a partnership is, relatively, more meaningful than that of a sole proprietorship. Perhaps, this is because there are legal distinctions or differences between partnership assets, which are jointly owned, and the personal assets of individual partners. Moreover, personal responsibility for business debts may ***not*** extended to all of the partners.

As such, creditors should understand the differences among the types of partnerships. For example, in a general partnership, all partners have unlimited personal liability for the debts of the business. This situation affords or gives creditors the maximum degree of protection. In a limited partnership, however, only the *general partners*

have personal liability for these obligations. In a limited liability partnership, liability for negligence or malpractice (سوء التصرف) extends only to those partners directly involved.

1.4 Corporations:

In any economy, nearly all large business and many small ones are organized as corporations (شركات الأموال). In the real world, there are much more sole proprietorships than corporations; however in money volume of business activity, corporations hold an impressive lead. As a result of the dominant or prevailing role of the corporation in any economy, it is important for everyone interested in business, economics, or politics to have an understanding of corporations and their accounting policies.

1.4.1 What is a Corporation?

A ***Corporation*** is a *legal entity*, having an existence separate and distinct from that of its owners. The owners of a corporation are called ***stockholders*** (or shareholders حملة الأسهم أو المساهمين), and their ownership is evidenced by

transferable shares (حصص أو أسهم قابلة للتداول) of ***capital stock*** (أسهم رأس المال أو رأسمال الأسهم).

Accordingly, a corporation is more difficult and costly to form than other types of organizations. And it must obtain a ***character*** (or personality شخصية أو كيان) from the authority and it also must receive authorization (ترخيص) from that authority to issue shares (حصص) of capital stock. The formation (تكوين أو تأسيس) of a corporation usually needs the services of attorney (lawyer محامى) and accountant.

A corporation, as a ***separate legal entity***, may own property in its own name. The assets of a corporation belong to the corporation itself, not to the stockholders. A corporation has legal status (منزلة أو وضع شرعي) in court, so it may sue (تقاضي أو تقيم دعوة) and be sued (يقام عليها دعوة) as if it were a person. As a **legal entity**, a corporation may enter

into contracts, is ***responsible for its own debts***, and ***pays income taxes*** on its earnings.

On a daily basis, corporations are run by ***salaried professional managers***, not by their stockholders. In many cases, the managers and stockholders are one and the same. In other words, managers may own stock, and stockholders may be hired into management roles. Nevertheless, ownership of stock does not *automatically* give the shareholder managerial authority. Therefore, the stockholders are primarily ***investors***, rather than active participants in the business.

The top level of a corporation's professional management is the ***board of directors*** (مجلس الإدارة). These directors are ***elected*** by the stockholders, and are responsible for hiring the other professional managers. Furthermore, the directors make basic policy decisions, including the extent to which

profits of the corporation are distributed or divided to stockholders.

The fact that directors are elected by the stockholders means that a stockholders or a group of stockholders owning more than 50% of the company's stock effectively controls the corporation. These ***controlling stockholders*** have the voting power to elect the directors; who in turn set company policies and appoint managers and corporate officers.

In effect, the transferability of corporate ownership, together with professional management, gives corporations a greater ***continuity of existence*** than other forms of organizations. Individual stockholders may sell, give, or bequeath (devise or transfer) their shares to someone else without disrupting (precluding) business operations. Thus, a corporation may

continue its business operations ***indefinitely***, regardless of changes in ownership.

1.4.2 Stockholders' Liability for Debts of a Corporation:

Stockholders in a corporation have ***no personal liability*** for the debts of the business. In case of corporation failure, stockholders potential losses are ***limited*** to the amount of their equity in the business.

Limited personal liability is considered the *greatest advantage* of the corporate form of business organization, regarding investors in large companies and the owners of many small businesses.

On the other hand, creditors should carefully understand the fact that shareholders are not personally liable for the debts of a corporation. Creditors have claims against only the ***assets of the corporation***, not the personal assets of the

corporation's owners. Limited shareholder liability, transferability of ownership, professional management, and continuity of existence make the corporation the best form of organization for pooling the resources of great many equity investors.

1.4.3 Accounting Practices of Corporations:

Of course, generally accepted accounting principles are basically the same for all types of business organizations. However, as a result of the legal characteristics of corporations, there are meaningful differences in the ways these organizations account for some things, such as salaries paid to owners, owners' equity, and distributions or appropriations of profits to their owners.

Regarding ***salaries paid to owners***, for instance, unincorporated businesses record such payments to their owners as ***drawings***, not as salaries expense.

But, the owners of a corporation cannot make ***withdrawals*** of corporate assets. Also, many of a corporation's employees may be stockholders. Thus, corporations make ***no distinction*** between employees who are stockholders and those who are not. All salaries paid to employees (including employee/stockholders) are recognized by the corporation as ***salaries expenses.***

1.4.3.1 Owners' Equity in a Corporate Balance Sheet:

Generally, in every form of business organization, there are two basic ***sources*** of owners' equity, they are: ***1)*** investment by the owners, and ***2)*** earnings from profitable operations. In practice, corporations distinguish in their balance sheets between the amounts of equity arising from such sources.

Illustration 1.4:

Assume that on January 1, 2018, Masry Elwatny and several investors started Masry's Co. by investing L.E.100,000,000 cash. In exchange, the corporation issued to these investors 10,000 shares of its capital stock. On December 31, 2020 and over its three-year life, Masry's Co. has earned total net income of L.E.180,000,000, of which L.E.60,000,000 has been distributed to the stockholders as ***dividends.*** The stockholders' equity section of the company's 2020 balance sheet is shown below:

MASRY'S COMPANY
Balance Sheet as on December 31, 2020

		Stockholders' equity:	
		Capital Stock…….	100,000,000
		Retained earnings…	120,000,000
		Total stockholders' equity	220,000,000

The Capital stock account represents the L.E.100,000,000 invested in the business by all

investors. This amount often is described as ***"invested capital"*** or ***"paid-in capital."*** The L.E.120,000,000 shown as ***retained earnings*** represents the *lifetime earnings* of the business, less the portion of these earnings which have been ***appropriated to the stockholders as dividends*** (that is, L.E.180,000,000 in net income, less L.E.60,000,000 in dividends, equal L.E.120,000,000). Retained earnings often are described as ***"earned capital."***

In a business organized as a ***corporation***, the term *stockholders' equity* is used rather than the term *owner's/partners' equity*. It is ***not*** customary to show separately the equity of each stockholder. In the case of large corporations, this clearly would be impossible, since these businesses often have ***several million*** individual stockholders or owners.

Stockholders' equity is subdivided into two general categories: ***(a)*** capital stock and ***(b)*** retained

earnings. ***Capital stock*** represents the amount which the stockholders originally invested in the business in exchange for shares of the company's stock. ***Retained earnings***, in the contrary, represent the increase in stockholders' equity that has accumulated over the years as a result of profitable operations.

1.4.3.2 The Issuance of Capital Stock:

Upon establishing of a corporation, it collects cash or other assets of the prospective investors. When the corporation receives such cash or other assts from its owners, it issues shares (حصص أو أنصبة) of capital stock (أسهم رأس المال) in exchange. Thus, the corporation records these investment transactions by crediting ***Capital Stock*** account and debiting such assets.

For example, the entry made by Masry's Co. to record the issuance of 10,000 shares of capital

stock in exchange of L.E.100,000,000 cash will be as bellow:

2018 Jan. 1	Cash……………….. Capital Stock…… Issued 10,000 shares of capital stock for cash.	100000000	 100000000

1.4.3.3 Accounting for Retained Earnings and Dividends:

In essence, ***retained earnings*** represent the owners' (shareholders) equity created through profitable operation of the business. Earning net income causes the balance in the *Retained Earnings* account to increase. But, many corporations follow a policy of ***appropriating to their stockholders (shareholders)*** some of the resources generated by profitable operations. These appropriations or distributions are termed ***dividends* (توزيعات).**

Dividends ***reduce*** or decrease both total assets and stockholders' equity (exactly the same as do

drawings in an unincorporated business). The reduction in stockholders' equity is reflected by decreasing the balance in the *Retained Earnings* account. Furthermore, retained earnings are reduced by any *net losses* incurred by the business.

You have to keep in your mind the fact that the balance of the ***Retained Earnings*** account does ***not*** represent the net income or net loss of one specific accounting period. Instead, it represents the ***cumulative*** net income (or net loss) of the business to date, ***minus*** any amounts which have been distributed to the stockholders as ***dividends***. Accordingly, retained earnings represent the earnings which have been ***retained*** in the corporation.

As a result, some of the largest corporations have become large by consistently retaining in the business most of the resources generated by profitable operations. Of course, retained earnings

are ***an element of owners' equity***. The owners' equity in a business ***does not*** represent cash or any other asset. The amount of cash owned by a corporation appears in the ***asset section*** of the balance sheet, ***not*** in the stockholders' equity section.

On the other hand, the owners of a corporation may not ***withdraw*** profits from the business at will. Rather, distributions of cash or other assets to the stockholders must be formally authorized or ***declared*** by the company's board of directors. These formal distributions are termed ***dividends***. Legally, dividends must be distributed to all stockholders ***in proportion to the number of shares owned.***

A dividend is officially declared by the board or directors on one date, and then is paid (distributed) in the near future.

Illustration 1.5:

Assume that on December 1, 2020, the directors of Masry's Co. declare a regular quarterly dividend of a half pound per share on the 10,000 shares of outstanding capital stock. The board's resolution (decision) determined that the dividend will be paid on December 15 to stockholders of record on December 10.

According to the given information, two entries are required: one on December 1 to record the ***declaration*** of the dividend, and the other on December 15 to record payment. Those could be made as below:

2020 Dec. 1	Dividends……………………	5,000	
	Dividends Payable………..		5,000
	Declared a dividend of 50 piaster per share payable Dec. 15 to stockholders of record on Dec. 10.		
15	Dividends Payable………….	5,000	
	Cash……………………..		5,000
	Paid dividend declared on Dec.1.		

It should be considered that at the ***declaration date***, December 1, there is no reduction in assets. Rather, the stockholders' right to receive the dividend is recognized as a liability. This liability is discharged on ***payment date***, December 15, when the dividend checks actually are mailed to stockholders.

At the end of the period, the ***Dividends*** account is closed into the ***Retained Earnings*** account, much like an owner's **drawing** account is closed into that owner's capital account. As an alternative treatment, instead of using ***Dividends*** account, some corporations follow the procedure of debiting the ***Retained Earnings*** account directly at the end of the time that the dividend is declared. This eliminates the need for closing the ***Dividends*** account at the end of the period.

1.4.3.4 Closing Entries and the Statement of Retained Earnings:

The *Retained Earnings* account should reflect the effect of profits, losses, and dividends during a given accounting period. As mentioned previously, the amount of retained earnings is increased by earning net income; it is decreased by bearing net losses and by declaring dividends. In the accounting records, these changes are recorded by ***closing*** the balances in the *Income Summary* account and *Dividends* account into the *Retained Earnings* account.

Illustration 1.6:

Assume that at December 31, 2019, Masry's Co. had retained earnings of ***L.E.80,000,000***. During 2020, the company earned net income of ***L.E.60,000,000*** and paid four quarterly dividends totaling ***L.E.20,000,000***. The entries at December 31, 2020, to close the *Income Summary* and *Dividends* accounts could be appeared as below:

Income Summary……... Retained Earnings..… To close the Income Summary account at the end of a profitable year.	60,000,000	 60,000,000
Retained Earnings.……. Dividends..………… To close the Dividends account, thereby reducing retained earnings by the amount of dividends declared during the year.	20,000,000	 20,000,000

On the contrary, if the corporation had incurred a ***net loss*** for the year, the *Income Summary* account would have had a debit balance. The entry to close the account then would have involved a ***debit*** to Retained Earnings, which would ***reduce*** total stockholders' equity, and a credit to the Income Summary account.

On the other hand, corporations prepare a ***Statement of Retained Earnings***, instead of a statement of owner's equity which is prepared by an unincorporated business. Statement of retained

earnings summarizes the changes in the amount of retained earnings over the year. However, many corporations instead prepare a ***Statement of Stockholders' Equity***, which shows the changes in *all* stockholders' equity accounts over the year. A statement of retained earnings for Masry's Co. appears as follows:

MASRY'S CO.
Statement of Retained Earnings
For the Year Ended December 31, 2020

Retained earnings, Dec. 31, 2019…… L.E.	80,000,000
Net income for the year………………	60,000,000
Subtotal………………………………..	*140,000,000*
Less: Dividends………………………	20,000,000
Retained earnings, Dec. 31, 2020…..L.E.	**120,000,000**

The *bottom line* of the statement represents amount of retained earnings that will appear in the company's year-end balance sheet.

1.4.3.5 Corporate Income Taxes:

As a legal entity, the corporation must pay income taxes on its earnings. Of course, total income taxes

expense for the year cannot be accurately determined until the corporation completes its annual income tax return or declaration (الإقرار الضريبي). However, the income taxes expense for each accounting period can be ***reasonably estimated*** by applying the current ***tax rate*** to the company's ***taxable income***. Such a relationship can be summarized as below:

Taxable income (Determined according To tax regulations)	×	***Tax rate (set by law)***	=	***Income taxes expense***

Taxable income is calculated in conformity with ***income tax regulations***, not generally accepted accounting principles. For simplification, it will be assumed that taxable income is equal to **income before income taxes**-a subtotal which often appears in a corporate income statement. Income before income taxes is simply total revenue less all expenses ***other than*** income taxes expense.

For example, assume that the net income before income taxes of Goldland Inc. for the year ended December 31, 2020 amounts L.E.500,000 and the tax rate is 40%. The yearend adjusting entry to recognize the related income taxes would be as follows:

2020 Dec. 31	Income Taxes Expense……. Income Taxes Payable..… To record income taxes expense on income earned in 2020 (L.E.500,000 × 40%).	200,000	 200,000

Income taxes payable is a short-term liability that will appear in Goldland's balance sheet. The presentation of income taxes expense in the company's December income statement is illustrated below:

GOLDLAND, INC.
Condensed Income Statement
For the Year Ended December 31, 2020

Net Sales……………………………………….L.E.	*5,000,000*
Cost of goods sold………………………	*3,000,000*
Gross profit………………………………......	*2,000,000*

General and administrative expenses..	*1,500,000*
Income before income taxes…………..	*500,000*
Income taxes expense………………..	***200,000***
Net income…………………………………	*300,000*

1.4.4 Evaluating the Financial Statements of a Corporation:

(1) The Adequacy of Net Income: Actually, the financial statements of a corporation are much easier to evaluate than those of an unincorporated business. For instance, the income of an incorporated business represents compensation to the owners for three distinct factors:

a. Services rendered to the business.

b. Capital invested in the business.

c. The risks of ownership, which often encompass unlimited personal liability.

However, this is ***not the case*** with a corporation. If stockholders render services to the business, they are compensated with a salary. The corporation recognizes this salary as an expense in the

computation of its net income. Therefore, the net income does ***not*** serve as compensation to the owners for personal services rendered to the business.

Furthermore, stockholders' financial ***risk of ownership*** is limited to the amount of their investment. Thus, the net income of a corporation represents simply the ***return on the stockholders' financial investment.*** The stockholder need only ask: "Is this net income sufficient to compensate me for risking the amount of my investment?" This makes it relatively easy for stockholders to compare the profitability of various corporations in making investment decisions.

(2) Evaluating Solvency: Creditors often look to the solvency of the individual **owners**, rather than that of the business entity, when extending credit to an ***unincorporated*** business. This is because the owners often are personally liable for the business

debts. However, in lending funds to a corporation, creditors generally may look only to the ***business entity*** for repayment. Thus, the financial strength of the business organization becomes much more critical when the business is formed as a corporation.

The most common differences among the corporate form of business, a sole proprietorship, and a general partnership are contrasted in the following table:

Characteristics of Forms of Business Organizations

Forms / Character	Sole Proprietorship	General Partnership	Corporation
1. Legal Status	Not a separate legal entity	Not a separate legal entity	Separate legal entity
2. Liability of owners for business debts	Personal liability for business debts	Personal liability for business debts	No personal liability for corporate debts
3. Accounting status	Separate entity	Separate entity	Separate entity
4. Tax status	Income taxable for owner	Income taxable for partnership	Files a corporate tax return and pays income taxes on its earnings
5. Persons with managerial	Owner	Every partner	Hired professional

authority			managers
6. Continuity of the business	Entity ceases with retirement or death of owner	New partnership is formed with a change in partners	Indefinite existence

1.4.5 Selecting an Appropriate Form of Business Organization:

Of course, anyone planning to start a business should give careful thought to the form of organization. Among the factors most often considered are:

1. The personal liability of the owner(s) for business debts.

2. Income tax considerations.

3. The need to raise or increase large amounts of equity capital.

4. The owners' need for flexibility in withdrawing assets from the business.

5. Whether all owners are to have managerial authority.

6. The need for continuity in business operations, despite future changes in ownership.

7. The ease and cost of forming the business.

1.4.6 Incorporating an Established Business:

In a real world, often a business starts out as a sole proprietorship or partnership, but as it grows larger, it is recognized as a closely held corporation. Eventually, the business may ***go public,*** meaning that it issues stock to the general public and its shares are treated on an organized stock exchange.

When an existing business is recognized as a corporation, the corporation is a ***new business entity.*** The valuation of the corporation's assets and liabilities is based upon their ***current market value*** when the new entity is established, not upon their values in the accounting records of the ***old*** business entity.

Illustration 1.7:

Assume that David Ryan has long owned and operated a sole proprietorship called Ryan Engineering. In January, 2020, Ryan decides to ***"incorporate"*** his business. He obtains a corporate charter (license) and transfers to the new corporation all of the assets used in his sole proprietorship. The new corporation also assumes (bears) responsibility for all of the proprietorship's business debts. In exchange for these ***"net assets"*** (assets minus liabilities), Ryan receives **20,000** shares of capital stock in the new corporation.

The following table lists the assets, liabilities, and owner's equity of the sole proprietorship at the date the new business is formed. The left-hand column indicates the values of these items in the proprietorship's accounting records. The right-hand column indicates the ***current market value*** of these items on this date. Note that: in each column,

owner's equity is equal to total assets, less total liabilities.

Item	Values in Proprietorship's Accounting Records	Current Market Values
Cash……………………	**300,000**	**300,000**
Accounts receivable……..	**750,000**	**600,000**
Inventory…………………	**100,000**	**150,000**
Land……………………	**400,000**	**1,000,000**
Building………………….	**600,000**	**500,000**
Equipment……………….	**700,000**	**800,000**
Notes payable……………	**550,000**	**550,000**
Accounts payable……….	**200,000**	**200,000**
Owner's equity………….	**2,100,000**	**2,600,000**

The entry to record the incorporation of this business is (note that the new business records the assets acquired at ***current market value***):

Description	Dr L.E.	Cr L.E.
Cash……………………………….	**300,000**	
Accounts receivable……………...	**600,000**	
Inventory…………………………	**150,000**	
Land………………………………	**1,000,000**	
Building…………………………..	**500,000**	
Equipment……………………….	**800,000**	
Notes payable………………...		**550,000**
Accounts payable…………….		**200,000**
Capital Stock…………………		**2,600,000**
Acquired assets and assumed		

liabilities of Ryan Engineering; issued 20,000 shares of capital stock in exchange.		

Again, notice that this journal entry is based upon the ***current market values*** of the assets received (and of the liabilities assumed). After all, these are the ***values*** that the new business entity receives in exchange for its shares of capital stock.

Illustration 1.8:

Gold-Key Auto Repair, Inc. is a small but growing chain of automobile repair shops. During the month of April 2020, the stockholders' equity accounts of this corporation were affected by the following events:

April 1 Issued an additional 10,000 shares of capital stock at L.E.250 per share.

April 5 Declared a L.E.5 per share dividend on 50,000 shares of outstanding capital stock.

April 20 Paid the dividend declared on April 5.

April 30 Recorded a liability for income taxes applicable to an income before taxes of L.E.520,000. (Assume an income tax rate of 40%).

Instructions:

a. Prepare journal entries for each of the above events in the accounts of Gold-Key Auto Repair.

b. Prepare a statement of retained earnings for the month ended April 30, 2020. Assume that the balance of retained earnings on March 31 was L.E.5,100,000.

Solution:

a. Journal entries for Gold-Key Auto Repair, Inc.

Date	Description	Dr L.E.	Cr L.E.
April 1	Cash……………………… Capital stock…………... Issued additional 10,000 shares of capital stock at L.E.250 per share.	2,500,000	2,500,000
April 5	Dividends………………… Dividends payable……. Declared a dividend of L.E.5 per share, payable April 20 (L.E.5 × 50,000 shares = L.E.250,000).	250,000	250,000

April 20	Dividends payable……….. Cash…………………… To record payment of dividend declared April 5.	250,000	 250,000
April 30	Income Taxes Expense…… Income Taxes Payable…. To accrue income taxes for the month of April (L.E.520,000 × 40%).	208,000	 208,000

b. Statement of Retained Earnings

GOLD-KEY AUTO REPAIR, INC.
Statement of Retained Earnings
For the Month Ended April 30, 2020

Retained earnings, March 31, 2020…	L.E.5,100,000
Net income for the month (520,000 - 208,000)	312,000
Subtotal……………………………………	5,412,000
Less: Dividends…………………………..	250,000
Retained earnings, April 30, 2020……….	5,162,000

1.5 Questions:

TRUE OR FALSE:

For each of the following statements, circle the **T** or the **F** to indicate whether the statement is **True** or **False**.

(1) **T** **F** The three major types of business organizations are sole proprietorship, partnerships, and corporations.

(2) **T** **F** In Egypt, like most of countries, there are two main forms of business organizations. They are sole proprietorships and partnerships.

(3) **T** **F** In Egypt, like most of countries, there are three main forms of business organizations. They are sole proprietorships, partnerships, and corporations.

(4) **T** **F** The risks incurred or borne both by equity investors and by creditors vary greatly depending upon the form of an organization.

(5) **T** **F** A sole proprietorship is an unincorporated business owned by one or more persons.

(6) **T** **F** Sole proprietorships are considered the most common form of business organization because they are so easy to form and start.

(7) **T** **F** Sole proprietorships are relatively large businesses with many financial reporting obligations.

(8) **T** **F** A business entity is an economic unit that engages in determined business activities.

(9) **T F** For accounting purposes, every business organization-including sole proprietorship- is treated as an entity separate from the other activities of its owner.

(10) **T** **F** The business assets in a corporation actually belong to the proprietor, not to the business.

(11) **T** **F** Tax laws see net income of the sole proprietorship as an income of business entity.

(12) **T** **F** The owner of a sole proprietorship is "***working for salary***".

(13) **T** **F** The owner of a sole proprietorship does not *personally responsible* for all of the business' debts.

(14) **T F** Unlimited personal liability is considered the greatest disadvantage to individual form of business organizations.

(15) **T** **F** Withdrawals of assets by the owner of a sole proprietorship are recorded by crediting the owner's drawing account.

(16) **T** **F** The only financial reporting obligation of many sole proprietorship is the information

that must be included in the owner's personal income tax return.

(17) **T F** In sole proprietorship form of business organization, if the business is to be considered successful, its net income should at least provide the owner with reasonable compensation for any personal services and equity capital which the owner has provided to the business.

(18) **T F** If the business is organized as a sole proprietorship, the balance sheet will be more useful to creditors.

(19) **T F** Actually, the solvency of a sole proprietorship may be affected by many things which do not appear in the financial statements of the business.

(20) **T F** A partnership can be defined as an unincorporated business owned by one or more partners.

(21) **T F** Partnerships are the least common form of business organization, probably because they often in too many bosses.

(22) **T F** Under the point of view of the law, the partnership is not separate from its owners.

(23) **T F** The law regards the partners as personally and jointly responsible for the activities of the business.

(24) **T F** Owners of sole proprietorships and general partnerships are personally liable for the debts of the business.

(25) **T F** A partnership may be created merely by two or more persons agreeing to act as partners.

(26) **T F** All partners are legally entitled to participate or share equally in the earnings of a partnership.

(27) **T F** From a legal standpoint, a partnership ends upon the withdrawal or death of an existing partner.

(28) **T F** Most, if not all, partnerships have continuity of existence extending beyond the participation of individual partners.

(29) **T F** Each general partner, can withdraw cash and many other assets from the business at will.

(30) **T F** In a general partnership, each partner has the full "authority of an Owner" to negotiate contracts binding or obligating upon the business.

(31) **T F** A limited partnership has one or more general partners and also one or more limited partners.

(32) **T F** In the limited liability partnership, each partner has unlimited personal liability for his or her own professional activities, but not for the actions of other partners.

(33) **T F** Partnerships recognize salaries expense for services provided to the organization by the partners.

(34) **T F** If a partnership pays for a personal expense of a partner, the amount should be recorded in the partner's drawing account.

(35) **T F** A distinct feature of a partnership is the need to divide or allocate the firm's net income among its partners.

(36) **T F** Actually, every partnership requires a carefully written partnership contract, prepared before the firm starts operations.

(37) **T F** A partnership contract or agreement prevents disputes arising among the partners and provides a contractual base for their resolution.

(38) **T F** In a limited partnership, all partners have personal liability for the partnership's obligations.

(39) **T F** Nearly all large businesses and many small ones are organized as corporations.

(40) **T F** A corporation is a legal entity, having an existence separate and distinct from that of its owners.

(41) **T F** The owners of a corporation are called partners, and their ownership is evidenced by transferable shares of capital stock.

(42) **T F** A corporation is easy and cheap to form than other types of organizations.

(43) **T F** A corporation, as a separate legal entity, may own property in its own name.

(44) **T F** On a daily basis, corporations are run by their stockholders.

(45) **T F** The stockholders are primarily investors, rather than active participants in the business.

(46) **T F** The transferability of corporate ownership, together with professional management, gives corporations a greater continuity of existence than other forms of organizations.

(47) **T F** Stockholders in a corporation have personal liability for the debts of the business.

(48) **T F** Limited personal liability is considered the greatest advantage of the corporate form of business organization.

(49) **T F** Corporations make distinction between employees who are stockholders and those who are not.

(50) **T F** In a business organized as a corporation, the term stockholders' equity is used rather than the term owner's/partners' equity.

(51) **T F** Capital stock represents the amount which the partners originally invested in the business in exchange for shares of the company's stock.

(52) **T F** Retained earnings represents the increase in stockholders' equity that has accumulated

over the years as a result of unprofitable operations.

(53) **T F** Creditors generally may look only to the business entity for repayment, when lending money to the partnership.

(54) **T F** The net income of a corporation represents simply the return on the stockholders' financial investment.

(55) **T F** The three major types of business organizations are sole proprietorships, partnerships, and corporations.

(56) **T F** The personal assets of the owner of a sole proprietorship should be included on the balance sheet of the business.

(57) **T F** The net income of a sole proprietorship should be sufficient to compensate the owner for services to the business, capital provided to the business, and the risks of ownership.

(58) **T F** Owners of sole proprietorships and general partnerships are personally liable for the debts of the business.

(59) **T F** Withdrawals from a sole proprietorship result in a reduction in the retained earnings of the business.

(60) **T F** A partnership may be created merely by two or more persons agreeing to act as partners.

(61) **T F** All partners are legally entitled to participate equally in the earnings of a partnership.

(62) **T F** No partner can enter into a contract on behalf of a partnership without a majority vote of all of the partners.

(63) **T F** A partnership legally ceases its existence upon the death or withdrawal of one of the partners.

(64) **T F** In evaluating whether to extend credit to a sole proprietorship, the most important factor is the financial position of the business.

(65) **T F** If a limited partnership defaults on a debt, the creditor may ***not*** look to any of the individual partners for payment.

(66) **T F** The board of directors of a corporation are appointed by corporate management and confirmed by the stockholders.

(67) **T F** Limited personal liability of the stockholders for debts of the business is a major advantage of the corporate form of organization.

(68) **T F** A corporation is dissolved whenever a stockholder dies or withdraws from the corporation.

(69) **T F** A corporation must have at least five stockholders.

(70) **T F** The net income of a corporation compensates stockholders for personal services

to the business and capital provided to the business.

(71) **T F** A corporation is a legal entity separate from its owners; it may sue and be sued; and it may own property in its own name.

(72) **T F** A limited partner generally participates in management of the partnership.

(73) **T F** Dividends generally are declared and paid on the same date.

(74) **T F** Dividends become a legal obligation of the corporation on the date of declaration.

(75) **T F** When a partnership is incorporated, the assets of the business are recorded at their current market values.

MULTIPLE CHOICES:

Choose the best answer for each of the following questions and circle the identifying letter.

1. Which of the following investors do not have unlimited liability for the debts of the business?

- **A** An owner of a sole proprietorship.
- **B** A partner of a general partnership.
- **C** A general partner of a limited partnership.
- **D** A stockholder of a corporation.

2. Which of the following types of business owners do ***not*** take an active role in the daily management of the business?

- **A** General partners.
- **B** Sole proprietors.

- **C** Sole traders.
- **D** Limited partner.

3. Net income of a corporation should be adequate to compensate the stockholders for:

- **A** Services provided to the corporation and invested capital.
- **B** Services provided to the corporation, invested capital, and the risks of ownership.
- **C** Invested capital and the risk of losing their investment.
- **D** Risks of personal liability for business debts.

4. The amount of cash which the owner of a sole proprietorship can ***withdraw*** from the business in a given year is limited to:

- **A** The amount of dividends declared by the directors of the business.
- **B** The balance of the Cash Account at the beginning of the year.
- **C** The net income for the year.
- **D** None of the above.

5. Which of the following is ***not*** a characteristic of a sole proprietorship?

- **A** The owner is personally liable for the debts of the business.
- **B** From an accounting standpoint, a sole proprietorship is regarded as an entity separate from the personal affairs of the owner.

- **C** The business is subject to double taxation as income taxes must be paid both by the business entity and then by its owner.
- **D** The owner is free to withdraw assets from the business at any time and in any amount.

6. Which of the following is ***true*** about a sole proprietorship?

- **A** The business assets are held in the name of the business.
- **B** The business pays income taxes.
- **C** The business is a separate legal entity.
- **D** The owner is personally liable for all debts of the business.

7. Which of the following is ***not*** a characteristic of a sole proprietorship?

- **A** Ease of formation.
- **B** Business pays income taxes.
- **C** business pays no salary to its owner.
- **D** Business assets belong to the owner.

8. Which of the following is ***not*** a characteristic of a sole proprietorship?

- **A** Unlimited personal liability for business debts by owner.
- **B** Personal assets of the owner belong to the business .
- **C** The business pays no salary to its owner.
- **D** Owned by an individual person.

9. The net income of a sole proprietorship compensates the owner for all of the following, ***except***:

- **A** Personal services provided by the owner to the business.
- **B** Capital invested by the owner.
- **C** Money borrowed by the owner from a bank for the business.
- **D** The risks of ownership of the business.

10. Which of the following investors do not have unlimited liability for the debts of the business?

- **A** An owner of a sole proprietorship.
- **B** A partner of a general partnership.
- **C** A general partner of a limited partnership.
- **D** A stockholder of a corporation.

11. Which of the following is ***not*** a characteristic of a general partnership?

- **A** Mutual agency.
- **B** Unlimited liability for business debts.
- **C** Pays no income taxes.
- **D** Limited life.

12. Which of the following is the most important disadvantage of the general partnership form of business organization?

- **A** Limited life.
- **B** Multiple owners.

- **C** Unlimited personal liability for business debts.
- **D** Taxation of business profits.

13. The characteristic of a general partnership known as ***mutual agency*** means that:

- **A** All partners may bind the partnership to contracts.
- **B** All partners participate in the profits of the partnership.
- **C** All partners have unlimited personal liability for the debts of the partnership.
- **D** Al partners are responsible for payment of income taxes expense payable on partnership profits.

14. Title to the assets of a partnership is held by:

- **A** The partnership.
- **B** The managing partner.
- **C** The individual partners that contributed the assets.
- **D** The board of directors of the partnership.

15. Which of the following is ***not*** a characteristic of a general partnership?

- **A** Each partner has the authority to bind the partnership to contracts.
- **B** Each partner's liability is limited to the amount he or she invested.
- **C** Ease of formation.

- **D** Each partner may manage the partnership.

16. Each partner of a general partnership may be held personally liable for:

- **A** Business debts equal to the balance of that partner's capital.
- **B** Only the amount that the partner originally invested in the business.
- **C** All debts of the business.
- **D** All debts of the business and all personal debts of the other partners.

17. Which of the following is ***not true*** regarding general partnership?

- **A** The individual partners are personally liable for the debts of the partnership.
- **B** The partnership pays income taxes on its profits.
- **C** The individual partners participate in management only if they are hired by the partnership.
- **D** Cash withdrawn by a partner is recorded in the partner's drawing account.

18. Which of the following is ***true*** regarding a general partnership?

- **A** A general partnership pays no income taxes on its net income.
- **B** Any individual partner may be held liable for all of the debts of the general partnership.

- **C** A general partnership distributes dividends from profits to the individual partners.
- **D** A general partnership is an incorporated entity.

19. The unique characteristic of a limited partnership is that:

- **A** None of the partners can be held personally responsible for the debts of the business.
- **B** The number of partners is limited to that specified in the partnership contract.
- **C** Only a limited portion of the partnership income is subject to income taxes.
- **D** The liability of some of the partners for losses incurred by the business is limited to the amount of their investments.

20. Which of the following statements does ***not*** describe a characteristic of a limited partnership?

- **A** This form of organization is often used for ventures investments.
- **B** Limited partners usually do not participate actively in the management of the business.
- **C** Limited partners have the right to participate in partnership profits, but their liability for losses is limited to the amount of their investments.
- **D** All of the partners are limited partners.

21. For which of the following types of organizations is the financial position of the business most important to a bank considering making a loan to the business?

- **A** A corporation.
- **B** A sole proprietorship.
- **C** A general partnership.
- D A limited partnership.

22. Which of the following types of business organizations has a legal existence separate and apart from its owner(s)?

- **A** A sole proprietorship.
- **B** A general partnership.
- **C** A corporation.
- D A limited partnership.

23. Which of the following is ***not*** a characteristic of the corporate form of organization?

- **A** The owners of a corporation cannot lose more than the amount of their investment.
- **B** Shares of stock in a corporation are more transferable than is an interest in a partnership.
- **C** Stockholders have authority to decide by majority vote the amount of dividends to be paid.
- D The corporation is a very efficient vehicle for obtaining large amounts of capital required for large-scale production.

24. Title to the assets of a corporation is legally held by:

- **A** The stockholders, jointly and severally.
- **B** The corporation as a legal entity.
- **C** The president of the corporation in trust for the stockholders.
- D The board of directors, as trustees.

25. Which of the following is ***not*** a characteristic of the corporate form of organization?

- **A** Ease of transferring ownership.
- **B** Limited liability of owners.
- **C** Ease of gathering large amounts of capital.
- D Owners' payment of the corporate income taxes based on the owner's proportionate share of corporate net income.

26. If a business needs large amounts of equity capital, the appropriate form of organization most likely is:

- **A** A corporation.
- **B** A general partnership.
- **C** A limited partnership.
- D A limited liability partnership.

27. Which of the following is the least important factor in deciding the appropriate form of business organization for a particular business?

- **A** Personal liability for debts.

- **B** Income tax consideration.
- **C** The need for equity capital.
- D The number of employees.

28. ***Retained earnings*** represents:

- **A** Cash that has been retained in the business.
- **B** The total investment by the owners of the business.
- **C** Income of the business that has been reinvested rather than distributed to the owners.
- D Cash available for dividends.

29. Which of the following forms of business organizations are normally treated as a going concern from an accounting viewpoint?

- **A** A sole proprietorship.
- **B** A partnership.
- **C** A corporation.
- D All of the above are treated as going concerns.

30. When a partnership is incorporated, the assets of the partnership are recorded on the books of the newly-formed corporation at:

- **A** The fair market values of the assets.
- **B** The amounts recorded on the partnership books.
- **C** The original cost of the assets to the partners.
- D Amounts established by the board of directors.

31. If Reams, Inc. earns L.E.700,000 before income taxes expense and the corporate pays income taxes at a rate of 40%, what is the entry necessary to record the income taxes expense for the period?

- **A** Income Taxes Payable 280,000
  Income Taxes Expense 280,000
- **B** Income Taxes Expense 420,000
  Income Taxes Payable 420,000
- **C** Income Taxes Expense 280,000
  Income Taxes Payable 280,000
- D Income Taxes Payable 420,000
  Income Taxes Expense 420,000

32. If Tanta, Inc. earns L.E.1,500,000 before income taxes expense and the corporate pays income taxes at a rate of 40%, what is the entry necessary to record the income taxes expense for the period?

- **A** Income Taxes Expense 600,000
  Income Taxes Payable 600,000
- **B** Income Taxes Payable 900,000
  Income Taxes Expense 900,000
- **C** Income Taxes Payable 600,000
  Income Taxes Expense 600,000
- D Income Taxes Expense 900,000
  Income Taxes Payable 900,000

33. On June 1, the board of directors of Information Corporation declared a regular quarterly dividend of L.E.15 per share on the 20,000 shares of outstanding capital stock. The dividend is payable on June 20. What entry is necessary to record the declaration of the dividend on June 1?

- **A** Dividends Payable…... 300,000
  Cash………………. 300,000
- **B** Dividends……………. 300,000
  Cash……………….. 300,000
- **C** Dividends……………. 300,000
  Dividends Payable... 300,000
- D Dividends Payable….. 300,000
  Dividends………….. 300,000

34. On June 1, the board of directors of Information Corporation declared a regular quarterly dividend of L.E.15 per share on the 20,000 shares of outstanding capital stock. The dividend is payable on June 20. What entry is necessary to record payment of the dividend on June 20?

- **A** Dividends Payable…... 300,000
  Cash………………. 300,000
- **B** Dividends……………. 300,000
  Cash……………….. 300,000
- **C** Cash…………………. 300,000

Dividends Payable... 300,000
- D Dividends Payable….. 300,000
Dividends………….. 300,000

35. Comic, Inc. had retained earnings of L.E.2,300,000 at the beginning of the current year. During the year, the corporation earned net income of L.E.340,000 and declared dividends in the amount of L.E.100,000. What is the balance of Comic's retained earnings at the end of the year?

- **A** L.E.1,840,000.
- **B** L.E.2,040,000.
- **C** L.E.2,540,000.
- D L.E.2,740,000.

36. Omer, Inc. had retained earnings of L.E.1,500,000 at the beginning of the current year. During the year, the corporation incurred a net loss of L.E.200,000 and declared dividends in the amount of L.E.50,000. What is the balance of Omer's retained earnings at the end of the year?

- **A** L.E.1,250,000.
- **B** L.E.1,300,000.
- **C** L.E.1,350,000.
- D L.E.1,650,000.

EXERCISES AND PROBLEMS:

(1) A corporation was formed at the beginning of 2019 by issuing 20,000 shares of capital stock at L.E.50 per share. The corporation reported a net loss of L.E.80,000 for 2019 and net income of L.E.150,000 for 2020. The corporation declared no dividends for either year.

Instructions:

Prepare the stockholders' equity section of the corporation's balance sheet at the end of 2020.

(2) Shown below are the amounts from the stockholders' equity section of the balance sheet of a corporation for the years ended December 31, 2020 and 2021:

		2021	2020
Stockholders' equity:			
Capital stock…………..	**L.E.**	**500,000**	**300,000**
Retained earnings……..		**2,000,000**	**1,800,000**
Total stockholders' equity..		**2,500,000**	**2,300,000**

Instructions:

a. Calculate the amount of additional investment that the stockholders made during 2021.

b. Assuming that the corporation declared and paid L.E.100,000 in dividends during 2021, calculate the amount of ***net income*** earned by the corporation during 2021.

(3) On January 1, 2020, several investors began a corporation, with an initial investment of L.E.1,500,000. By retaining profits in business, the stockholders' equity increased to L.E.5,300,000 as of December 31, 2020. In 2021, the corporation earned net income L.E.6,100,000 and declared and paid dividends of L.E.4,800,000. The corporation closes its accounts annually at December 31.

Instructions:

1. Prepare journal entries to close the Income Summary account and Dividends account at December 31, 2021.

2. Prepare a statement of retained earnings for 2021.
3. Prepare the stockholders' equity section of the company's balance sheet at December 31, 2021.

(4) During the first 10 months of 2020, RedCar Transit Co. earned income before taxes (taxable income) of L.E.9,000,000. The company prepares monthly financial statements and estimates income taxes expense as 40% of the income (or loss) before income taxes. In November, RedCar earned income before taxes of L.E.1,500,000. In December, however, the company sustained a L.E.2,200,000 loss before income taxes.

<u>Instructions:</u>

1. Prepare the adjustment journal entries necessary at November 30, and December 31to recognize the estimated monthly income taxes expense.

2. Illustrate the last three lines of the company's income statement-income (or loss) before

income taxes, income taxes, and net income (or loss) - for (1) the ***month*** ended November 30, 2020, (2) the ***month*** ended December 31, 2020, and (3) the ***year*** ended December 31, 2020.

(5) The Top Hat, Inc. is a chain of magic shops that is organized as a corporation. During the month of June, the stockholders' equity accounts of the Top Hat were affected by the following events:

June 3 The corporation sold 1,000 shares of capital stock at L.E.2,000 per share.

June 10 The corporation declared a L.E.25 per share dividend on its 20,000 shares of outstanding capital stock, payable on June 23.

June 23 The corporation paid the dividend declared on June 10.

June 30 The Income Summary account showed a credit balance of L.E.6,000,000; the corporation's accounts are closed monthly.

Instructions:

1. Prepare journal entries for each of the above events in the accounts of The Top Hat. Include the entries necessary to close the Income Summary and Dividends accounts.

2. Prepare a statement of retained earnings for June. Assume that the balance of retained earnings on May 31 was L.E.52,000,000.

(6) Eastern Wear, Inc. is organized early in 2020. On January 15, the corporation issued to investors 40,000 shares of capital stock at L.E.200 per share.

After the revenue and expense accounts (except Income Taxes Expense) were closed into the Income Summary account at the end of 2020, the account showed a before-tax profit of

L.E.1,200,000. The income tax rate for the corporation is 40%. No dividends were declared during the year.

On March 15, 2021, the board of directors declared a cash dividend of L.E.5 per share, payable on April 15.

Instructions:

a. Prepare the journal entries for 2020 to (1) record the issuance of the common stock, (2) record the income tax liability at December 31, (3) close the Income Taxes Expense account.

b. Prepare the journal entries in 2021 for the declaration of the dividend on March 15 and payment of the dividend on April 15.

c. Operations in 2021 resulted in an L.E.180,000 ***net loss***. Prepare the journal entries to close the Income Summary and Dividends accounts at December 31, 2021.

d. Prepare the stockholders' equity section of the balance sheet at December 31, 2021. Include a separate supporting schedule showing your determination of retained earnings at that date.

(7) The two cases described below are independent of each other. Each case provides the information necessary to prepare the stockholders' equity section of a corporate balance sheet.

- Early in 2019, Nile Corporation was formed with the issuance of 50,000 shares of capital stock at L.E.500 per share. The corporation reported a net loss of L.E.3,200,000 for 2019, and a net loss of L.E.1,200,000 in 2020. In 2021, the corporation reported net income of L.E.9,000,000, and declared a dividend of L.E.50 per share.
- Wonder Industries was organized early in 2017 with the issuance of 100,000 shares of capital

stock at L.E.1,000 per share. During the first 5 years of its existence, the corporation earned a total of L.E.80,000,000 and paid dividends of L.E.25 per chare each year on the common stock.

Instructions:

Prepare the stockholders' equity section of the corporate balance sheet for each company for the year ended December 31, 2021.

(8) [Comparison of Proprietorship with Corporation] Cairo Eyeshades is a retail store owned solely by Tarek. During the month of November, the equity accounts were affected by the following events:

Nov. 9 Tarek invested an additional L.E.150,000 in the business.

Nov. 15 Tarek withdrew L.E.15,000 for his salary for the first two weeks of the month.

Nov. 30 Tarek withdrew L.E.15,000 for his salary for the second two weeks of the month.

Nov. 30 Cairo Eyeshades distributed L.E.10,000 of earnings to Tarek.

Instructions:

a. Assuming that the business is organized as a sole proprietorship:

1. Prepare the journal entries to record the above events in the accounts of Cairo Eyeshades.

2. Prepare the closing entries for the month of November. Assume that after closing all of the revenue and expense accounts, the Income Summary account has a balance of L.E.50,000.

b. Assuming that the business is organized as a corporation:

1. Prepare the journal entries to record the above events in the accounts of Cairo

Eyeshades. Assume that the distribution of earnings on November 30 was payment of a dividend that was declared on November 20.

2. Prepare the closing entries for the month of November. Assume that after closing all of the revenue and expense accounts (except Income Taxes Expense), the Income Summary account has a balance of L.E.20,000. Before preparing the closing entries, prepare the entries to accrue income taxes expense for the month, and to close the Income Taxes Expense account to the Income Summary account. Assume that the corporate income tax rate is ***30%***.

(9) [Incorporation of a Proprietorship] The following table shows the assets, liabilities, and owner's equity of Happy Baby Stores, a sole

proprietorship, at March 31, 2021. On this date, the owners plans to incorporate the business.

	Values in the Proprietorship's Records	Current Market Values
Cash……………………	200,000	200,000
Accounts receivable……	350,000	300,000
Inventory……………….	1,100,000	1,250,000
Store equipment………..	950,000	1,000,000
Notes payable………….	500,000	500,000
Accounts payable………	100,000	100,000
Owner's equity…………	2,000,000	2,150,000

Instructions:

Prepare the general journal entry to record the formation of the new corporation. Assume that the corporation issued 10,000 shares of stock in exchange for acquisition of assets and liabilities of the proprietorship.

CHAPTER TWO
ADJUSTING ENTRIES

CHAPTER TWO

ADJUSTING ENTRIES

2.1 Introduction:

In this chapter, adjusting entries will be extensively highlighted. As we will see, other types of expenses, in addition revenue may require some ***adjustments.*** Furthermore, because ***adjustments*** are considered the first step when preparing the final accounts of any business enterprise, adjusting entries were also closely discussed in Chapter Two of this textbook.

2.2 Types of Adjusting Entries:

In practice, and for the purpose of determining business income and preparing financial statements, the life of any business enterprise is divided into a systematic series of what is called **ACCOUNTING PERIODS.** This process allows users of information and decision makers to make comparison among the financial statements of successive accounting periods.

However, determining or measuring the net income of relatively short accounting periods may face a problem. The expected problem is that some economic transactions may affect the revenue or expenses of ***more than one accounting period***. As such, adjusting entries are required at the end of each accounting period. The purpose beyond adjusting entries is to assign or determine to each period the proper amounts of revenue and expense.

For instance, newspaper and magazine publishers usually market or sell more than one-year subscriptions to their publications. Accordingly, at the end of each accounting period, these publishers make *adjusting entries* recognizing the portion of their advance receipts which is considered earnings belonging the current accounting period. On the other hand, most business enterprises own depreciable assets. Therefore, at the end of each accounting period, these enterprises make *adjusting entries* to allocate part of the cost of these assets to depreciation expense.

To sum up, adjusting entries are required whenever business transactions affect (influence) the revenue or expenses of **more than one accounting period.** Accordingly, these adjusting entries assign (determine) revenues to the periods in which they are ***earned***, and expenses to the

periods in which the related goods or services are ***used***.

In practice, adjusting entries are made *only at the end of each accounting period*. Therefore, **"adjusting the accounts"** is considered an *end-of-the-period* procedure related to the ***preparation*** of financial statements.

The required number of adjustments at the end of each accounting period relies on the nature of the enterprise's business activities. Nevertheless, most adjusting entries fall into one of four general categories (Meigs et. al, 1996):

1. Entries to apportion recorded costs:

In practice, a cost that will be expected to benefit more than one accounting period usually is recorded by debiting an asset account. So, in each period that benefits from the use of this asset, an adjusting entry is made to allocate a portion of asset's cost to expense.

2. Entries to apportion unearned revenue:

A business entity may collect in advance for services to be done or rendered to customers in future accounting periods. In the period in which these services are actually rendered, an adjusting entry is needed to be made in order to record the portion of the revenue earned during the period.

3. Entries to record unrecorded expenses:

we mean that an expense may be incurred (borne) in the current accounting period even though no bill has yet been received and payment will not occur until a future period. In this case, unrecorded expenses are recorded (journalized) by an adjusting entry which is made at the end of the accounting period.

4. Entries to record unrecorded revenue:

Normally, revenue may be earned during the current period, however not yet billed to customers or recorded in the accounting records. In this case,

unrecorded revenue is journalized by making an adjusting entry at the end of the accounting period.

2.3 Illustrating the Various Types of Adjusting Entries:

In order to deeply understand adjustments' technique, the different types of adjusting entries will be illustrated, using our example which involves **Engineer Auto Service.** We will look ahead to **December 31, 2019.** This is the end of the enterprise's first complete year of operations. Such practice will give us the opportunity to illustrate the preparation of ***annual*** financial statements, in stead of those statements which cover only a separate month.

For simplification, it is assumed that an enterprise adjusts and closes its accounts at the *end of each month.* However, closing the accounts every single month is ***not*** considered a common business practice. Most business enterprises may *adjust* their accounts every month. Nevertheless, they do make closing entries **only at year-end.** In

this illustration it will be assumed that **Engineer Auto Service** has been following this approach during **2019.** Accordingly, the firm's ***unadjusted*** trial balance as of **December 31, 2019** is shown below.

ENGINEER AUTO SERVICE
Trial Balance
December 31, 2019

Accounts Titles	Debit	Credit
Cash………………………….. L.E.	27,950	
Accounts receivable (Debtors)…	6,500	
Shop supplies…………………..	1,800	
Unexpired insurance……………	3,000	
Land……………………………	52,000	
Building………………………..	36,000	
Accumulated depreciation: building		1,800
Tools & equipment………………	15,000	
Acc. Dep..: tools & equipment		2,950
Notes payable……………………		40,000
Accounts payable………………..		2,690
Unearned rent revenue…………..		6,000
Ahmed Adel, Capital……………..		81,000
Ahmed Adel, drawing……………	44,800	
Repair service revenue…………..		161,460
Advertising expense……………..	3,900	
Wages (salaries) expense………..	56,800	
Supplies expense…………………	6,900	
Depreciation expense: building….	1,650	

Dep. expense: tools & Equip…….	2,200	
Utilities expense………………….	19,400	
Insurance expense………………..	15,000	
Interest expense…………………..	3,000	
Total	295,900	295,900

As **Engineer** now closes its accounts only at year-end, the balances in the revenue, expense, and owner's drawing accounts represent the activities of the ***whole year***, instead of those of a separate month. However, **Engineer** last **adjusted** its accounts on **November 30**; therefore, it is still required to make adjusting entries for the month of **December**.

As such, in the next few pages it will be illustrated several transactions, and also the related *adjusting entries.* Those transactions and related adjusting entries are appeared in the format of **general journal** entries.

2.3.1 Apportioning Recorded Costs:

Usually, when an enterprise pays or makes an expenditure which will be expected to benefit more than one accounting period, the amount is debited to an appropriate asset account. Therefore, at the end of each accounting period that benefits from this expenditure, an adjusting entry is needed to transfer a proper portion of the cost from the asset account to an expense account. This adjusting entry refers to the fact that part of the asset has been used up. In other words, this procedure means that an appropriate portion of the asset became an expense during the current accounting year. As such, an adjusting entry to apportion (allocate) a recorded cost consists of a debit to an expense account and a credit to an asset account or a ***contra-asset account.*** Some examples of these adjustments encompass (include) the entries to record

depreciation expense and to divide (apportion) the costs of ***prepaid expenses*.**

Prepaid Expenses:

Prepaid expenses are payments in advance which are often made for some items such as insurance, rent, and office supplies. Accordingly, if the advance payment or prepayment will be expected to benefit more than just the current accounting period, the cost ***represents an asset*** rather than an expense. The cost of this asset will be allocated to expense in the accounting periods in which the services or the supplies are used. To this point, you have to take in your account the fact that **prepaid expenses are assets**; the become expenses only when the goods or services are used up or rendered.

1. Shop Supplies:

For illustration purpose, we will consider **Engineer's** accounting polices for shop supplies.

When supplies are purchased, their cost is debited to the asset account called **“Shop Supplies”**, making the following journal entry:

By Shop Supplies a/c…………. XXX	
To Cash or Creditors a/c…..	*XXX*
Being shop supplies purchased….	

On the other hand, it is not practical to make journal entries every few minutes as supplies are used. But, an estimate is made of the supplies which remain on hand at the end of each month or accounting period and the supplies which are **missing** are assumed to have been used.

To illustrate, prior to making adjusting entries at December 31, the balance in **Engineer’s** Shop Supplies Account is **L.E.1,800.** Assume that at December 31, **Ahmed Adel**, estimates there are about **L.E.1,200**-worth of shop supplies remaining on hand. This estimation indicates that supplies costing about **L.E.600** have been **used** in

December. Therefore, the following **adjusting entry** is made:

Dec. 31 By Supplies Expense a/c…… 600
To Shop Supplies a/c...... 600
Estimate of shop supplies used in December.

This includes transferring the cost of supplies used from the asset account to expense account. Thus, this **adjusting entry** serves two objectives: **(a)** it charges to expense the cost of supplies used in December, and **(b)** it reduces the balance of the **Shop Supplies Account** to **L.E.1,200**, which represents the amount of supplies estimated to be on hand at December 31.

2. Insurance Policies:

Insurance policies are also considered a prepaid expense. as we know, these policies provide a service, insurance protection, over a specific period of time. Accordingly, as the time passes, part of the insurance policy **expires**, because it is ***used up*** in

the business operations. To illustrate, assume that on February 1, **Engineer** purchased for **L.E.18,000** a one-year insurance policy providing comprehensive liability insurance and insurance against fire and damage to customers' vehicle while in **Engineer's** facilities. This transaction, which reflects expenditure, was debited to an asset account, as follows:

Feb. 1 By Unexpired Insurance a/c.. 18,000
To Cash a/c…………… 18,000
Purchased an insurance policy providing coverage for the next 12 months.

According to the insurance policy, this **L.E.18,000** expenditure provides insurance coverage for a period of one year. Hence, $\frac{1}{12}$ of this cost, or **L.E.1,500** (18,000 ÷ 12), is recognized as insurance expense every month. So, the insurance expense for the month of December is

recorded by the following **adjusting entry** at December 31:

Dec. 31 By Insurance Expense a/c……	*1,500*	
To Unexpired Insurance a/c…		*1,500*
Insurance expense for December.		

This reflects cost of insurance coverage expiring in December. This entry, as it was followed regarding shop supplies, transfers to expense that portion of an asset which was **used up** during the period.

3. Depreciation of Buildings:

As we will see, the recording of depreciation expense at the end of an accounting period gives us another example of an adjusting entry which **allocates or apportions a recorded cost.** For example, the **adjusting entry** to record depreciation on **Engineer's** building is the same entry every month throughout the building's

estimated useful (economic) life (20 years). Accordingly, this entry is shown as bellow:

Dec. 31		
By Depreciation Expense: Building	*150*	
To Accumulated Depreciation: Building		*150*
Monthly depreciation on building (L.E.36,000 ÷ 240 months).		

We notice that the monthly depreciation expense is based on the following facts: the building cost **L.E.36,000**, and has an estimated useful life of **20** years (**20 × 12 = 240 mo.**). Under the **Straight-line** method of depreciation, the cost assumed to expire each month is $\frac{1}{240}$ of **L.E.36,000, or L.E.150 (150 × 12 = 1,800 yearly).**

In practice, accountants often use the term *book value or carrying value* to describe the net valuation of an asset in an enterprise's accounting records. Regarding depreciable assets, such as buildings, trucks, cars, and equipment, book value

is equal to the cost of the asset, minus the related amount of accumulated depreciation. In our example and after **Engineer** has posted its December **adjusting entries**, the accumulated depreciation on the building will total **L.E.1,950** (the accumulated depreciation balance of **L.E.1,800** plus the **L.E.150** recognized in December). Hence, the book value of the building is **L.E.34,050** **(L.E.36,000 − L.E.1,950).** Book value is considered important information for accounting purposes. It represents costs that will be offset or matched against the revenue of future periods.

4. <u>Depreciation on Tools and Equipment</u>:

In our illustration, **Engineer** depreciates its tools and equipment over a period of five years (or 6o months), using the **straight-line** method. The December 31 trial balance shows that the enterprise owns tools and equipment which cost **L.E.15,000.**

Thus, the ***adjusting entry*** to record December's depreciation expense is as follows:

Dec. 31
By Dep. Expense a/c: Tools & Equipment 250
To Accumulated Depreciation a/c:
Tools and equipment………………….. 250
Monthly depreciation on tools and Equipment (L.E.15,000 ÷ 60 months = L.E.250/month).

2.3.2 Apportioning unearned revenue:

Commonly, customers may *pay in advance* for services to be rendered (provided) in later accounting periods. In the real world, for instance, **sports clubs**, especially football teams, collects much of their revenue through the sale of season tickets and subscriptions. **Health clubs**, also collect in advance by selling long-term membership contracts. Moreover, **airlines** sell many of their tickets in advance of a scheduled flight.

Accordingly, for accounting purposes, amounts collected in advance against services which will be rendered in the future **do not represent revenue**, because these amounts have ***not yet been earned.*** Therefore, amounts collected from customers in advance are **recorded** by **debiting** the Cash Account and **crediting** an **Unearned Revenue** Account, which also may be called **deferred revenue**.

As such, when an enterprise collects money in **advance** from its customers, it has an **obligation** to render services in the future. Thus, the balance of an **Unearned Revenue Account** is considered to be a **liability;** *it appears in the liability section of the balance sheet, not in the income statement.*

Unearned revenue differs from other liabilities because it usually will be **settled** by rendering services, rather than by making payment in cash. In fact, **unearned revenue** will be *worked off (or*

disposed) rather than **paid off**. Nevertheless, if the business enterprise is **unable** to render the service, of course, it must discharge this liability by refunding money to its customers.

Therefore, when the enterprise renders the services for which customers have paid in advance, it is **disposing or working off** its liability to these customers and is earning the revenue. Thus, at the end of the accounting period, an **adjusting entry** is made to transfer a proper amount from the unearned revenue account to a **revenue account.** Such adjusting entry consists of a **debit** to a *liability account* (unearned revenue account) and a **credit** to a revenue account.

For illustrating these concepts, let us assume that on December 1, **Almadina Company** agreed to rent a space in **Engineer's** building to provide indoor storage for some its Taxis. The agreed-upon rent is **L.E.2,000** per month, and **Almadina Co.**

paid for the first three months in advance. The needed journal entry to record this **accounting transaction** on December 1 was as follows:

Dec. 1 By Cash a/c………………… 6,000
To Unearned Rent Revenue a/c.. 6,000
Collected in advance from Almadina Co.
for rental of storage space for 3 months.

It should be considered that **Unearned Rent Revenue** is a **liability** account. It is **not a revenue account. Engineer** will earn rental revenue **gradually** over a three-month period as it provides storage facilities to **Almadina Co.** At the end of each of these three months, **Engineer** will make an *adjusting entry* which will transfer **L.E.2,000** from the **Unearned Revenue Account** to an **Earned Revenue Account**, which will appear in **Engineer's** income statement. the first in this series of monthly transfers will be made at December 31 as follows:

Dec. 31 By Unearned Rent Revenue a/c 2,000
To Rent Revenue Earned a/c.. 2,000
Part of rent received in advance from Almadina Co. that was earned in December (L.E.6,000 ÷ 3 months).

The above **adjusting entry** shows that some **unearned** revenue has now been **earned.** Hence, after this adjusting entry has been posted, the **Unearned Rent Revenue Account** will have a **L.E.4,000** credit balance. This balance represents **Engineer's** obligation to render **L,E.4,000-worth** of services over the next two months and will appear in the **liability** section of the enterprise's **Balance Sheet**. On the other hand, the **Rent Revenue Earned Account** will appear in **Engineer's Income Statement.**

2.3.3 Recording Unrecorded Expenses:

In a previous section (Section 3.3.1) we knew how to allocate recorded costs which represent

expenditure that was expected to benefit more than one accounting period. But, an **adjusting entry** related to recording unrecorded expenses recognizes expenses that will be paid in **future accounting transactions.** Therefore, no cost has yet been recorded in the accounting records. In practice, **salaries** of employees and **interest** on borrowed money are common examples of expenses which accumulate from day to day, but which usually are not recorded until they are paid. Conventionally, these expenses are said to **accrue** (**grow/accumulate**) over time. So, at the end of the accounting period, an **adjusting entry** is required to record any expenses which have **accrued**, but which have not yet been recorded. Since these expenses will be paid at a future date, the **adjusting entry** consists of a **debit** to an expense account and a **credit** to a liability account.

1. Accrual of Wages or Salaries Expense:

Similar to many business enterprises, **Engineer Auto Service** pays its employees every month. For example, assume that at December 31, **Engineer** owes its employees approximately **L.E.1,950** for work performed in December, **for which employees have not yet been paid.** Accordingly, the following **adjusting entry** should be made to record this amount both as **wages expense** of the current period and as a **liability**:

Dec. 31 By Wages Expense a/c……… 1,950
To Wages (Salaries) Payable a/c 1,950
To record wages owed to employees, but unpaid as of month-end.

As shown above, this **adjusting entry** increases **Engineer's** wages expense for 2019 and also creates a liability (Wages Payable) that will appear in the December 31 Balance Sheet.

On January 1, 2020, **Engineer** will pay its regular payroll. In this case, the entry to record payment is shown below:

2020
Jan. 1 By Wages (Salaries) Payable a/c 1,950
To Cash a/c 1,950
Payment of L.E.1,950 which had been accrued at December 31, 2019.

2. Accrual of Interest Expense:

Assume that on November 30, 2019, **Engineer Auto Service** borrowed **L.E.40,000** from Egyptian National Bank against issuing a note payable . The bank agreement is that this loan is to be repaid in three months (on February 2020), along with interest computed at the annual rate of **9%.** The entry which was made on November 30, 2019, to record this borrowing transaction could be as follows:

Nov. 30 By Cash a/c……………….. 40,000
To Notes Payable a/c…… 40,000

Borrowed cash from National Bank, issuing a 9% L.E.40,000 note payable, due in 3 months.

According to the bank agreement, in February 2020, **Engineer** has to pay the bank **L.E.40,900.** This amount represents the **L.E.40,000** amount borrowed, **plus L.E.900 interest (L.E.40,000 × 9% ×** $\frac{3}{12}$ **).** But, the **L.E.900** interest charge covers a period of **3 months**. Although no payment will be made until February 2020, interest expense is **incurred (born)** at the rate of **L.E.300** per month. Therefore, the following **adjusting entry** is made at December 31 to charge December operations with one month's interest expense and also to record the amount of interest owed to the bank at month-end:

Dec. 31 By Interest Expense a/c………..... 300
To Interest Payable a/c…..... 300
Interest expense accrued during December on note payable (L.E.40,000 × 9% × $\frac{1}{12}$*).*

The above ***adjusting entry*** increases the amount of interest expense recognized during the year from **L.E.3,000** (see the previous unadjusted trial balance) to **L.E.3,300,** the amount which will appear in **Engineer's** 2019 income statement. Additionally, both **L.E.300** in interest payable, and also the **L.E.40,000** note payable to Egyptian National Bank will be shown as ***liabilities*** in December 31 balance sheet, as we will see later.

Furthermore, **Engineer** will make an adjusting entry recognizing another **L.E.300** in interest expense on January 31, 2020. Also, the journal entry in February 2020 to record repayment of this loan, including **L.E.900** in interest charges, will be as below:

2020	
Feb.28 <u>By sundries</u>	
Notes Payable a/c……	*40,000*
Interest Payable a/c (from December and January)	*600*

Interest Expense a/c (February only) 300
To Cash a/c……… 40,900
Repaid L.E.40,000 note payable, to Egyptian National Bank, including L.E.900 in interest charge.

2.3.4 Recording Unrecorded Revenue:

Usually, a business enterprise may earn revenue during the current accounting period but not charge or bill the customer till a future accounting period. Such situation is probably to occur if further services are being performed for the same customer, in which case the bill might not be prepared till all services are completed. However, any revenue which has been **earned but not recorded** during the current accounting period must be recorded at the end of the period by means of an ***adjusting entry***. Such **adjusting entry** consists of a **debit** to an Accounts Receivable and a **credit** to the appropriate revenue account. In such

situations, the term **Accrued Revenue** often is used to describe revenue which has been earned during the accounting period but which has not been recorded prior to the closing date.

For example, assume that in December, **Engineer Auto Service** entered into an agreement to perform routine maintenance on several vans owned by **Almaha Service Co. Engineer** agreed to maintain these vans for a flat (fixed or determined) fee of **L.E.1,500** per month, payable on the fifteenth of each month. Notice that no entry was made to journalize the signing of this agreement, because no services had yet been rendered (offered). **Engineer** started rendering services on **December 15,** but the first monthly payment will not be received until **January 15** of the next year. Thus, **Engineer** should make the following ***adjusting entry*** at December 31 to

record the revenue ***earned*** from **Almaha Service Co.** during the month:

Dec. 31 By Accounts Receivable (Debtors) 750
Or By Accrued Revenue a/c 750.
To Repair Service Revenue a/c 750
To recognize revenue from services rendered on Almaha maintenance contract during December. Account is settled on the 15th of each month.

On the other hand, the collection of the first monthly fee from **Almaha Service Co.** will occur in the next accounting period, January 15. Hence, of this **L.E.1,500** cash receipt, **L.E.750** represents collection of the receivable recorded on December 31; the other **L.E.750** represents revenue earned in January. Therefore, the journal entry to record the receipt of **L.E.1,500** from **Almaha Co.** on January 15 will be as follows:

2020

Jan. 15 By Cash a/c………………… 1,500

To Sundries:

Accounts Receivable (Debtors) 750

Repair Service Revenue a/c 750

Or To Sundries:

Accrued Revenue a/c 750

Repair Service Revenue a/c 750

Collected from Almaha Co. for van maintenance, Dec. 15 to Jan. 15.

From the above, it is noted that the net result of the December 31 ***adjusting entry*** has been to divide the revenue from maintenance of **Almaha Co.'s** vans between December and January in proportion to the services offered during each month.

2.4 The Final Effects of the Adjusting Entries:

Eight of the separate ***adjusting entries*** that **Engineer** will make at December 31 have been discussed. These **adjusting entries** are repeated again, but in the format of general journal entries. **Notice** that **Engineer** also recorded many transactions which occurred throughout the month of December. For the discussion purposes, the enterprise's December transactions are not illustrated now. The following general journal includes only ***adjusting entries*** which are recorded at the end of the accounting period:

General Journal

Date		Account Titles & Explanation	L P	Debit	Credit
2019 Dec.	31	By Supplies Expense a/c…. To Shop Supplies a/c….. Shop supplies used during December.		600	600
	31	By Insurance Expense a/c…. To Unexpired Insurance a/c Insurance expense for Dec.		1,500	1,500
		By Depreciation Expense:			

	31	Building…………………….. To Accumulated Depreciation: Building… Monthly depreciation on building = (L.E.36,000/240).		150	150
	31	By Depreciation Expense: Tools and Equipment……… To Accumulated Depreciation: T & E….. Monthly depreciation on tools and equipment (L.E.1500 ÷ 60 months).		250	250
	31	By Unearned Rent Revenue To Rent Revenue Earned Portion of rent received in advance from Almadina Co. that was earned in December (L.E.6,000 ÷ 3 months)		2,000	2,000
	31	By Wages Expense a/c….. To Wages Payable a/c…. To accrue wages owed to employees, but unpaid as of month-end.		1,950	1,950
	31	By Interest Expense a/c….. To Interest Payable a/c… Interest expense accrued during December on note payable ($40,000 \times 9\% \times 1/12$)		300	300
	31	By Accounts Receivable…… To Repair Service Revenue a/c……………. To recognise revenue from services rendered on Almaha Co. maintenance contract		750	750

		during December.			

After posting these adjustments to the appropriate ledger accounts, **Engineer's** ledger accounts will be updated, except for the balance in the owner's capital account, which will be updated, of course, after the preparation of the financial statements and making closing entries, as we will see next. Moreover, the enterprise's ***adjusted trail balance*** at December 31, 2019, is shown as follows. Notice that those accounts affected by the month-end ***adjusting entries*** are **highlighted** for more emphasis.

ENGINEER AUTO SERVICE
Adjusted Trial Balance
December 31, 2019

Account Titles	**Debit**	**Credit**
Cash……………………………… L.E	*27,950*	
Accounts receivable…………...	***7,250***	
Shop supplies…………………..	***1,200***	
Unexpired insurance………….	***1,500***	
Land………………………………	*52,000*	
Building…………………………	*36,000*	

Accumulated depreciation: building		***1,950***
Tools and equipment……………	*15,000*	
Accumulated depreciation: tools and equipment……………………..		***3,200***
Notes payable………………………		*40,000*
Accounts payable………………….		*2,690*
Unearned rent revenue…………...		***4,000***
Wages payable……………………		***1,950***
Interest payable…………………..		***300***
Ahmed Adel, capital………………		*81,000*
Ahmed Adel, drawing…………….	*44,800*	
Repair service revenue…………...		***162,210***
Rent revenue earned…………….		***2,000***
Advertising expense………………	*3,900*	
Wages expense……………………	***58,750***	
Supplies expense…………………	***7,500***	
Depreciation expense: building…	***1,800***	
Depreciation expense: tools and equipment………………………...	***2,450***	
Utilities expense…………………..	*19,400*	
Insurance expense……………….	***16,500***	
Interest expense………………….	***3,300***	
Total	***299,300***	***299,300***

2.5 Preparing the Financial Statements:

In Chapter One, it was explained that the ***Income Statement, Statement of Owner's Equity and Balance Sheet*** can be prepared *directly from the amounts appeared in the adjusted trial balance*. In order to illustrate which accounts appear in which financial statements, accounts shown in the above adjusted trial balance that relate to each statement are listed below:

Income Statement accounts:

Repair service revenue, rent revenue earned, advertising expense, wages expense, supplies expense, depreciation expense: building, depreciation expense: tools and equipment, utilities expense, insurance expense and, interest expense. *Note*: all of these accounts are **nominal** (or **temporal)** accounts which represent revenue, expense and loss accounts.

Statement of Owner's Equity accounts:

Ahmed Adel Capital: must be updated for transactions recorded in the income statement accounts**; Ahmed Adel drawing.**

Balance Sheet Accounts:

Cash, accounts receivable, shop supplies, unexpired insurance, land, building, accumulated depreciation: building, tools and equipment, accumulated depreciation: tools and equipment, notes payable, accounts payable, unearned rent revenue, wages payable, interest payable and, Ahmed Adel capital. *Note*: all of these accounts are **real and personal** accounts which represent properties and persons' accounts.

Engineer Auto Service's financial statements for the year-ended December **31, 2019** are illustrated below. You will see that the **Income Statement** is prepared first, as the amount of net income appears in the **Statement of Owner's**

Equity. On the other hand, the **Statement of Owner's Equity** determines the amount of owner's capital appearing in the balance sheet.

ENGINEER AUTO SERVICE
Income Statement
For the Year Ended December 31, 2019

Revenue:	**L.E.**	**L.E.**
Repair service revenue………..		162,210
Rent revenue earned…………..		2,000
Total revenue…………….		**164,210**
Expenses:		
Advertising……………………	3,900	
Wages…………………………..	58,750	
Supplies………………………...	7,500	
Depreciation: building………...	1,800	
Depreciation: tools and equipment	2,450	
Utilities…………………………..	19,400	
Insurance………………………..	16,500	
Interest………………………….	3,300	**113,600**
Net income………………………		***50,610***

ENGINEER AUTO SERVICE
Statement of Owner's Equity
For the Year Ended December 31, 2019

Ahmed Adel, capital, Dec. 31, 2019 ……	**L.E.**81,000
Add (Plus): **Net income ………………**	**50,610**
Subtotal ………………………………………	131,610
Less (Minus): Withdrawals ……………...	44,800
Ahmed Adel, capital, Dec. 31, 2019 ……	**86,810**

ENGINEER AUTO SERVICE
Balance Sheet
December 31, 2019

Assets		Liabilities & Owner's Equity	
Cash ………… L.E.	27,950	**Liabilities:** L.E.	
Accounts receivable	7,250	Notes payable….	40,000
Shop supplies ……	1,200	Accounts payable	2,690
Unexpired insurance	1,500	Wages payable	1,950
Land ……………..	52,000	Interest payable	300
Building … 36,000		Unearned rent	
Less: Acc. Dep. 1,950	34,050	revenue	4,000
Office Equip. 15,000		*Total liabilities*	48,940
Less: Acc. Dep. 3,200	11,800	**Owner's equity:**	
		Capital Dec. 31, 19	86,810
Total	**135,750**	***Total***	**135,750**

2.6 Relationship between Adjusting Entries and Accounting Principles:

From the above discussion, it is appeared that adjusting entries are ***tools (means)*** by which accountants apply the *realization* and *matching* principles. By making these entries, <u>revenues</u> are **recognized** as they **earned**, and <u>expenses</u> are **recognized** as the related goods and services are **used**. Also, another generally accepted accounting principle plays an essential role in the making of adjusting entries. This is the concept of *Materiality*.

<u>The Concept of Materiality</u>:

The term <u>materiality</u> refers to the ***relative importance*** of an item or an event. Accordingly, an item is considered to be **material** if knowledge of the item might reasonably <u>*affect (influence) the decisions*</u> of users of financial statements. Therefore, accountants must be sure that all

material items are properly recorded in financial statements.

On the other hand, the concept of materiality gives accountants the freedom to use estimated amounts and even to neglect (ignore) other accounting principles if the results of these applications **don't have a *material effect*** on the financial statements. To this point, the question which imposes itself is that: "**what is the relationship between materiality and adjusting entries?** The answer to this question is that the concept of materiality allows (enables) accountants to minimize (shorten or brief) and simplify the process of making adjusting entries. This can occur in several ways, of which are the following examples:

(1) Business enterprises may purchase a variety of **assets** which will be consumed swiftly in business operations. Examples may include

wastebaskets, light bulbs (lamps), washing-up liquids and stationery. The materiality concept allows (permits) charging or bearing such purchases *directly* to ***expense accounts,*** instead of asset accounts. Such treatment will eliminate the need for an adjusting entry at the end of the accounting period to transfer a portion of these costs from an asset account to expense. This accounting treatment is acceptable as long as the cost of the **unconsumed (unused)** items on hand at the end of the period is considered **immaterial.**

(2) In practice, some expenses, which include, for example, telephone bills and utility bills, may be charged to expense as the bills are **paid,** rather than as the services are used. From the technical aspect, this treatment may violates or does not agree with the ***matching principle.*** Nevertheless, accounting for utility bills on a

cash basis is very appropriate, because the monthly cost of utility service is not known until the utility bill is received. By adopting this "**cash" basis** approach, one month's utility bill is charged to expense each month. But, although the bill charged to expense is actually the *prior or last* month's bill, the resulting **"error"** in the financial statements is not likely to be material.

(3) Adjusting entries to accrue unrecorded expenses or unrecorded revenue may be neglected if the pound amounts are considered to be immaterial.

(4) In addition to the above, if the amount of error is not likely to be material, adjusting entries may be based on ***estimates***. For instance, when apportioning recorded costs it is illustrated an adjusting entry to allocate part of the **L.E.1,800** balance in the **Shop Supplies Account** to expense. The amount of supplies

used during the period, **L.E.600,** was based upon an **estimate** of the supplies that are still on hand, (**1,200**). This **L.E.1,200** estimate is a **professional or educated guess**, as no one actually counts all of the shop supplies on hand and looks up their cost. In addition, the adjusting entry recording accrued **wages payable** also was based on an estimate, not a detailed calculation.

On the other hand, it should be taken into consideration that **materiality is a matter of professional judgment.** That is, whether or not a particular item or event is **material** is a matter of professional judgment. Therefore, when making these judgments, accountants take in their consideration a variety of factors:

First: what is considered to be a **material amount** varies with the size of the organisation. For instance, a **L.E.2,000** expenditure may be material regarding the financial statements of a small

enterprise, but not regarding the financial statements of a large business organisation. As such, there are no official rules in relation to what represents or constitutes a **material amount,** but most accountants would consider amounts of less than **2 or 3%** of *net income* to be **immaterial**, unless there were other factors that must be considered.

Second: the other factor which should be considered is the ***aggregate or cumulative effect*** of various *immaterial* items or events. For example, each of a dozen items may be **immaterial** when considered by itself. However, when viewed together, the *combined effect* of all 12 items may be material.

Finally: the concept of *materiality* greatly depends on the **nature** of the item, in addition to its pound amount. For example, assume that the person who is responsible for managing a business enterprise

systematically has been stealing money from the company. Owners probably would consider this fact important even if the pound amounts were small comparing to the enterprise's total resources.

2.7 Closing the Accounts:

In practice, accountants in some cases use the phrase "***closing the accounts***" to refer to all of the 'year-end' procedures. But technically, closing the accounts describes only one specific step in the **accounting cycle**. This step includes closing (or transferring) the balances of all revenue, expense, and drawing accounts into the owner's capital account. Accordingly, closing accounts is not at all difficult. So, balances are simply transferred from one account to another. As such, the entries to close **Engineer's** revenue and expense accounts, in addition to the owner's drawing account, at December 31, 2019, are presented as follows:

General Journal

Date	Account Titles & Explanation	L P	Debit	Credit
2019	By Sundries:			
Dec.	Repair Service Revenue		162,210	
31	Rent Revenue Earned		2,000	
	To Income Summary a/c			164,210
	To close the revenue			

	accounts.			
31	By Income Summary a/c To Sundries: Advertising Expense a/c Wages Expense a/c Supplies Expense a/c Depreciation Expense: Building ……… Depreciation expense: Tools and Equipment Utilities Expense a/c … Insurance Expense a/c Interest Expense a/c … To close the expense accounts.		113,600	 3,900 58,750 7,500 1,800 2,450 19,400 16,500 3,300
31	By Income Summary a/c To Capital a/c …… To close the Income Summary account.		50,610	 50,610
31	By Capital a/c ……… To Drawing a/c … To close the owner's drawing account.		44,800	 44,800

Furthermore, after posting these entries, the revenue, expense, and drawing accounts will have **zero** balances and be ready for use in measuring the activities of the next year.

2.8 Questions:

TRUE OR FALSE:

For each of the following statements, circle the **T** or the **F** to indicate whether the statement is **True** or **False**.

(1) **T F** In a large business, adjusting entries normally will be required on a daily basis.

(2) **T F** If no errors are made in the daily recording of transactions, adjusting entries are unnecessary at the end of the period.

(3) **T F** Adjusting and closing entries ordinarily do not affect the Cash account.

(4) **T F** A company paid L.E.24,000 cash for an insurance policy providing three years' protection against fire loss. This transaction could properly be recorded by a L.E.24,000 debit to Unexpired Insurance and a L.E.24,000 credit to Cash.

(5) **T F** An adjusting entry to recognize wages payable at year-end causes a decrease in total assets.

(6) **T F** An account entitled Unearned Commission Revenue normally has a credit balance and is classified as a liability account.

(7) **T F** An adjusting entry to recognize that an advance payment from a customer has now been earned will cause an increase in assets.

(8) **T F** The adjusting entry to recognize depreciation affects an expense account and a contra-asset account.

(9) **T F** An expenditure that will benefit several accounting periods may be reported as an expense of the current period if the amount is immaterial.

(10) **T F** The Accumulated Depreciation account has a credit balance and is increased by the year-end adjusting entry for depreciation.

(11) **T F** An adjusting entry to recognize that a fee received in advance has now been earned will cause a decrease in total liabilities.

(12) **T F** The adjusting entry to apportion a recorded cost involves the recognition of revenue.

(13) **T F** Omission of the adjusting entry needed to accrue an unrecorded expense at the end of the period would cause liabilities to be understated.

(14) **T F** The purpose of adjusting entries is to correct errors made in recording transactions during the period.

(15)**T F** Every adjusting entry affects either the amount of revenue or the amount of an expense recognized for the period.

(16)**T F** Every adjusting entry affects both an income statement account and a balance sheet account.

(17)**T F** Adjusting entries to accrue unrecorded expenses such as salaries and interest expense cause an increase in expenses and a corresponding decrease in assets.

(18)**T F** A business must adjust and close its accounts monthly in order to prepare monthly financial statements.

(19)**T F** In the worksheet prepared for a profitable business, the figure for net income will appear in both the Income Statement credit column and the Balance Sheet debit column.

(20)**T F** The balance of the owner's drawing account should appear in the Income Statement debit column of the worksheet.

(21)**T F** In a worksheet prepared at year-end, the number of account titles applicable to the Adjusted Trial Balance columns is usually greater than the number of account titles applicable to the Trial Balance columns.

MULTIPLE CHOICES:

Choose the best answer for each of the following questions and circle the identifying letter.

1. Which of the following activities is ***least*** likely to be limited to “year-end?

- **A** Closing the accounts.
- **B** Drafting notes to accompany the financial statements.
- **C** Recording transactions.
- **D** Undergoing an audit.

2. The accounting period covered by an income statement:

- **A** Is termed “fiscal year” of the business.
- **B** Must cover the same span of time as every other income statement prepared for the business.
- **C** Must be equal in length to the accounting period of another income statement if we wish to compare the operating results shown on each.
- **D** Must coincide with the calendar year.

3. We can compare income of the current period with income of a previous period to determine whether the operating results are improving or declining:

- **A** Only if each accounting period covered is a full year.
- **B** Only if the same accountant prepares the income statement each period.
- **C** Only if the accounting periods are equal in length.
- **D** Only if a manual accounting system is used in both periods.

4. The purpose of adjusting entries is to:

- **A** Prepare the revenue and expense accounts for recording the revenue and expenses of the next accounting period.
- **B** Record certain revenue and expenses that are not properly measured in the course of recording daily routine transactions.
- **C** Correct errors made during the accounting period.
- **D** Update the owner's Capital account for the changes in owner's equity that had been recorded in revenue and expense accounts throughout the period.

5. Ream Office Supplies occupies a rented building and pays L.E.10,000 per month rent on the first day of each month. Under these circumstances:

- **A** The entry to record the monthly rental payment will consist of a debit to Prepaid Rent and a credit to Cash.
- **B** No adjusting entry will be necessary with respect to rent.
- **C** The monthly rent payments should be credited to a liability account.
- **D** The Rent Expense account will have a credit balance of L.E.10,000 at the end of the year.

6. Which of the following is ***not*** a purpose of adjusting entries?

- **A** To prepare the revenue and expense accounts for recording transactions of the following period.
- **B** To apportion the proper amounts of revenue and expense to the current accounting period.
- **C** To establish the proper amounts of assets and liabilities in the balance sheet.
- **D** To accomplish the objective of offsetting the revenue of the period with all the expenses incurred in generating that revenue.

7. Which of the following situations does ***not*** require an adjusting entry at the end of January?

- **A** On January 1, Gad Company purchased delivery equipment with an estimated useful life of five years.

- **B** On January 1, Gad Company began delivery service for a large client who will pay at the end of a three-month period.
- **C** At the end of January, Gad Company pays the custodian (guard) for January office cleaning services.
- **D** On January 1, Gad Company paid rent for six months on its office building.

8. Adjusting entries are needed:

- **A** Whenever revenue is not received in cash.
- **B** Whenever expenses are not paid in cash.
- **C** Only to correct errors in the initial recording of business transactions.
- **D** Whenever transactions affect the revenue or expenses of more than one accounting period.

9. Adjusting entries help achieve the goals of accrual accounting by applying the following two accounting principles:

- **A** Business entity concept and realization principle.
- **B** Cost principle and the accounting equation.
- **C** Realization principle and matching principle.
- **D** Matching principle and safety principle.

10. No adjusting entry should consist of:

- **A** A debit to an expense and a credit to an asset.
- **B** A debit to an expense and a credit to revenue.
- **C** A debit to an expense and a credit to a liability.
- **D** A debit to a liability and a credit to revenue.

11. The entry to record depreciation is an example of an adjusting entry:

- **A** To apportion a recorded cost.
- **B** To apportion unearned revenue.
- **C** To record unrecorded expenses.
- **D** To record unrecorded revenue.

12. XYZ Systems prepares monthly financial statements. XYZ would record a prepaid expense in each of the following situations ***except***:

- **A** XYZ Systems purchased a two-year fire insurance policy.
- **B** XYZ Systems paid for six months' gardening services in advance.
- **C** A tenant paid XYZ Systems three months' rent in advance.
- **D** XYZ Systems purchased enough office supplies to last several months.

13. Which of the following statements is ***not*** true regarding prepaid expenses?

- **A** Prepaid expenses represent assets.
- **B** Prepaid expenses are shown in a special section of the income statement.
- **C** Prepaid expenses become expenses only as goods or services are used up.
- **D** Prepaid expenses appear in the balance sheet.

14. The account Unearned Management Fees would appear in the financial statements as a(n):

- **A** Asset.
- **B** Expense.
- **C** Revenue.
- **D** Liability.

15. The balance of an ***unearned revenue*** account:

- **A** Appears in the balance sheet as a component of owner's equity.
- **B** Appears in the income statement along with other revenue accounts.
- **C** Appears in a separate section of the income statement for revenue not yet earned.
- **D** Appears in the liability section of the balance sheet.

16. In which of the following situations would Apple Company record unearned revenue in ***May?***

- **A** In April, Apple Company received payment from a customer for services that are performed in May.
- **B** Apple Company completes a job for a customer in May; payment will be received in June.
- **C** Apple Company is paid on May 25 for work done in the first two weeks of May.
- **D** Apple Company receives payment in May for work to be performed in June and July.

17. Interest which has accrued during accounting period on a note payable to the bank calls for an adjusting entry consisting of:

- **A** A debit to Interest Expense and a credit to Cash.
- **B** A debit to Notes Payable and a credit to Interest Payable.
- **C** A debit to an asset and a credit to a liability.
- **D** A debit to Interest Expense and a credit to Interest Payable.

18. The adjusting entry to recognize an ***unrecorded expense*** is necessary:

- **A** When an expense is paid in advance.

- **B** When an expense has been neither paid nor recorded as of the end of the accounting period.
- **C** Whenever an expense remains unpaid at the end of an accounting period.
- **D** Because the accountant is likely to forget to pay these unrecorded expenses.

19. In which of the following situations would an adjusting entry be made at the end of January to record ***unrecorded expense***?

- **A** Ali's Firm purchased playground equipment on January 1 with an estimated useful life of six years.
- **B** On January 25, Ali's Firm hired a college student to drive the minibus; the new employee is to begin work in February.
- **C** January 31 falls on a Tuesday; salaries are paid on Thursday of each week.
- **D** On January 31, Ali's Firm paid the interest owed on a note payable for January.

20. As of January 31, Hussein Company owes L.E.6,000 to Rent-It Co. for equipment used during January. If ***no adjustment*** is made for this item at January 31, how will Hussein's financial statements be affected?

- **A** Cash will be overstated at January 31.
- **B** Net income for January will be overstated.

- **C** Owner's equity will be understated.
- **D** The financial statements will be accurate since the L.E.6,000 does not have to be paid yet.

21. The accountant for the Lila Company forgot to make an adjusting entry to record revenue earned but not yet billed to customers. The effect of this error is:

- **A** An overstatement of assets and of net income offset by an understatement of owner's equity.
- **B** An overstatement of net income and an understatement of assets.
- **C** An understatement of assets, net income, and owner's equity.
- D An overstatement of liabilities offset by an understatement of owner's equity.

22. An adjusting entry involving recognition of ***unrecorded revenue*** is necessary at the ***end of March*** in which of the following situations?

- **A** Financial Consultants received payment in February for consulting services rendered in March.
- **B** Financial Consultants began working for a client on March 15; bills will be sent monthly beginning April 15.

- **C** Financial Consultants made payment in January for office rent for the first three months of the year.
- ***D*** On March 31, a major customer paid his bill for a consulting job completed in February.

23. Of the following adjusting entries, which one results in an increase in liabilities and the recognition of an expense at the end of an accounting period?

- **A** The entry to accrue salaries owed to employees at the end of the period.
- **B** The entry to record revenue earned but not yet collected or recorded.
- **C** The entry to record earned portion of rent previously received in advance from a tenant.
- ***D*** The entry to write off a portion of unexpired insurance.

24. Which of the following entries causes an immediate decrease in assets and in net income?

- **A** entry to record depreciation expense.
- **B** The entry to record revenue earned but not yet received.
- **C** The entry to record the earned portion of rent received in advance.
- ***D*** The entry to record accrued wages payable.

25. Which of the following is ***not*** considered an end-of-period adjusting entry?

- **A** entry to record the portion of unexpired insurance which has become expense during the period.
- **B** An entry to record revenue which has been earned but has not yet been billed to customer.
- **C** The entry to record depreciation expense.
- ***D*** An entry to record repayment of a bank loan and to recognize related interest expense.

26. The CPA firm auditing a company found that net income had been overstated. Which of the following errors could be the cause?

- **A** Failure to record depreciation expense for the period.
- **B** No entry made to record purchase of land for cash on the last day of the year.
- **C** Failure to record payment of an account payable on the last day of the year.
- **D** Failure to make an adjusting entry to record revenue which had been earned but not yet billed to customers.

27. After preparing the financial statements for the current year, the accountant closed the owner's drawing account at year-end by debiting Income Summary and crediting the owner's drawing account. What is the effect of this

entry on current-year ***net income*** and the balance in the owner's capital account at year-end?

- **A** Net income is overstated; balance in the owner's capital account is correct.
- **B** Net income is correct; balance in the owner's capital account is correct.
- **C** Net income is understated; balance in the owner's capital account is correct.
- **D** Net income is understated; balance in the owner's capital account is understated.

28. When a business closes its accounts only at year-end:

- **A** Financial statements are prepared only at year-end .
- **B** Adjusting entries are made only at year-end.
- **C** Revenue and expense accounts reflect year-to-date amounts throughout the year.
- **D** Monthly and quarterly financial statements cannot be prepared.

29. When a business adjusts its records monthly, but closes its accounts only at year-end:

- **A** Interim financial statements are prepared using the amounts shown in an adjusted trial balance at the end of the interim period desired.

- **B** Only annual financial statements can be prepared.
- **C** Interim financial statements are prepared by subtracting prior balances from current balances for all accounts.
- **D** The revenue and expense accounts in an adjusted trial balance reflect year-to-date amounts.

30. In which of the following situations would the ***largest*** amount be recorded as an expense of the current year? (Assume accrual basis accounting.)

- **A** L.E.20,000 is paid in January for equipment with a useful life of five years.
- **B** L.E.9,000 is paid in January for a two-year fire insurance policy.
- **C** L.E.50,000 cash is withdrawn by the owner for personal use.
- **D** L.E.5,000 is paid to an attorney for legal services rendered during the current year.

31. An enterprise purchased display shelves on March 1 for L.E.30,000. If this asset has an estimated useful life of five years, what is the ***book value*** of the display shelves on April 30?

- **A** L.E.500.
- **B** L.E.29,000.
- **C** L.E.29,500.

- D L.E.1,000.

32. Video Connection offered books of video rental coupons to its patrons (customers) at L.E.30 per book. Each book contained a certain number of coupons for video rentals. During the current period 1,000 books were sold for L.E.30,000, and this amount was credited to Unearned Rental Revenue. At the end of the period it was determined that L.E.10,000 worth of book coupons had been used by customers to rent videos. The appropriate adjusting entry at the end of the period would be:

- **A** Debit Rental Revenue L.E.20,000 and credit Unearned Rental Revenue L.E.20,000.
- **B** Debit Rental Revenue L.E.10,000 and credit Unearned Rental Revenue L.E.10,000.
- **C** Debit Unearned Rental Revenue L.E.20,000 and Credit Rental Revenue L.E.20,000.
- **D** Debit Unearned Rental Revenue L.E.10,000 and credit Rental Revenue L.E.10,000.

33. Property Management Corporation, which maintains its accounts on the basis of a fiscal year ending June 30, began the management of an office building on June 15 for an agreed monthly fee of L.E.8,000. The first payment is

due on July 15. The adjusting entry required at June 30 is:

- **A** A Debit to Management Fees Receivable for L.E.4,000 and a credit to a revenue account, Management Fees Earned.
- **B** A L.E.4,000 debit to Unearned Management Fees and a L.E.4,000 credit to Management Fees Earned.
- **C** A debit to Cash for L.E.4,000 and a credit to Management Fees Earned.
- **D** A debit to Cash for L.E.8,000 offset by a credit to a revenue account for L.E.4,000 and a liability for L.E.4,000.

34. DCC Co. began providing day care for children of employees of a large corporation on January 15 for an agreed monthly fee of L.E.45,000. The first payment is to be received on February 15. The adjusting entry required by DCC Co. on ***January 31*** includes:

- **A** A credit to Child Care Fees Earned of L.E.22,500.
- **B** A debit to Child Care Fees Receivable of L.E.45,000.
- **C** A debit to Unearned Child Care Revenue of L.E.22,500.
- **D** A debit to Fees Receivable of L.E.45,000.

35. Before any month-end adjustments are made, the net income of Giant Company is L.E.800,000. However, the following adjustments are necessary: Office supplies used, L.E.4,000; services performed for clients but not yet recorded or collected, L.E.25,000; interest accrued on note payable to bank, L.E.6,000. After adjusting entries are made for the items listed above, Giant Company's ***net income would be:***

- **A** L.E.765,000.
- **B** L.E.823,000.
- **C** L.E.815,000.
- **D** L.E.827,000.

36. The accountant for Clear Painting forgot the following two adjustments at the end of 2021:

(a) The entry to record depreciation: L.E.9,000.

(b) The entry to record the portion of fees received in advance which have now been earned: L.E.9,000.

As a result of these two omissions:

- **A** Net income for Clear Painting for 2021 is overstated.
- **B** Net income for Clear Painting for 2021 is understated.

- **C** Assets of Clear Painting are overstated at December 31, 2021.
- **D** Liabilities of Clear Painting are understated at December 31, 2021.

37. Before making month-end adjustments, net income of a company was L.E.980,000 for March. Adjusting entries are necessary for the following items

-Depreciation for the month of March: L.E.21,000.

-Interest accrued to March 31, on deposits in banks: L.E.5,000.

-Supplies used in March: L.E.2,000.

-Fees earned in March that had been collected in advance: L.E.28,000.

After recording these adjustments, net income for March is:

- **A** L.E.980,000.
- **B** L.E.990,000.
- **C** L.E.924,000.
- **D** L.E.984,000.

Use the following data for questions 38 through 42.

Elite Property Management adjusts its books ***each month*** but closes its books at the end of the year.

The trial balance at January 31 ***before adjustments*** is as follows:

	Debit	Credit
Cash ……………. L.E.	83,100	
Accounts Receivable ………	60,000	
Supplies ……………………	7,500	
Prepaid Advertising ……………	18,000	
Equipment ……………………..	144,000	
Accumulated Depreciation: Equipment		50,000
Unearned Management Fees ……		39,000
Owner's Capital …….		124,000
Management Fees Earned…..		175,000
Salaries Expense …….	64,000	
Utilities Expense …….	2,400	
Rent Expense ………..	9,000	
L.E.	388,000	388,000

38. Refer to Elite's unadjusted trial balance above to answer this question. According to property management contracts, L.E.24,000 of the Unearned Management Fees has been earned in January. The amount of Management Fees Earned (revenue) to be reported in the January ***income statement*** is:

- **A** L.E.24,000.
- **B** L.E.151,000.

- **C** L.E.199,000.
- **D** L.E.190,000.

39. ***Refer to Elite's unadjusted trial balance above to answer this question.*** On December 1 of the last year, Elite paid in advance for six months' advertising in the local newspaper. The necessary adjusting entry at January 31 includes which of the following?

- **A** A credit to Prepaid Advertising for L.E.3,600.
- **B** A credit to Prepaid Advertising for L.E.15,000.
- **C** A debit to Advertising Expense for L.E.3,000.
- **D** A debit to Advertising Expense for L.E.14,400.

40. ***Refer to Elite's unadjusted trial balance above to answer this question.*** At January 31, the amount of supplies on hand is L.E.4,100. What amount is reported in the January income statement for ***supplies expense***?

- **A** L.E. 4,100.
- **B** L.E.11,600.
- **C** L.E.7,500.
- **D** L.E.3,400.

41. ***Refer to Elite's unadjusted trial balance above to answer this question***. The equipment had an estimated useful life of six years. Compute the ***book value*** of the equipment at January 31, after the proper January adjustment is recorded.

- **A** L.E. 92,000.
- **B** L.E.144,000.
- **C** L.E.142,000.
- D L.E.70,000.

42. ***Refer to Elite's unadjusted trial balance above to answer this question***. Employees are owed L.E.3,500 for services since the last payday in January, to be paid the first week in February. The amount to be reported in January income statement for ***salaries expense*** is:

- **A** L.E.3,500.
- **B** L.E.67,500.
- **C** L.E.60,500.
- **D** L.E.64,000.

43. On December 31, Cairo Jewellers made an adjusting entry to record L.E.12,000 accrued interest payable on its mortgage. On January 10, the mortgage payment was made. This payment included interest charges of L.E.18,000, L.E.6,000 of which were

applicable to the period from January 1 through January 10. In recording this mortgage payment the accountant should:

- **A** Debit Interest Expense L.E.6,000 and debit Accrued Interest Payable L.E.12,000.
- **B** Debit Interest Expense L.E.18,000.
- **C** Debit Accrued Interest Payable L.E.18,000.
- **D** Debit Interest Expense L.E.6,000 and credit Accrued Interest Payable L.E.18,000.

EXERCISES AND PROBLEMS:

(1) Listed below are 9 technical accounting terms used in explaining this chapter:

Unrecorded revenue, Materiality, Adjusting entries, Accrued expenses, Closing entries, Unearned revenue, Adequate disclosure, Prepaid expenses, and Book value.

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

a. The net amount at which an asset is carried in the accounting records as distinguished from its market value.

b. An accounting concept that may justify departure from other accounting principles for purposes of convenience and economy.

c. The accounting principle intended to assist users in *interpreting* financial statements.

d. Revenue earned during the current accounting period but not yet recorded or billed, which requires an adjusting entry at the end of the period.

e. Entries made at the end of the accounting period to achieve the goals of accrual accounting by recording revenue when it is earned and by recording expenses when the related goods and services are used.

f. A type of account credited when customers pay in advance for services to be rendered in the future.

g. A balance sheet category used for reporting advance payments of such items as insurance, rent, and office supplies.

h. Entries made during the accounting period to correct errors in the original recording of complex transactions.

(2) **Al-Ahly**, a professional football team, prepares financial statements on a monthly basis. In Egypt, football season begins in August, but in July the team engaged in the following transactions:

a. Paid **L.E.1,500,000** to Cairo City as advance rent for use of Cairo Stadium for the five-month period from August 1 through December 31. this payment was debited to the asset account, Prepaid Rent.

b. Collected **L.E.2,560,000** cash from sales of season tickets for the team's 8 home games. This amount was credited to Unearned Ticket Revenue.

During the month of August, **Al-Ahly** played one home game.

Required:

Prepare the two adjusting entries required at August 31 to apportion this recorded cost and recorded revenue.

(3) When Ahmed Enterprise began its business on August 1, it purchased a 1-year fire insurance policy and debited the entire cost of **L.E.7,200** to Unexpired Insurance. Ahmed Enterprise *adjusts* its accounts at the end of each month, and *closes* its books at the end of the year.

***Required*:**

a. Give the **adjusting entry** required at December 31 with respect to this insurance policy.

b. Give the **closing entry** required at December 31 with respect to insurance expense. Assume that this policy is the only insurance policy the enterprise had during the year.

c. Compare the pound amount appearing at the December 31 adjusting entry (part **a**) with that in the closing entry (part **b**). Are the pound amounts the same? Why or why not? Explain.

(4) When ***Egypt Air*** sells tickets for future flights, it debits **Cash Account** and credits an account entitled **Advance Ticket Sales.** With respect to this **Advance Ticket Sales** account:

a. What does the balance of the account represent? Where should the account appear in Egypt Air's financial statements?

b. Explain the activity that normally ***reduces*** the balance of this account. Can you think of any *other* transaction that would reduce this account?

(5) Gold Star Company adjusts its accounts at the end of each month. Prepare the adjusting entries required at December 31 based on the following information. (Notice that not all of these items may require adjusting entries.)

a. A bank loan had been obtained on December 1. Accrued interest on the loan at December 31 amounts to **L.E.1,500.** No interest expense has yet been recorded.

b. Depreciation of office equipment is based on an estimated life of five years. The balance in the **Office Equipment Account** is **L.E.24,000**; no change has occurred in the account during the year.

c. Interest revenue earned on Egypt government bonds during December amounts to **L.E.1,000.** This accrued interest revenue has not been recorded or received as of December 31.

d. On December 31, an arrangement was signed to lease a truck for 12 months beginning January 1 at a rate of **2 pounds** per a kilo Meter. Usage is expected to be **2,000** Kilo per month and the contract specifies a minimum payment equivalent to **18,000** Kilo Meter a year.

e. The company's policy is to pay all employees up-to-date each month. There was a liability to employees at December 31 amounting to **L.E.3,000.**

Assume that **prior** to making December 31 adjusting entries, Gold Star company's net income was **L.E.129,500**. Compute net income **after** December adjustments have been recorded. Show your work.

(6) **Charm El-Sheikh Resort** adjusts its accounts **monthly** and closes its accounts annually. Most guests of the resort pay at the time they check out,

and the amounts collected are credited to **Rental Revenue.** A few guests pay in advance for rooms, and these amounts are credited to **Unearned Rental Revenue** at the time of receipt. The following information is available as a source for preparing adjusting entries at December 31.

a. Salaries earned by employees but not yet recorded or paid amount to **L.E.7,900.**

b. As of December 31, Charm El-Sheikh has earned **L.E.11,075** rental revenue from current guests who will not be billed until they are ready to check out. (Debit Rent Receivable Account – or Accrued Rental Revenue.)

c. On November 1, a suite of rooms was rented to a company for six months at a monthly rental of **L.E.3,200**. The entire six months' rent of **L.E.19,200** was collected in advance and credited to **Unearned Rental Revenue Account.**

d. A limousine to carry guests to and from the airport had been rented beginning December 19 from Transport Rentals, Co., at a daily rate of **L.E.120.** No rental payment has yet been made. (The limousine has been rented for 13 days in December.)

e. A six month loan in the amount of **L.E.30,000** had been obtained on December 1. Interest is to be computed at a rate of **10%** per year and is payable when the loan is due. No interest has been paid and no interest expense has been recorded.

f. Depreciation on the resort's buildings is based upon an estimated useful life of 30 years. The original cost of the buildings was **L.E.1,755,000.** Charm El-Sheikh uses the straight-line method.

g. In December, Charm El-Sheikh resort entered into an agreement to host the annual International Economic Forum in April next year. The resort

expects to earn rental revenue of at least **L.E.90,000.**

h. A 1-year fire insurance policy had been purchased on September 1. The premium of **L.E.7,200** for the entire life of the policy had been paid on September 1 and recorded as Unexpired Insurance.

***Required*:**

(1) For each of the above statements, draft a separate adjusting journal entry (including explanation) if the information indicates that an adjusting entry is needed. One or more of the above statements may not require any adjusting entry.

(2) As of December 31, how much of the L.E.19,200 received on November 1 has been earned by Charm El-Sheikh? Is this amount the same as the amount of revenue recognised in your adjusting entry for item c? Explain.

(7) On January 1, 2020, **Abokrisha**, an attorney, opened his own legal practice, to be known as the Law Office of **Abokrisha.** The business adjusts its accounts at the end of each month. The following trial balance was prepared at January 31, 2020, **after 1 month** of operations:

LAW OFFICE OF ABOKRISHA
Trial Balance
January 31, 2020

Account Titles	**Dr L.E.**	**Cr L.E.**
Cash…………………………………….	10,060	
Legal fees receivable……………………	xx	
Unexpired insurance…………………….	3,000	
Prepaid office rent……………………….	4,800	
Office supplies…………………………..	1,460	
Office equipment………………………..	26,400	
Accumulated depreciation: office equipment……………………………….		xx
Notes payable……………………………		16,000
Interest payable………………………….		xx
Salaries payable…………………………		xx
Unearned retainer fees…………………..		16,020
Abokrisha, capital……………………….		20,000
Abokrisha, drawing……………………...	4,000	
Legal fees earned………………………..		1,580
Salaries expense…………………………	2,680	

Miscellaneous expense………………….	1,200	
Office rent expense…….........................	xx	
Office supplies expense…………………	xx	
Depreciation expense: office equipment..	xx	
Interest expense…………………………	xx	
Insurance expense……………………….	xx	
	53,600	53,600

***Other Data*:**

a. No interest has yet been paid on the note payable. Accrued interest at January 31 amounts to **L.E.180.**

b. Salaries earned by the office staff but not yet recorded or paid amounted to **L.E.3,470** at January 31.

c. Many clients are asked to make an advance payment for the legal services to be rendered in future months. These advance payments are credited to the Unearned Retainer Fees account. During January, **L.E.7,700** of these advances were earned by the business.

d. Some clients are not billed until all services relating to their matter have been rendered. As of

January 31, services priced at **L.E.4,780** had been rendered to these clients but had not yet been recorded in the accounting records.

e. A professional liability insurance policy was purchased on January 1. The premium of **L.E.3,000** for the first six months was paid and recorded as Unexpired Insurance.

f. The business rents an office at a monthly rate of **L.E.1,600.** On January 1, 3 months' rent was paid in advance and charged to the Prepaid Office Rent Account.

g. Office supplies on hand at January 31 amounted to **L.E.1,100.**

h. The office equipment was purchased on January 1 and is being depreciated over an estimated useful life of 10 years.

***Required*:**

(1) Prepare the adjusting entries required at January 31.

(2) Determine the amount of net income to be reported in the enterprise's income statement for the month ended January 31, 2020.

(8) Morad Elbloshi operates a private consulting business called Elbloshi Consultative Office. Some clients are required to pay in advance for the enterprise's services, while others are billed after the services have been rendered. Advance payments are credited to an account entitled Unearned Retainer Fees, which represents unearned revenue. The business adjusts its accounts each month and closes its accounts at the end of each quarter. At March 31, the end of the first quarter, the trial balance appeared as follows:

ELBLOSHI CONSULTATIVE OFFICE
Trial Balance
March 31, 2020

Account Titles	**Dr L.E.**	**Cr L.E.**
Cash…………………………………	17,150	
Fees receivable……………………..	37,800	

Unexpired insurance…………………	1,600	
Prepaid rent………………………….	5,400	
Office supplies………………………	1,050	
Office equipment……………………	17,100	
Accumulated depreciation: office equipment…………………………		5,700
Accounts payable…………………		3,900
Unearned retainer fees……………		24,000
Elbloshi, capital..…………………		45,300
Elbloshi, drawing…………………	3,200	
Fees earned………………………		33,320
Depreciation expense……………	570	
Salaries expense…………………	19,500	
Travel expense………………….	3,400	
rent expense……..........................	3,000	
Office supplies expense…………	450	
Telephone expense………………	1,200	
Insurance expense………………	800	
	112,220	112,220

***Other Data*:**

a. The useful life of the office equipment was estimated at five years.

b. Fees of **L.E.8,400** were earned during the month by performing services for clients who had paid in advance.

c. Salaries earned by employees during the month but not yet recorded or paid amounted to **L.E.1,665.**

d. On March 1, the business moved into a new office and paid the first three months' rent in advance.

e. Consulting services rendered during the month but not yet collected or billed to clients amounted to **L.E.3,900.**

f. Office supplies on hand March 31 amounted to **L.E.700.**

g. On January 1, **L.E.2,400** was paid as the premium for six months' liability insurance.

***Required*:**

(1) Prepare the adjusting entries required at March 31. (Use the straight-line method for depreciation.)

(2) Determine the amount of net income to be reported in the enterprise's income statement for the quarter ended March 31, 2020.

(9) **Sea Fish Firm** operates a large ship which takes tourists at several places in the Red Sea on diving and sailing journeys. The business adjusts its accounts at the end of each month. Selected account balances appearing on the June 30 **adjusted trial balance** are as follows:

Prepaid rent	*L.E.6,000*	
Unexpired insurance	*L.E.1,400*	
Ship	*L.E.46,200*	
Accumulated depreciation: ship		*L.E.9,240*
Unearned passenger revenue		*L.E. 825*

***<u>Other Data</u>*:**

a. The ship is being depreciated over a ten-years estimated useful life, with no residual value.

b. The unearned passenger revenue represents ticks good for future rides sold to a resort hotel for L.E.15 per ticket on June 1. During June, 145 of the tickets were used.

c. Six months' rent had been prepaid on June 1.

d. The unexpired insurance is a 12-month fire insurance policy purchased on March 1.

***Required*:**

A. Determine

1- The age of the ship in months

2- How many L.E.15 tickets for future rides were sold to the resort hotel on June 1.

3- The monthly rent expense.

4- The original cost of the 12-months fire Insurance policy

B. Prepare the adjusting entries which were made on June 30.

(10) On September 1, 2020, Abused Elhelaly organized a business called Safe Truck for the purpose of operating an equipment rental yard. The new business was able to begin operations immediately by purchasing the assets and taking over the location of Rent and Possess It, an equipment rental company that was going out of business. Safe Truck uses the following chart of accounts:

Cash…………………1	Abused Elhelaly, Capital…….30
Accounts Receivable 4	Abused Elhelaly, Drawing……35
Prepaid Rent…...........6	Income Summary……………..40
Unexpired Insurance 7	Rental Fees Earned……………50
Office Supplies……. 8	Salaries Expense………………60
Rental Equipment... 10	Maintenance Expense……..….61
Accumulated Depreciation:	
Rental Equipment…12	Utilities Expense……..……...62
Notes Payable……...20	Rent Expense…………….........63
Accounts Payable….22	Office Supplies Expense………..64
Interest Payable…...25	Depreciation Expense:
Salaries Payable…...26	Rental Equipment…..…………..65
Unearned Rental Fees 29	Interest Expense……………...66

The business closes its accounts and prepares financial statements at the end of each month. During September, the enterprise entered into the following transactions:

Sept. 1 Abused Elhelaly deposited **L.E.100,000** cash in a bank account in the name of the business, Safe Truck.

Sept. 1 Paid **L.E.9,000** to Santawy Realty as three months' advance rent on the rental yard and office formerly occupied by Rent and Possess It.

Sept. 1 Purchased for **L.E.180,000** all the equipment formerly owned by Rent and Possess It. Paid **L.E.70,000** cash and issued a one-year note payable for **L.E.110,000**, plus interest at the annual rate of **9%.**

Sept. 4 Purchased office supplies on account from Modern Office Co., **L.E.1,630.** Payments due in 30 days. (These supplies are expected to last for several months; debit the Office Supplies asset account.)

Sept. 8 Received **L.E.10,000** cash from Bahgat Construction Co. as advance payment on rental equipment.

Sept. 12 Paid salaries for the first two weeks in September, **L.E.3,600.**

Sept. 15 Excluding the Bahgat advance, equipment rental fees earned during the first 15 days of September amounted to **L.E.6,100,** of which **L.E.5,300** was received in cash.

Sept. 17 Purchased on account from Earth Good, Inc., **L.E.340** in parts needed to repair a rental tractor. Payment is due in 10 days.

Sept. 23 Collected **L.E.210** of accounts receivable recorded on September **15.**

Sept. 25 Rented a backhoe to Mission Landscaping at a price of **L.E.100** per day, to be paid when the backhoe is returned. Mission Landscaping expects to keep the backhoe for about two or three weeks.

Sept. 26 Paid biweekly salaries, **L.E.3,600.**

Sept. 27 Paid the account payable to Earth Good, Inc., **L.E.340.**

Sept. 28 Abozeid Elhelaly withdrew **L.E.2,000** cash from the business to pay the rent on his personal residence.

Sept. 29 Purchased a 12-month public-liability insurance policy for **L.E.2,700.** This policy protects the business against liability for injuries

and property damage caused by its equipment. However, the policy goes into effect on October 1.

Sept. 30 Received a bill from Universal Utilities for the month of September, **L.E.270.** Payment is due in 30 days.

Sept. 30 Equipment rental fees earned during second half of September and received in cash amounted to **L.E.8,450.**

***Data for Adjusting Entries*:**

a. The advance payment of rent on September 1 covered a period of three months.

b. Interest accrued on the note payable to Rent and Possess It amounted to **L.E.825** at September 30.

c. The rental equipment is being depreciated by the straight-line method over a period of 10 years.

d. Office supplies on hand at September 30 are estimated at **L.E.1,100.**

e. During September, the business earned **L.E.4,840** of the rental fees paid in advance by Bahgat Construction Co. on September 8.

f. As of September 30, Safe Truck has earned five day's rent on the backhoe rented to Mission Landscaping on September 25.

g. Salaries earned by employees since the last payroll date (September 26) amounted to **L.E.900** at month-end.

***Required*:**

a. Journalize the above transactions.

b. Post to ledger accounts.

c. Prepare an income statement and a statement of owner's equity for the month of September, and a balance sheet as of September 30.

d. Prepare adjusting and closing entries and post to ledger accounts.

e. Prepare an after-closing trial balance as of September 30.

CHAPTER THREE
FINANCIAL STATEMENT ANALYSIS
AND
THE STATEMENT OF CASH FLOWS

CHAPTER THREE

FINANCIAL STATEMENT ANALYSIS AND THE STATEMENT OF CASH FLOWS

3.1 Introduction:

Practically, the chief objective of accounting is to provide economic decision makers with ***useful information***. Accordingly, the aim of this chapter is to perceive how decision makers may use the information contained in financial statements to obtain knowledge or insight into a firm's financial position, profitability, and future prospects. The application in this chapter will concentrate primarily to businesses organized as ***corporations.*** Accordingly, the main objectives that may be covered in this chapter include (Meigs et. Al, 1996):

1. Explain the nature and purpose of classification in financial statements.

2. Prepare a classified balance sheet. Compute widely used measures of liquidity and credit risks.

3. Interpret and evaluate financial ratios and measurements.

4. Explain owners' personal liability for the debts of a business.

5. Prepare a multiple-step and a single-step income statement.

6. Compute widely used measures of profitability.

7. Describe the purpose, content, and format of a statement of cash flows.

3.2 Financial Statements' Designing:

In their nature, financial statements are designed to help users in identifying key relationships and trends. The financial statements of majority publicly owned companies are ***classified***, and are presented in ***comparative form***. Often, the word ***consolidated*** appears in the heading of the statements. Users of financial statements must have a clear understanding of such terms.

Most business organizations prepare ***classified financial statements***. This means that items with certain characteristics are placed together in a group, or ***classification.*** The idea behind of these classifications is to *develop useful subtotals* which will assist users of the statements in their analyses. Conventionally, these classifications and subtotals are standardized throughout most of business organizations. Such practice assists decision

makers in comparing the financial statements of different companies.

In comparative financial statements, the financial statement amounts ***for several years*** appear side by side in vertical columns. This helps investors in identifying and evaluating significant changes and trends.

Most large corporations *own other companies* through which they conduct some of their business activities. A corporation which owns other businesses is the **parent company**, and the owned companies are called **subsidiaries**. Consolidated financial statements present the financial position and operating results of the parent company and its subsidiaries **as if they were a single business organization**.

3.3 Measures of Liquidity and Credit Risks:

A number of ratios and other computations used in financial statement analysis will be introduced in the following sections of this chapter. Most of these computations are used in evaluating either ***liquidity and credit risk***, or ***profitability***.

In essence, measures of liquidity and credit risk are primarily of interest to *creditors* of the organization. However, equity investors too have an interest in a company's liquidity. If a company becomes ***insolvent*** (غير قادرة علي السداد), it may be forced into ***bankruptcy*** (الإفلاس). Eventually, the company may have to cease operations and sell its assets to satisfy the claims of creditors. Such a sequence of events may greatly reduce, or perhaps eliminate, the owners' equity in the company.

The most common measures of liquidity (or solvency) are developed from a **classified**

balance sheet. These include the current ratio, quick ratio, and amount of a company's working capital.

A Classified Balance Sheet:

In a classified balance sheet, ***assets*** usually are presented in three groups: (1) current assets, (2) plant and equipment, and (3) other assets. Liabilities are classified into two categories: (1) current liabilities and (2) long-term debt. A classified balance sheet of a company appears as follows:

XYZ COMPANY
Balance Sheet
December 31, 2021

Assets		**L.E.**	**L.E.**
Current assets:			
Cash…………………………			300,000
Marketable securities………..			110,000
Notes receivable…………….			50,000
Accounts receivable…………			600,000
Inventory…………………….			700,000
Prepaid expenses…………….			40,000
Total current assets………..			***1,800,000***
Plant and equipment:			
Land…………………………		1,510,000	
Building……………………..	1,200,000		

Less: Accumulated depreciation 90,000	1,110,000	
Sales fixtures & equipment… 450,000		
Less: Accumulated depreciation 270,000	180,000	
Total plant and equipment…..		***2,800,000***
Other assets:		
Land held as a future building site		1,700,000
Total assets……………………...		***6,300,000***
Liabilities & Stockholders' Equity		
Current liabilities:		
Notes payable (due in six months).		100,000
Accounts payable……………….		620,000
Income taxes payable…………...		130,000
Added value taxes payable……..		30,000
Accrued expenses payable……..		80,000
Unearned revenue & customer deposits		40,000
Total current liabilities……….		***1,000,000***
Long-term liabilities:		
Mortgage payable (due in 10 years)		1,100,000
Total liabilities……………………		***2,100,000***
Stockholders' equity:		
Capital stock (15,000 shares issued and outstanding)…………………………..	1,500,000	
Retained earnings……………………	2,700,000	
Total stockholders' equity…………...		***4,200,000***
Total liabilities & stockholders' equity		***6,300,000***

The classifications **current assets** and **current liabilities** are especially useful in evaluating the short-term liability (or solvency) of the business entity.

Current Assets Current assets are relatively ***liquid*** resources. This group includes cash, investments in marketable securities, receivables, inventories, and prepaid expenses. Of course, to qualify as a current asset, an asset must be capable of *being converted into cash* within a relatively short period of time, without interfering with normal business operations.

Practically, the time period in which current assets are expected to be converted into cash usually is one year. If a company needs more than a year to complete its normal operating cycle, however, the ***length of the operating cycle*** determines current assets. In essence, the time period used in defining current assets is one year or the length of the operating cycle, whichever is ***longer***. Most business organizations have an operating cycle far shorter than one year. Nevertheless, companies that sell merchandise on

long-term installment contracts, or that manufacture products such as ships, may have an operating cycle of several years. The user of financial statements should consider that certain current assets are less liquid as the length of the operating cycle increases.

Inventory and accounts receivable normally qualify as current assets, even if these assets require more than one year converting into cash.

In a balance sheet, current assets are listed in order of liquidity. This meaning that the closer an asset is to becoming cash, the greater its liquidity. Hence, cash always is listed first among the current assets, followed by investments in marketable securities, receivables, inventory, and prepaid expenses. Actually, prepaid expenses do not ***convert*** into cash, but they ***substitute*** for cash by eliminating the need to make certain future cash outlays or expenditures.

Current Liabilities Current liabilities are ***existing debts*** which must be paid within the same time period used in defining current assets. Furthermore, these debts are expected to be paid from current assets or by rendering services. Among the most common current liabilities are notes payable, which are due within one year, accounts payable, unearned revenue, and accrued expenses, such as income taxes payable, salaries payable, or interest payable. In the balance sheet, notes payable usually are listed first, followed by accounts payable; other types of current liabilities may be listed in any sequence.

The ***relationship*** between current assets and current liabilities is more important than the total pound amount in either category. Current liabilities must be paid in the near future, and the cash to pay these liabilities normally comes from current assets. Accordingly, decision makers evaluating

the solvency of a business often compare the relative amounts of current assets and current liabilities.

Current Ratio:
The most widely used measure of short-term debt-paying ability is the **current ratio** (معدل التداول). This ratio is calculated by dividing total current assets by total current liabilities. In the above illustrated balance sheet, current assets amount to L.E.1,800,000 and current liabilities total L.E.1,000,000. Accordingly, company's current ratio is ***1.8 to 1***, computed as follows:

Current assets……………………………...	***L.E.1,800,000***
Current liabilities…………………………..	***L.E.1,000,000***
Current ratio (L.E.1,800,000 ÷ L.E.1,000,000)	***1.8 to 1***

A current ratio of 1.8 to 1 indicates that the company's current assets are 1.8 times as large as its current liabilities.

The ***higher*** the current ratio, the more solvent the company appears to be. Many bankers and other short-term creditors traditionally have believed that a retailer should have a current ratio of at least 2 to 1 to qualify as a good credit risk. By this standard, ***XYZ*** Company comes up a little short; the company might ***not*** receive a top credit rating from a bank or other short-term creditor.

Evaluating Financial Ratios:

Users of financial statements must be cautioned ***towards*** placing much confidence in rules or measures; such as ***a current ratio should be at least 2 to 1.*** to interpret any financial ratio properly, the decision makers must first understand the characteristics of the company and the industry in which it operates.

For instance, retailers tend to have higher current ratios than do wholesalers or manufacturing companies. In effect, Businesses which render

services and have no inventory, generally have lower current ratios than merchandising or manufacturing companies. However, large businesses with good credit ratings and reliable sources of revenue are able to operate with lower current ratios than are small companies.

On the other hand, although a high current ratio is one indication of strong debt-paying ability, an extremely high ratio-such as 4 or 5 to 1-may indicate that *too much* of the company's resources are tied up in current assets. In maintaining such a highly liquid position, the company may be using its financial resources inefficiently.

Standards for Comparison Financial analysts generally use two criteria in evaluating the reasonableness of a financial ratio. One criterion is the ***trend*** in the ratio over a period of years. By reviewing this trend, analysts are able to determine whether a company's performance or financial

position is improving (يتحسن) or deteriorating (يتدهور). Second, analysts often compare a company's financial ratios with those of ***similar companies***, and also with ***industry-wide averages.*** Such comparisons assist analysts in evaluating a specific ratio in light of the company's current business environment.

Annual Reports Publicly owned corporations issue ***general purpose annual reports*** providing a great deal of information about the company. For instance, annual reports include comparative financial statements that have been audited by a firm of independent public accountants. They also include preceding years' ***summaries*** of key financial data, and ***management's discussion and analysis*** of the company's operating results, liquidity, and financial position. In this section of the report, management identifies and discusses

favorable and unfavorable trends, and events that may affect the company in the future.

Industry Information Financial information regarding ***entire industries*** is available through a number of financial publications and on-line computer database.

Usefulness and Limitations of Financial Ratios A financial ratio expresses or shows the relationship of one amount to another. Most users of financial statements find that certain ratios help them in quickly evaluating the financial position, profitability, and future prospects of a business. A comparison of key ratios for several successive years usually indicates whether the business is becoming stronger or weaker. Furthermore, ratios provide a means of comparing quickly the financial strength and profitability of different companies.

Nevertheless, users of financial statements should recognize that ratios have several

limitations. Management, for example, may enter into legitimate year-end transactions which temporarily improve key ratios. This process is called ***window dressing*** (تحريف الحقائق لإعطاء صورة خادعة عن الوضع المالي).

For example, the balance sheet of XYZ Company includes current assets of L.E.1,800,000 and current liabilities of L.E.1,000,000, including a current ratio of ***1.8 to 1.*** What would happen if shortly before year-end, management used L.E.200,000 of the company's cash to pay accounts payable? This transaction would reduce current assets to L.E.1,600,000 and current liabilities to L.E.800,000. Nevertheless, it would also increase the company's year-end current ratio to a more impressive ***2 to 1*** (L.E.1,600,000 ÷ L.E.800,000).

Financial statement ratios contain the same limitations as do the pound amounts used in financial statements. For example, most assets are

valued at historical costs rather than current market values. In addition, financial statement ratios express only ***financial*** relationships. They give no indication of a company's progress in achieving nonfinancial goals, such as improving customer satisfaction or creating new jobs. A thorough analysis of investment opportunities involves more than merely calculating and comparing financial ratios.

Actually, ***no ratio tells the whole story.*** A high current ratio does not guarantee solvency, and a low current ratio does not necessarily mean that bankruptcy is near. A ratio focuses upon only ***one aspect*** of a company's financial picture. There may be other factors which are of great importance to the company's future.

Briefly, ratios are useful tools, but they can be interpreted properly only by individuals who

understand the characteristics of the company and its environment.

Quick Ratio:

Inventory and prepaid expenses are the ***least liquid*** of the current assets. In a business with a long operating cycle, it may take many months to convert inventory into cash. Therefore, some short-term creditors prefer the ***quick ratio*** (معدل التداول السريع) to the current ratio as a measure of short-term solvency.

The quick ratio compares only the ***most liquid*** current assets-named **quick assets**-with current liabilities. Quick assets include cash, marketable securities, and receivables-the current assets which can be transferred or converted most quickly into cash. XYZ Company's quick ratio at the end of 2021 is ***1.06 to 1***, computed as follows:

Quick assets (cash, marketable securities, and receivables………...........	***L.E.1,060,000***
Current liabilities…………………………..	***L.E.1,000,000***

Quick ratio (L.E.1,060,000 ÷ L.E.1,000,000)	***1.06 to 1***

Traditionally, a quick ratio of 1 to 1 is considered satisfactory. Quick ratios are especially useful in evaluating the solvency of companies that have inventories of slow-moving merchandise (such as real estate), or inventories which have become excessive in size.

Working Capital:

Working capital (رأس المال العامل) is another measurement often used to express the relationship between current assets and current liabilities. ***Working capital*** is the ***excess*** of current assets over current liabilities. XYZ Company's working capital amounts to L.E.800,000, computed as follows:

Current assets…………………………….	***L.E.1,800,000***
Less: Current liabilities…………………...	***L.E.1,000,000***
Working capital…………………………...	***L.E. 800,000***

The amount of working capital that a company needs to remain solvent varies with the size of the organization and the nature of its business activities. In essence, a company with current liabilities in excess of its current assets has a ***negative*** amount of working capital. Negative working capital ***does not*** necessarily mean that a company is insolvent. Any company with a current ratio of less than 1 to 1 has a negative amount of working capital. An analyst familiar with the nature of a company's operations usually can determine from the amount of working capital whether the company is in a sound financial position or is heading for financial difficulties.

Debt Ratio:

If a business fails and must be liquidated, the claims of creditors take priority over those of the owners. But if the business has accumulated a great deal of debt, there may not be enough assets even

to make full payment to all creditors. A basic measure of the safety of creditors' claims is the ***debt ratio*** (معدل الديون), which states total liabilities as a ***percentage*** of total assets. A company's debt ratio is computed by dividing total liabilities by total assets, as presented below for XYZ Company:

Total liabilities……………………………...	***L.E.2,100,000***
Total assets……..…………………………..	***L.E.6,300,000***
Debt ratio (L.E.2,100,000 ÷ L.E.6,300,000)	***33⅓%***

The debt ratio is not a measure of short-term liquidity. Rather, it is a measure of creditors' long-term ***risk.*** The smaller the portion of total assets financed by creditors, the smaller the risk that the business may become unable to pay its debts. From the creditors' point of view, the **lower** the debt ratio, the **safer** their position. The financial analyst must be familiar with industry

characteristics. For example, banks have very high debt ratios-usually over 90%.

The Owners' Responsibility for Debts of a Business:

Conventionally, accountants view a business entity as separate from the other economic activities of its owners, regardless of how the business is organized. The law, nevertheless, draws an important distinction between ***corporations*** and ***unincorporated*** business organizations. Users of financial statements should understand this legal distinction, as it may affect both creditors and owners.

Under the law, the owners of unincorporated businesses (sole proprietorships and partnerships) are ***personally liable*** for any and all debts of the business organization. Accordingly, creditors of unincorporated businesses often base their lending decisions upon the solvency of the ***owners***, rather

than the financial strength of the business entity. As discussed in another chapter, in a ***limited*** partnership, only the ***general partners*** are personally responsible for the debts of the business. Every limited partnership must have one or more general partners.

On the other hand, if a business is organized as a corporation, the owners (stockholders) are ***not*** personally responsible for the debts of the business. Creditors may look ***only to the business entity*** in seeking payment of their claims. Therefore, the solvency of the business entity becomes much more important if the business is organized as a corporation.

3.4 Measures of Profitability:

Measures of a company's **profitability** are of interest primarily to equity investors and management, and are drawn from the income statement. The measures that will be discussed in this chapter include percentage changes, gross profit rates, operating income, net income as a percentage of sales, earnings per share, return on assets, and return on equity.

Classifications in the Income Statement:

Practically, an income statement may be prepared in either the ***multiple-step*** or the ***single-step*** format. The multiple-step income statement is more useful in illustrating accounting concepts, and has been used in all of presented illustration. A multiple-step income statement for XYZ Company is shown below:

XYZ COMPANY
Income Statement
For the Year Ended December 31, 2021

Net sales ………………………. L.E.			***9,000,000***
Less: Cost of goods sold (including transportation-in)			***5,400,000***
Gross profit …………………………			***3,600,000***
Less: Operating expenses:			
Selling expenses:			
Sales salaries and commissions.	648,000		
Advertising …………………….........	420,000		
Delivery services …………………	142,000		
Depreciation: store equipment……	90,000		
Other selling expenses……………	60,000		
Total selling expenses…………..		1,360,000	
General & administrative expenses:			
Administrative & office salaries…...	930,000		
Utilities…………………………….	31,000		
Depreciation: building…………….	30,000		
Other general & administrative expenses……………………………	49,000		
Total general & administrative expenses…………………………		1,040,000	
Total operating expenses……………			***2,400,000***
Operating income……………………			***1,200,000***
Less (add): Nonoperating items:			
Interest expense ……………………	120,000		
Purchase discounts lost…………….	12,000		
Interest revenue ……………………	(32,000)		***100,000***
Income before income taxes………..			***1,100,000***
Income taxes expense………………			***380,000***
****Net income…………………………***			***720,000***
Earning per share…………………..			***L.E.48***

This income statement also is ***classified,*** meaning that revenue and expenses have been classified into several categories.

Multiple-Step Income Statements:

Actually, a multiple-step income statement draws its name from the ***series of steps*** in which costs and expenses are deducted from revenue. As a first step, the cost of goods sold is deducted from net sales to determine the subtotal ***gross profit.*** As a second step, operating expenses are deducted to obtain a subtotal called ***operating income*** (or income from operations). As a final step, income taxes expense and other *nonoperating* items are taken into consideration to arrive at ***net income***.

It should be noticed that the income statement is divided into four sections: (1) revenue, (2) cost of goods sold, (3) operating expenses, and (4) nonoperating items. Multiple-step income

statements are noted for their numerous sections and the development of significant subtotals.

The Revenue Section In a merchandising company, the revenue section of the income statement usually contains only one line, entitled **net sales.** (Other types of revenue, if any, appear in the final section of the statement.)

Of course, investors and managers are vitally interested in the ***trend*** in net sales. As one means of evaluating this trend, they often compute the percentage change in net sales from year to year. A ***percentage change*** is the pound amount of the change in a financial measurement, expressed as a percentage. It is computed by dividing the pound amount of increase or decrease by the pound amount of the measurement ***before*** the change occurred. (Pound changes ***cannot*** be expressed as percentages if the financial statement amount in the

earlier period is zero, or has changed from a negative amount to a positive amount.)

In the prevailing economy, most prices increase over time. The average increase in prices during the year is called the ***rate of inflation.*** Because of inflation, a company's net sales may increase slightly from year to year even if the company is not selling greater amounts of merchandise. If a company's physical sales volume is increasing, net sales usually will grow ***faster*** than the rate of inflation.

If a company's sales grow faster than the ***industry average***, the company increases its ***market share***-that is, its share of total industry sales. Publicly owned corporations include in their annual reports schedules summarizing key operating data-such as net sales-for a period of five or ten years.

The Cost of Goods Sold Section The second section of a merchandising company's income statement shows the cost of goods sold for the period. Cost of goods sold usually appears as a single pound amount, which includes such incidental items as transportation-in and normal shrinkage losses.

Gross Profit: A key Subtotal In a multiple-step income statement, gross profit appears as a subtotal. This makes it easy for users of the income statement to compute the company's ***gross profit margin*** (or gross profit rate).

The gross profit rate is gross profit expressed as a ***percentage of net sales.*** In 2021, XYZ earned an average gross profit rate of ***40%***, calculated as follows:

Pound amount of gross profit …….……..L.E.3,600,000
Net sales ……..…………………………....L.E.9,000,000
Gross profit rate (L.E.3,600,000 ÷ L.E.9,000,000) 40%

In evaluating the gross profit margin of a particular company, the analyst should consider the rates earned in prior periods, and also the rates earned by ***other companies*** in the same industry. For most merchandising companies, gross profit rates usually lie between 20% and 50%, depending upon the types of products sold. These rates usually are lowest on fast-moving merchandise, such as groceries, highest on specialty and novelty products.

Under normal circumstances, a company's gross profit margin tends to remain ***reasonably stable*** from one period to the next. Significant changes in this rate may provide investors with an early indication of changing consumer demand for company's products.

The Operating Expense Section Operating expenses are incurred for the purpose of *producing revenue*. Generally, these expenses are subdivided

into the classifications of ***selling expenses*** and ***general and administrative expenses***. Subdividing operating expenses into functional classifications aids management and other users of statements in separately evaluating different aspect of the company's operations. For example, selling expenses often rise and fall in concert or consistency with changes in net sales. On the other hand, administrative expenses usually remain more constant or stable from one period to the next.

Operating Income: Another Key Subtotal Some of the revenue and expenses of a business stem from activities other than the company's basic operations. Prevailing or common examples include interest earned on investments and income taxes expense.

Operating income (or income from operations) shows the relationship between revenue earned from customers and expenses incurred in

producing this revenue. In essence, operating income measures the profitability of a company's **basic business operations** and *leaves out* other types of revenue and expenses.

Nonoperating Items Revenue and expenses which are not directly related to the company's primary business activities are listed in a final section of the income statement following the determination of operating income. Two significant ***nonoperating items*** are interest expense and income taxes expense. Interest expense emerges from the manner in which assets are *financed*, not the manner in which these assets are used in business operations. Income taxes expense is not included among the operating expenses because paying income taxes ***does not help to produce revenue***. Nonoperating revenues, such as interest and dividends earned on investments, also are listed in this final section of the income statement.

Net Income Most equity investors consider net income (or net loss) to be the most important figure in the income statement. This amount represents the overall increase (or decrease) in owners' equity resulting from all business activities during the period. Practically, financial analysts often compute net income as a ***percentage of net sales*** (net income divided by net sales). This measurement provides an indication of management's ***ability to control expenses***, and to retain a reasonable portion of its revenue as profit.

The ***normal*** ratio of net income to net sales varies greatly by industry. In some industries, companies may be successful by earning a net income equal to only 2 or 3% of net sales. In other industries, net income may amount to as much as 20 or 25% of net sales revenue. In 2021, XYZ Company's net income amounts to ***8%*** of net sales, which is very good for a retailer.

Net income ……………………..……..……...L.E.720,000
Net sales …….……………………………...L.E.9,000,000
Net income as a percentage of net sales.
….(L.E.720,000 ÷ L.E.9,000,000) ….………. 8%

Earnings Per Share:

Normally, ownership of a corporation is evidenced by ***shares*** of capital stock. What does the net income of a corporation mean to someone who owns, for example, 100 shares of a corporation's capital stock? To assist individual stockholders in relating the corporation's net income to ***their ownership shares***, large corporations compute earning per share, and show these amounts at the bottom of their income statements. Earnings per share are net income, expressed on a per share basis. For instance, the balance sheet of XYZ Company indicates that the company has 15,000 shares of capital stock outstanding. Assuming these shares had been outstanding all year, earnings per share amounts to ***L.E.48:***

Net income ……………………….……..……...L.E.720,000
Shares of capital stock outstanding……..   15,000
Earnings per share (L.E.720,000 ÷ 15,000 shares)L.E.48

Earnings per share are perhaps the most widely used of all accounting ratios. The ***trend*** in earnings per share-and the expected earnings in future periods-are ***major factors*** affecting the market value of a company's shares.

Price-Earnings Ratio:

Financial analysts express the relationship between the market price of a company's stock and the underlying earnings per share as a **price-earning ratio** (or P/E ratio). This ratio is computed by dividing the current market price per share of the company's stock by annual earnings per share.

For illustration, assume that at the end of 2021, XYZ Company's capital stock is trading among investors at market price of ***L.E.720*** per share. The

p/e ratio of the company's stock is computed as follows:

Current market price per share of stock.........	***L.E.720***
Earnings per share (for the last 12 months)...	***L.E. 48***
Price-earnings ratio (L.E.720 ÷ L.E.48)…….	***15***

Technically, this ratio is ***15 to 1***. But it is common practice to omit the ***to 1***, and merely to describe a P/E ratio by the first number. The P/E ratios of many publicly owned corporations are quoted daily in the financial pages of newspapers.

The P/E ratio reflects ***investor's expectations*** concerning the company's ***future performance***. The more optimistic these expectations, the higher the P/E ratio are likely to be. In today's market, stocks of financially sound companies with stable earnings usually sell at between 12 and 15 times earnings. If investors anticipate rapid earnings growth, p/e ratios rise into the twenties, thirties, or even higher. A p/e ratio of 10 or less usually

indicates that investors expect earnings to ***decline*** from the current level. (A p/e ratio cannot be computed for a period in which the company incurs a net loss.)

If earnings decline to ***very low levels***, the price of the stock usually does not follow the earnings *all the way down.* Hence, a company with ***very low earnings*** is likely to have a ***high P/E ratio*** even if investors are not optimistic about future earnings.

Single-Step Income Statement:

Many publicly owned corporations present their financial statements in a highly condensed format. For this reason, the ***single-step*** income statement is widely used in annual reports.

The single-step form of income statement takes its name from the fact that all costs and expenses are deducted from total revenue in a single step. No subtotals are shown for gross profit or for operating income, although the statement provides investors

with enough information to compute these subtotals on their own. The 2021 income statement of XYZ Company appears below in a single-step format:

XYZ COMPANY Income Statement For the Year Ended December 31, 2021		
Revenue:	**L.E**	***L.E.***
Net sales ……………………………..		*9,000,000*
Interest earned ………………………		*32,000*
Total revenue ………………………		*9,032,000*
Less: Costs and expenses:		
Cost of goods sold…………………...	*5,400,000*	
Selling expenses ……………………	*1,360,000*	
General & administrative expenses..	*1,040,000*	
Interest expense ……………………	*120,000*	
Purchase discounts lost…………….	*12,000*	
Income taxes expense………………	*380,000*	
Total costs and expenses …………		*8,312,000*
**Net income…………………………*		*720,000*
Earnings per share…………………		*L.E.48*

Evaluating the Adequacy of Net Income:

The question which imposes itself is that: How much net income must a business earn to be considered successful? Obviously, the pound amount of net income that investors consider

adequate depends upon the ***size of the business***. An annual net income of L.E.16 million might seem impressive for an automobile dealership, but would represent very poor performance for a company the size of General Motors Egypt.

Investors usually consider two factors in evaluating a company's profitability: ***(1)*** the trend in earnings, and ***(2)*** the amount of current earnings in relation to the amount of resources needed to produce the earnings.

Most investors regard the ***trend*** in earnings from year to year as more important than the amount of net income in the current period. Equity investors stand to benefit from the company's performance over the long-run. Years of steadily increasing earnings may increase the value of the stockholders' investment many fold.

In evaluating the current level of earnings, many investors use ***return on investment*** analysis.

Return on Investment:

A basic purpose of accounting is to assist decision makers in efficiently allocating and using economic resources. In deciding where to invest their money, equity investors want to know how efficiently companies utilize resources. The most common method of evaluating the efficiency with which financial resources are employed is to compute the ***rate of return*** earned on these resources. This rate of return is called the ***return on investment***, or ***ROI.***

Mathematically, computing the return on investment is a simple concept: the annual return (or profit) generated by the investment is stated as a ***percentage*** of the average amount invested throughout the year. The basic idea is illustrated by the following formula:

Return on investment (ROI) = $\frac{\text{Re}\textit{turn}}{\textit{AverageAmountInvested}}$

The return is earned ***throughout*** the period. Accordingly, it is logical to express this return as a percentage of the ***average*** amount invested during the period, rather than the invested at year-end. The average amount invested usually is computed by adding the amounts invested as of the beginning and end of the year, and dividing this total by 2.

Practically, the concept of ROI is applied in many different situations, such as evaluating the profitability of a business, a branch location, or a specific investment opportunity. As a result, a number of variations in the basic ROI ratio have been developed, each suited to a particular type of analysis. These ratios differ in the manner in which ***return*** and ***average amount invested*** are defined. Tow common applications of the ROI concept will be introduced: **return on assets** and **return on equity**.

Return on Assets (ROA):

Return on assets' ratio is used in evaluating whether management has earned a reasonable return with the assts under its control. In this calculation, *return* usually is defined as **operating income**, since interest expense and income taxes are determined by factors other than the manner in which assets are used. The ***return on assets*** is computed as follows:

$$\textbf{Return on assets (ROA)} = \frac{Operating Income}{Average Total Assets}$$

Now, the return on assets earned by the management of XYZ Company in 2021 is determined. Operating income, as shown in the income statement presented in the preceding sections amounts to ***L.E.1,200,000.*** Assume that XYZ Company's assets at the beginning of 2021 totalled L.E.5,700,000. The preceding illustrated balance sheet shows total assets of L.E.6,300,000

at year-end. Hence, the company's ***average*** total assets during the year amounted to ***L.E.6,000,000*** (L.E.5,700,000 + L.E.6,300,000 ÷ 2). The return on assets in 2021 is ***20%***, determined as follows:

$$\frac{Operating Income}{Average Total Assets} = \frac{L.E.1,200,000}{L.E.6,000,000} = \mathbf{20\%}$$

In the real world, most successful businesses earn a return on average total assets of, maybe, 15% or more. Accordingly, businesses must pay interest rates of between 6% and 12% in order to borrow money. If a business is well-managed and has good future prospects, management certainly should be able to earn a return on assets that is higher than the company's cost of borrowing.

Return on Equity (ROE):

In general, the return on assets measures the efficiency with which management has utilized the assets under its control, regardless of whether these assets were financed with debt or equity capital. On

the contrary, the ***return on equity*** ratio looks only at the return earned by management on the stockholders investment–that is, upon ***owners' equity***.

The ***return*** to stockholders is the ***net income*** of the business. Therefore, return on equity is computed as follows:

Return on equity (ROE) = $\frac{Net Income}{Average Total Stockholders' equity}$

Returning to the 2021 financial statements of XYZ Company, the company earned net income of ***L.E.720,000***. The year-end balance sheet shows total stockholders' equity of L.E.4,200,000. To complete required computation, it will be assumed that the stockholders' equity at the ***beginning*** of the year amounted to L.E.3,800,000. Therefore, the ***average*** stockholders' equity for the year amounts to ***L.E.4,000,000*** {(L.E.3,800,000 +

L.E.4,200,000) ÷ 2}. The return on stockholders' equity in 2021 is ***18%***, computed as follows:

$$\frac{Net Income}{Average Total Stockholders' equity} = \frac{L.E.720,000}{L.E.4,000,000} = \mathbf{18\%}$$

Traditionally, stockholders have expected to earn an average annual return of perhaps 12% or more from equity investments in large, financially strong companies. Annual returns on equity of 30% or more are not uncommon, especially in rapidly growing companies with new or highly successful products.

The return on equity may be higher or lower than the overall return on assets, depending upon how the company has financed its assets, and upon the amounts of its nonoperating revenue and expenses. A company that suffers a net loss provides its stockholders with a ***negative*** return on stockholders' equity.

3.5 Introduction to the Statement of Cash Flows:

In addition to an income statement, statement of retained earnings, and balance sheet, a complete set of financial statements includes a ***statement of cash flows***. The basic purpose of the statement of cash flows is to provide information about a company's ***cash receipts*** and ***cash payments*** during the accounting period. The term ***cash flows*** describe both cash receipts (inflows) and cash payments (outflows). In this illustration, cash ***outflows*** are designated by brackets around the pound amount.

An example of a statement of cash flows appears below.

XYZ COMPANY
Statement of Cash Flows
For the Year Ended December 31, 2021

	L.E.	L.E.
Cash flows from operating activities:		
Cash collected from customers…………….	8,905,000	
Interest received…………………………......	5,000	
Cash receipts from operating activities	……………	**8,910,000**
Payments to suppliers and employees……..	(7,725,000)	
Interest paid………………………………..	(125,000)	
Income taxes paid…………………………..	(250,000)	
Cash payments for operating activities	……………	**(8,100,000)**
Net cash provided by operating activities	……………	**810,000**
Cash flows from investing activities:		
Payments to purchase marketable securities..	(80,000)	
Receipts from sales of marketable securities.	40,000	
Payments to acquire plant assets………….	(170,000)	
Receipts from disposals of plant assets……	30,000	
Net cash used for investing activities……..	....	**(180,000)**
Cash flows from financing activities:		
Proceeds from borrowing………………….	100,000	
Payments of amounts borrowed…………....	(290,000)	
Proceeds from issuance of capital stock…..	80,000	
Dividends paid to stockholders……………	(320,000)	
Net cash used in financing activities……..	……………	**(430,000)**
Net increase in cash during the year……..	……………	**200,000**
Cash, December 31, 2020 (per balance sheet)……………………………………	……………	**100,000**
Cash, December 31, 2021 (per balance sheet)……………………………………	……………	**300,000**

Cash Flows Are Not "Account Balances" You will notice that the cash flows in this statement are identified by ***descriptive captions***, rather than by ledger account titles. The majority of businesses design their chart of ledger accounts to measure revenue and expenses, rather than cash flows. Although the different types of cash flows are not recorded in separate ledger accounts, they can be computed easily at the end of accounting period. The present goal of this introduction to the statement of cash flows is to explain the general ***content*** and ***format*** of the cash flow statement.

Classifications of Cash Flows:

In this financial statement, cash flows are classified according to the ***nature of the underlying business activity.*** The three basic classifications are: ***operating activities, investing activities,*** and ***financing activities.***

Operating Activities The operating activities section shows the *cash effects* of revenue and expense transactions. For illustrating the difference between **revenue and expenses** and the **cash effects** of the underlying transactions, a sale on account is considered. In the income statement, a credit sale is recognized as revenue when the sale occurs. The ***cash effect*** of a credit sale occurs at a later date-when cash is collected from the customer. Similar timing differences often exist between the recognition of an expense and the related cash payment.

Briefly, an income statement measures the ***"profitability"*** of business operations ***without regard to when cash is received or paid.*** The operating activities section of a cash flow statement provides additional information about the company's operations by showing the related cash receipts and cash payments. Cash flows from

operating activities are presented in a direct method format.

The concept of ***operating activities*** in the statement of cash flows differs from that of ***operating income*** in an income statement. In the income statement, ***operating income*** includes only the revenue and expenses relating to the company's ***primary business activities.*** In the statement of cash flow, however, ***operating activities*** include the cash effects of ***all types*** of revenue and expense transactions, including interest and income taxes.

Investing Activities Investing activities are the cash flows emerging from purchases and disposals of plant assets and/or investments.

Financing Activities Financing activities include most of the cash flows between an organization and ***(1)*** its owners (stockholders), and ***(2)*** creditors who ***lending money*** to the business. Notice that payments to creditors who provide

goods or services to the business usually are viewed as the *"cash effects of expense transactions"* and, therefore, are classified as ***operating activities.*** This reasoning applies to ***interest payments***, which are classified as operating activities, rather than financing activities. Typical sources of cash from investing activities include the proceeds from borrowing or from issuance of stock. Common cash outlays include repayment of amounts borrowed (but not including interest payments) and dividends paid to stockholders.

Net Cash Flows:

The term ***net cash flow*** refers to a category of cash receipts ***less any related cash outlays.*** A statement of cash flows includes ***subtotals*** showing the net cash flow of each category of business activity.

Relationship Between Cash Flows and the Balance Sheet The last three lines of cash flow

statement reconcile the net cash flow for the period with the amounts of cash appearing in the company's balance sheets. This reconciliation ***"proves"*** that the cash flow statement ***explains fully*** the change in the amount of cash owned from one balance sheet date to the next. It is noticed that the *"bottom line"* of XYZ Company's cash flow statement is the amount of cash appearing in the year-end balance sheet.

The Critical Importance of Cash Flow from Operating Activities In the long run, a business *must* generate a positive net cash flow from its operating activities if it is to survive. A business with negative cash flows from operating activities will not be able to raise cash indefinitely from other sources. Creditors and stockholders quickly tire of investing in companies that do not generate positive cash flows from their business operations.

As the net cash flow from operating activity remains after payment of ordinary expenses and operating liabilities, it is considered a key measure of liquidity.

Cash Flows from Investing and Financing Activities It is ***not*** important for the net cash flows from investing or financing activities to be positive in any given year. In effect, many successful businesses usually report ***negative*** net cash flows for these activities. Purchases of plant assets require cash disbursements. Therefore, growing businesses usually report ***negative*** net cash flows from investing activities.

Major financing transactions, such as borrowing, the issuance of capital stock, or the payment of a large loan, occur infrequently. In any given year, many companies engage in none of these transactions. When they do, a single transaction is likely to determine whether the

financing activities cash flow for the entire year is positive or negative.

Nevertheless, many successful corporations pay ***dividends*** on a regular basis. In the absence of other financing transactions, dividend payments cause many successful companies to report negative net cash flows from their financing activities.

The Usefulness of Cash Flows' Information:

The logical question which imposes itself is that: who uses information about cash flows? Outsiders, in the form of investors and creditors, use the statement of cash flows primarily for evaluating the ***solvency*** of a business. By studying the cash flow statement for a series of years, they gain insight into such questions as:

- Is the company becoming more or less solvent?

- Do operating activities consistently generate enough cash to assure prompt payment of operating expenses, maturing liabilities, interest obligations, and dividends?
- Do operating activities also generate enough cash to finance growth and/or create a likelihood of increases in the dividends paid to stockholders?
- Is the company's ability to generate cash from operating activities improving or deteriorating?

In the short run, solvency and profitability may be *independent* of one another. That is, even a profitable business may run out of cash and become insolvent. On the other hand, an unprofitable business may remain solvent for years if it has vast or huge resources or borrowing ability. In assessing the future prospects of any business organization, equity investors should

evaluate both the company's profitability and its solvency. Creditors, especially short-term creditors, often attach greater importance to solvency than to profitability.

Management's Interest in Cash Flows:

In fact, no group of decision makers is more interested in a company's cash flows than management. Management is responsible for keeping the business solvent and for using resources efficiently. ***Cash budgets*** (الموازنات النقدية) are accounting reports specifically designed to assist management in meeting these responsibilities.

Cash Budgets Cash budgets are ***forecasts of the cash flows expected to occur in future periods***. In preparing or developing these budgets, accountants work closely with departmental managers throughout the business organization. Forecasting future cash flows involves forecasting the future

levels of all types of operating, investing, and financing activities.

Cash budgets are similar to statements of cash flows in that both reports reflect cash receipts and payments. Nevertheless, these reports differ in several important ways. The basic differences are summarized in the following table:

Statement of Cash Flows	***Cash Budget***
*A formal financial statement, distributed to decision makers outside of the organization. *Reflects the actual results of past cash transactions.	*Not a financial statement; used only by decision makers within the organization. *Shows the expected results of future cash transactions.
*Summarizes the overall cash flows of the entire business entity for a period of one year.	*Shows in detail the cash flows expected from each department within the business, usually on a monthly basis.

Management uses cash budgets both in planning future operations and in evaluating past performance. The process of preparing the budget makes management aware of the cash flows likely to occur in future periods. If cash shortages appear

likely, management is forewarned and has an opportunity to take preventive actions.

As each period progresses, the accounting department gathers information about the ***actual*** cash flows taking place. Detailed comparisons are made between the actual cash flows and the previously budgeted amounts. Management uses these comparisons as one means of evaluating departmental performance and the effectiveness of business strategies.

Summary of Analytical Measurements:

The financial ratios and other measurements presented in this chapter, in addition to their significance, are summarized in the following table:

Ratio or Other Measurement	Method of Computation	Significance
Liquidity measures: *Current ratio	$\frac{CurrenAssets}{CurrentLiabilities}$	*A measure of short-term debt paying ability.
*Quick ratio	$\frac{QuickAssets}{CurrentLiabilities}$	*A measure of short-term debt paying ability.
*Working capital	Current assets – Current liabilities	*A measure of short-term debt paying ability.
*Net cash provided by operating activities	Appears in the statement of cash flows	*Indicates the cash generated by operations *after* allowing for cash payment of expenses and operating liabilities.
Measure of long-term credit risk: *Debt ratio	$\frac{TotalLiabilities}{TotalAssets}$	*A measure of creditors' long-term risk.
Profitability measures: *Percentage change	$\frac{PoundAmountofChange}{FinancialStatement\ amountInTheEarlierYear}$	*The ***rate*** at which an amount is increasing or decreasing.
*Gross profit rate	$\frac{PoundGrossProfit}{NetSales}$	*A measure of the profitability of the company's products.
*Operating income	*Gross profit – Operating expenses	*The profitability of a company's **"basic"** business activities.
*Net income as a percentage of net sales	$\frac{NetIncome}{NetSales}$	*An indicator of management's ability to control costs.
*Earnings per share	$\frac{NetIncome}{AverageNumberof\ SharesOutstanding}$	*Net income applicable to each share of capital stock.
*Return on assets	$\frac{OperatingIncome}{AverageTotalAssets}$	*A measure of the productivity of assets, regardless of how the assets are financed.
*Return on equity	$\frac{NetIncome}{AverageTotalEquity}$	*Rate of return earned upon the stockholders' equity in the business.
Measure of investors' expectations: *Price-earnings ratio	$\frac{PershareMarketStockPrice}{EarningsPerShare}$	*A measure of investors' enthusiasm about the company's future prospects.

Financial Analysis and Stock Price:

Assume that a corporation has rapidly increasing net sales and earnings, and also earns high returns on assets and stockholders' equity. Is its stack a ***"good buy"*** at the present price? Maybe; but maybe not. Stock prices, like p/e ratios, are a ***measure of investors' expectations.*** A company may be highly profitable and growing fast. But if investors had expected even better performance, the market price of its stock may decline. Similarly, if a troubled company's losses are smaller than expected, the price of its stock may rise.

In financial circles, evaluating stock price by looking at the underlying profitability of the company is termed ***fundamental analysis.*** This approach to investing works better in the long run than in the short run. In the short run, stock prices can be significantly affected by many factors,

including short-term interest rates, current events, fads (بدع أو هوس), and rumors (إشاعات). But in the long run, good companies increase in value.

To sum up, successful investing requires more than an understanding of accounting concepts. It requires experience, judgment, patience, and the ability to absorb some losses. And good luck helps a lot. But knowledge of accounting concepts is invaluable to the long-term investor-and it reduces the risk of ***"getting burned."***

3.6 Questions:

TRUE OR FALSE:

For each of the following statements, circle the **T** or the **F** to indicate whether the statements are **True** or **False**.

(1) **T F** The basic purpose in preparing classified financial statements is to develop various subtotals which will assist users of these statements.

(2) **T F** Comparative financial statements show side-by-side financial data for two or more companies.

(3) **T F** Consolidated financial statements report the results of two or more corporations as if they were a single business entity.

(4) **T F** The inventory of a grocery store is a current asset, but the inventory of shipbuilder is not.

(5) **T F** The current ratio of a merchandising company is always higher than its quick ratio.

(6) **T F** Service businesses tend to have higher current ratios than do merchandising companies.

(7) T F A company with a current ratio of less than 1 to 1 is insolvent.

(8) T F The debt ratio is a measure of working capital.

(9) T F The owners of a corporation are personally responsible for the debts of the business.

(10) T F A single-step and multiple-step income statement differ in form but not in the amount of net income reported.

(11) T F A company whose sales are growing at less than the rate of inflation may actually be selling ***less*** merchandise every year.

(12) T F A company may be increasing its market share even if net sales are ***declining***.

(13) T F Net income stated as a percentage of sales is one means of evaluating a company's ability to control its expenses.

(14) T F A company whose future earnings are expected to rise substantially is likely to have a higher p/e ratio than a company whose future earnings are expected to decline.

(15) T F It is unlikely that a company with extremely low earnings will have a high p/e ratio.

(16) T F The return on assets ignores how the assets of the business have been financed. The return on equity, on contrast, takes financing costs-and also income taxes- into consideration.

(17) T F The return on equity may be either higher or lower than the return on assets.

(18) T F Publicly owned corporations prepare a statement of cash flows instead of an income statement.

(19) T F A statement of cash flows is organized into two basic sections: cash receipts and cash payments.

(20) T F In the long-run, it is more important to generate net cash inflows from operating activities than from financing activities.

(21) T F A successful and growing business often reports negative cash flows-that is, a net ***use*** of cash-from its investing activities.

(22) T F A business is profitable when total holdings of cash and cash equivalents increase; the business is unprofitable when these holdings decline.

(23) T F A cash budget focuses upon expected future cash flows, whereas a statement of cash

flows summarizes transactions that already have occurred.

(24) T F The primary advantage of financial ratios is that they eliminate the need for developing an understanding of the company and the environment in which operates.

(25) T F Financial analysis is better suited to predicting short-term fluctuations in stock price than long-run trends.

MULTIPLE CHOICE:

Choose the best answer for each of the following questions and circle the identifying letter.

1. The term ***classified financial statements*** refers:

- **A** To the financial statements of all companies working on government projects.
- **B** Only to the financial statements of general contractors working on special projects.
- **C** To financial statements prepared for use by management, but not for distribution outside of the organization.
- **D** To financial statements in which items with certain characteristics are placed together in a group in an effort to develop useful subtotals.

2. *Comparative* financial statements compare the company's current statements with:

- **A** Those of prior periods.
- **B** Those of other companies in the same industry.
- **C** Those of the company's principal competitor.
- **D** The budgeted level of performance for the period.

3. ***Consolidated*** financial statements:

- **A** Combine in one statement the revenues, expenses, and cash flows of the organization.
- **B** Present the financial position and operating results of a parent company and its subsidiaries as if they were a single organization.
- **C** Present only limited aspects of the company's financial position and/or its operating results.
- **D** Cover an accounting period of two or more years.

4. The measures most often used in evaluating solvency-the current ratio, quick ratio, and amount of working capital-are developed from amounts appearing in the:

- **A** Balance sheet.
- **B** Income statement.
- **C** Statement of retained earnings.
- **D** Statement of cash flows.

5. The basic purpose in preparing ***classified*** financial statements is to:

- **A** Aid management in controlling expenses.
- **B** Develop useful subtotals which will assist users of the statements in their analysis of the company's financial position, profitability, and future prospects.
- **C** Create a balance sheet which measures the profitability of the business as well as its financial position.
- **D** Determine that the amounts shown in the financial statements are in agreement with the company's subsidiary ledgers.

6. In a ***classified*** balance sheet, the asset categories usually include:

- **A** Cash and noncurrent assets.
- **B** Current assets and noncurrent assets.
- **C** Current assets, plant and equipment, and "other" assets.
- **D** Operating assets and nonoperating assets.

7. The current ratio:

- **A** Is computed by dividing current assets by current liabilities.
- **B** Is computed by subtracting current liabilities from current assets.
- **C** Remains unchanged throughout the operating cycle.
- **D** Is a measure of short-term profitability.

8. In evaluating a particular company's current ratio, which of the following is the ***least*** important consideration?

- **A** Whether the ratio exceeds 2:1.
- **B** The trend in the ratio in recent periods.
- **C** The "normal" current ratio for companies of this size and operating in this industry.
- **D** Characteristics of the company and the industry in which it operates.

9. Financial ratios for entire industries:

- **A** Are not relevant to an investor who is evaluating one particular company.
- **B** Would be useful, but are not available because an industry is not an entity that issues financial statements.
- **C** Are useful and available, but only to investors able and willing to obtain the annual report of every company in the industry.
- **D** Are readily available to all investors through a number of financial publications and data-base services.

10. The quick ratio:

- **A** Is computed by dividing current assets by current liabilities.
- **B** Is always higher than the current ratio.
- **C** Cannot be higher than the current ratio.
- **D** May be higher or lower than the current ratio.

11. Short-term creditors are most likely to use the quick ratio instead of the current ratio in evaluating the solvency of a company with large, slow-moving:

- **A** Plant and equipment.
- **B** Receivables.
- **C** Inventories.
- **D** Employees.

12. Working capital:

- **A** Is computed by dividing current assets by current liabilities.
- **B** Is computed by subtracting current liabilities from current assets.
- **C** Remains unchanged throughout the operating cycle.
- **D** Is equal to cash plus total owners' equity.

13. Which of the following transactions would cause a change in the amount of a company's working capital?

- **A** Collection of an account receivable.
- **B** Payment of an account payable.
- **C** Borrowing cash over a 90-day period.
- **D** Selling merchandise at a price above its cost.

14. The debt ratio indicates the percentage of:

- **A** Total assets financed by long-term mortgage.
- **B** Revenue consumed by interest expense.

- **C** Total assets financed by creditors.
- **D** Total liabilities classified as current.

15. The debt ratio is used primarily as a measure of:

- **A** Short-term liquidity.
- **B** Creditor's long-term risk.
- **C** Profitability.
- **D** ROI.

16. Owners assume greater ***personal*** liability for the debts of:

- **A** Large corporations.
- **B** Small corporations.
- **C** Unincorporated businesses.
- **D** Companies with debt ratios over 50%.

17. All of the following captions or subtotals are typical of a multiple-step income statement ***except for***:

- **A** Net sales.
- **B** Gross profit.
- **C** Total costs and expenses.
- **D** Operating income.

18. Assume that National Department store's net sales are increasing at a rate ***above the industry average,*** but ***well below the rate of inflation.*** It appears that:

- **A** National's market share is increasing, although the company is selling less merchandise.
- **B** National's market share is decreasing, although the company is selling more merchandise.
- **C** National's market share is increasing and the company is selling more merchandise.
- **D** National's market share is decreasing and the company is selling less merchandise each year.

19. The gross profit rate represents:

- **A** Total sales revenue.
- **B** The percentage change in net sales from the prior period.
- **C** The percentage of sales revenue remaining after providing for the cost of the merchandise sold.
- **D** Net income stated as a percentage of total sales revenue.

20. A rising gross profit rate most strongly suggests:

- **A** An increase in physical sales volume.
- **B** Strong consumer demand for the company's products.
- **C** Intense competition.
- **D** Increased short-term solvency.

21. The highest gross profit rates usually are earned by companies that:

- **A** Sell fast-moving merchandise, such as groceries.
- **B** Sell specialty or novelty items.
- **C** Face the most intense competition.
- D Sell merchandise at the lowest prices.

22. Assume that net sales are increasing faster than the rate of inflation, and that the company's gross profit rate is rising. Of the following, the most logical conclusion is that:

- **A** The company's cost of purchasing merchandise is rising rapidly.
- **B** Operating expenses are falling.
- **C** Demand for the company's products is very strong.
- D The company has achieved an increase in sales volume by reducing its sales prices.

23. Assume that net sales are increasing faster than the rate of inflation, and that the company's gross profit rate is falling. The most likely explanation is:

- **A** The company's cost of purchasing merchandise is falling.
- **B** Operating expenses are rising.
- **C** Demand for the company's products is very strong.

- D The company has achieved an increase in sales volume by reducing its sales prices.

24. In a multiple-step income statement, which of the following would be classified as an operating expense?

- **A** Depreciation expense.
- **B** Cost of goods sold.
- **C** Income taxes expense.
- D Interest expense.

25. In a multiple-step income statement, interest expense usually is not classified as an operating expense because interest charges:

- **A** Do not contribute to the production of revenue.
- **B** Stem from the manner in which assets are financed, not the manner in which they are used in business operations.
- **C** Relate directly to the cost of goods sold.
- D The statement is incorrect. Interest usually is classified as an operating expense.

26. In a multiple-step income statement, income taxes are not classified as operating expenses because:

- **A** Income taxes do not contribute to the production of revenue.

- **B** Income taxes emerge from the manner in which assets are financed, not the manner in which they are used in business operations.
- **C** Not all forms of business organization are subject to income taxes.
- D The statement is incorrect; income taxes are classified as operating expense.

27. Assume that for several years, the net income of Delta-Beans (DB) has been rising as a percentage of the company's net sales. Analysts normally would interpret this to mean that:

- **A** DB's sales volume has been declining.
- **B** DB has been successful in efforts to control expenses.
- **C** DB's net sales are increasing faster than the rate of inflation.
- D The portion of DB's total assets financed by creditors is decreasing.

28. Return on investment computations are used in evaluating:

- **A** Solvency.
- **B** Profitability.
- **C** Gross profit.
- D Whether a ratio is improving or deteriorating over time.

29. The financial ratio intended to measure the effectiveness with which management has utilized the resources of the business, regardless of how these resources are finances, is:

- **A** Gross profit rate.
- **B** Current ratio.
- **C** Return on assets.
- D Return on equity.

30. The return on assets usually is computed as:

- **A** Net sales divided by average total assets.
- **B** Gross profit divided by average total assets.
- **C** Operating income divided by average total assets.
- D Net income divided by average total assets.

31. The return on equity usually is computed as:

- **A** Net income divided by average total assets.
- **B** Operating income divided by average total stockholders' equity.
- **C** Gross profit divided by average total stockholders' equity.
- D None of the above answers is correct.

32. The measurement which best reflects ***investors' expectations*** about ***future*** earnings is:

- **A** Earnings per share.
- **B** Return on assets.
- **C** The price/earnings ratio.

- D Return on equity.

33. A statement of cash flows is intended to provide information about the:

- **A** Profitability of operating, investing, and financing activities.
- **B** Cash receipts and cash payments during the period.
- **C** Cash receipts and cash payments budgeted for an upcoming period.
- D Transactions affecting a particular bank account.

34. A statement of cash flows is ***not*** intended to assist investors in evaluating:

- **A** The profitability of the business.
- **B** The sources of cash receipts and the purpose of cash expenditures.
- **C** The company's ability to meet its obligations as they come due and to pay dividends.
- D The solvency of the business.

35. In a statement of cash flows, cash transactions are classified into three basic categories. Which of the following is ***not*** one of these three categories?

- **A** Operating activities.
- **B** Spending activities.
- **C** Investing activities.

- D Financing activities.

36. In the long-run, it is most important for a business to generate a positive cash flow from its:

- **A** Investing activities.
- **B** Financing activities.
- **C** Operating activities.
- D None of these answers is correct-in terms of generating a positive cash flow, these activities are of equal importance.

37. A successful and growing business is most likely to report a ***negative*** cash flow in its:

- **A** Operating activities.
- **B** Transactions with customers.
- **C** Financing activities.
- D Investing activities.

38. In a statement of cash flows, payments as interest are classified as:

- **A** Non-operating expense.
- **B** Operating activities.
- **C** Investing activities.
- D Financing activities.

39. In a statement of cash flows, payments of dividends to stockholders are classified as:

- **A** Operating activities.
- **B** Investing activities.

- **C** Financing activities.
- D None of the above-dividends payments are reported in the statement of retained earnings, not the statement of cash flows.

40. If a retail store has a current ratio of 2½ to 1 and current assets of L.E.750,000, the amount of working capital is:

- **A** L.E.300,000.
- **B** L.E.1,125,000.
- **C** L.E.600,000.
- D L.E.450,000.

41. The Titanic Company has working capital of L.E.600,000 and a current ratio of 3 to 1. The amount of current assets is:

- **A** L.E.1,800,000.
- **B** L.E.1,200,000.
- **C** L.E.900,000.
- D L.E.600,000.

42. During the years 2019 through 2021 Beach House Ltd. reported the following amounts of net income (pounds in thousands):

2021	**2020**	**2019**
L.E.1200	L.E.1000	L.E.800

Relative to the prior year, the ***percentage change*** in net income:

- **A** Was the same in 2020 and 2021.
- **B** Was larger in 2021 than in 2020.
- **C** Was smaller in 2021 than in 2020.
- D Cannot be determined without knowing how many shares of stock were outstanding.

Use the following data for questions 43 through 46.

Shown below are selected data from the balance sheet of Amine Hardware, a small retail store (pound amounts are in thousands):

Cash……………………………	L.E. 200
Accounts receivable……………	1,000
Inventory………………………	1,950
Total assets……………………..	4,500
Current liabilities……………….	1,500
Non-current liabilities…………..	1,200

43. Refer to the above data. The quick ratio is:

- **A** .133 to 1.
- **B** .8 to 1.
- **C** 1.25 to 1.
- D Some other amount.

44. Refer to the above data. The current ratio is:

- **A** .48 to 1.
- **B** .8 to 1.
- **C** 1.25 to 1.
- D Some other amount.

45. Refer to the above data. Working capital amounts to:

- **A** Minus L.E.300,000.
- **B** L.E.1,650.
- **C** L.E.1,800.
- D Some other amount.

46. Refer to the above data. Amine's debt ratio is:

- **A** 33%.
- **B** 300%.
- **C** 60%.
- D Some other amount.

Use the following data for questions 47 through 50.

Shown below are selected data from the balance sheet of Happy Day Auto Parts, a small retail store (pound amounts are in thousands):

Cash……………………………	L.E. 500
Accounts receivable……………	2,500
Inventory………………………	3,000
Total assets……………………..	10,000
Current liabilities……………….	2,500
Non-current liabilities…………..	2,000

47. Refer to the above data. The quick ratio is:

- **A** 5%.
- **B** 1.2 to 1.

- **C** 20%.
- D Some other amount.

48. Refer to the above data. The current ratio is:

- **A** 1.2 to 1.
- **B** Less than 2 to 1, but not 1.2 to 1.
- **C** 2.4 to 1.
- D More than 2 to 1, but not 2.4 to 1.

49. Refer to the above data. Working capital amounts to:

- **A** L.E.3,500.
- **B** L.E.3,000.
- **C** L.E.5,500.
- D Some other amount.

50. Refer to the above data. Happy Day's debt ratio is:

- **A** 20%.
- **B** 25%.
- **C** 55%.
- D Some other amount.

Use the following data for questions 51 through 55.

Shown below are selected data from the financial statements of High Quality Systems (pound amounts are in millions, except for the per-share data):

Income statement data:

Net sales……………………………	L.E.2,000
Cost of goods sold……………………	900
Operating expenses.…………………	700
Net income…..………………………..	300

Balance sheet data:

Average total equity.…………………	1,500
Average total assets……..…………..	2,500

Per share data (these amounts stated in actual pounds, not millions):

High Quality reported earnings per share for the year of **L.E.5** and paid cash dividends of **L.E.2** per share. At year-end, the ***Al-Ahram Economist Journal*** listed High Quality's capital stock as trading at **L.E.100** per share.

51. Refer to the above data. High Quality's gross profit rate was:

- **A** 15%.
- **B** 45%.
- **C** 55%.
- D Some other amount.

52. Refer to the above data. High Quality's operating income was:

- **A** L.E.200.
- **B** L.E.300.
- **C** L.E.400.

- D Some other amount.

53. Refer to the above data. High Quality's return on assets was:

- **A** 12%.
- **B** 16%.
- **C** 20%.
- D More than 20%.

54. Refer to the above data. High Quality's return on equity was:

- **A** 12%.
- **B** 16%.
- **C** 20%.
- D More than 20%.

55. Refer to the above data. High Quality's price/earnings ratio at year-end was:

- **A** 50.
- **B** 20.
- **C** One third.
- D Some other amount.

Use the following data for questions 56 through 60.

Shown below are selected data from the financial statements of Egypt Telecom, Inc. (Pound amounts are in millions, except for the per-share data):

Income statement data:

Net sales…………………………………	L.E.3,000
Cost of goods sold……………………	1,800
Operating expenses..…………………	900
Net income…..………………………..	150

Balance sheet data:

Average total equity..…………………	600
Average total assets……..…………..	1,500

Per share data (these amounts stated in actual pounds, not millions):

Telecom reported earnings per share for the year of **L.E.3** and paid cash dividends of **L.E.1.5** per share. At year-end, the ***Al-Ahram Economist Journal*** listed Telecom's capital stock as trading at **L.E.36** per share.

56. Refer to the above data. Telecom's price/earnings ratio at year-end was:

- **A** .8.
- **B** 12.
- **C** 24.
- D Some other amount.

57. Refer to the above data. Telecom's gross profit rate was:

- **A** 20%.
- **B** 40%.
- **C** 60%.

- D Some other amount.

58. Refer to the above data. Telecom's operating income was:

- **A** L.E.1,200.
- **B** L.E.900.
- **C** L.E.300.
- D Some other amount.

59. Refer to the above data. Telecom's return on assets was:

- **A** 10%.
- **B** 20%.
- **C** 25%.
- D Some other amount.

60. Refer to the above data. Telecom's return on equity was:

- **A** 10%.
- **B** 20%.
- **C** 25%.
- D Some other amount.

EXERCISES AND PROBLEMS:

(1) The following data is adapted from a recent annual report of **The Mother Department Stores Company** (Pound amounts in millions):

	2021	2020
Balance sheet data:		
Quick assets……………	L.E. 2,539	2,611
Current assets………….	4,654	4,574
Current liabilities………	1,975	1,522
Average stockholders' equity	2,981	2,624
Average total assets……	8,637	8,482
Income statement data:		
Net sales……………….	L.E.10,469	9,700
Gross profit……………	2,778	2,361
Operating income……..	1,257	1,112
Net income…...………..	603	515

Instructions:

a. Compute the following for 2020 and 2021. (Round to one decimal place.)

1. Quick ratio.
2. Current ratio.
3. Working capital (in millions).

b. Compute the percentage changes for 2021 in the amounts of net sales and net income. (Round to one-tenth of one percent.)

c. Compute the following for 2020 and 2021. (Round to one-tenth of one percent.)

1. Gross profit rate.
2. Net income as a percentage of net sales.
3. Return on average assets.
4. Return on average stockholders' equity.

Solution:

	2021	**2020**
a.		
1. Quick ratio:		
(L.E.2,539 ÷ L.E.1,975)	1.3 to 1	
(L.E.2,611 ÷ L.E.1,522)		1.7 to 1
2. Current ratio:		
(L.E.4,654 ÷ L.E.1,975)	2.4 to 1	
(L.E.4,574 ÷ L.E.1,522)		3 to 1
3. Working capital (in millions):		
(L.E.4,654 – L.E.1,975)	L.E.2,679	
(L.E.4,574 – L.E.1,522)		L.E.3,052

b. Percentage changes from 2020: 2021

Net sales: [(L.E.10,469 – L.E.9,700) ÷ L.E.9,700]………………….. +7.9%

Net income: [(L.E.603 – L.E.515) ÷ L.E.515]………………….. +17.1%

c.

1. Gross profit rate:		
(L.E.2,778 ÷ L.E.10,469)	26.5%	
(L.E.2,361 ÷ L.E.9,700)		24.3%

2. Net income as a percentage of net sales:

(L.E.603 ÷ L.E.10,469) 5.8 %
(L.E.515 ÷ L.E.9,700) 5.3%

3. Return on average assets:
(L.E.1,257 ÷ L.E.8,637) 14.6%
(L.E.1,112 ÷ L.E.8,482) 13.1%

4. Return on average equity:
(L.E.603 ÷ L.E.2,981) 20.2%
(L.E.515 ÷ L.E.2,624) 19.6%

(2) Listed below are twelve technical accounting terms introduced or emphasized in this chapter:

P/e ratio Market share Current ratio

Debt ratio Earnings per share Quick ratio

Operating income Operating activities

Return on equity Subsidiary Parent company

Comparative financial statements

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

a. A ratio that relates the total net income of a corporation to the holdings of individual stockholders.

b. The classification in a statement of cash flows from which it is most important to generate positive cash flows.

c. A measure of the long-term safety of creditors' positions.

d. A measure of investors' expectations of the future profitability of a business.

e. An ROI measure of the effectiveness with which management utilizes a company's resources, regardless of how those resources are financed.

f. A company that does business through other companies that it owns.

g. A measure of the profitability of a company's ***primary*** business activities.

h. The most widely used measure of short-term debt-paying ability.

i. A form of business organization in which the owners are ***personally*** liable for the debts of the business organization.

j. Financial statements in which similar items are grouped in a manner that develops useful subtotals.

(3) Reebok-Egypt is a manufacturer of toys and children's products. Shown below are selected items appearing in recent balance sheet. (Pound amounts are in millions.)

Cash and short-term investments……. L.E.	32.6
Receivables………………………………	160.9
Inventories……………………………….	64.8
Prepaid expenses and other current assets..	43.0
Total current liabilities……………………	116.0
Total liabilities……………………………	223.3
Total stockholders' equity………………..	231.9

***Required*:**

d. Using the information above, compute the amounts of Reebok-Egypt's (1) total quick assets, and (2) total current assets.

e. Compute the company's (1) quick ratio, (2) current ratio, and (3) working capital. (Round ratios to one decimal place.)

(4) Shown below is a recent income statement for ***The Map***, a specialty retailer. (Pounds amounts in thousands, except per share amounts.)

THE MAP, INC.
Statement of Earnings
For the Year Ended January 31, 2021

Net sales………………………………….	L.E.2,960,409
Costs and expenses:	
Cost of goods sold and occupancy expenses.	(1,955,553)
Operating expenses………………………..	(661,252)
Interest expense……………………………	(3,763)
Earnings before income taxes…………….	L.E. 339,841
Income taxes………………………………	(129,140)
Net earnings………………………………	210,701
Earnings per share……………………….	***L.E.1.47***

Comparative balance sheets indicate average total assets for the year of **L.E.1,263,331**, and average

total equity of **L.E.782,814** (pound amounts in thousands).

Required:

a. Prepare an income statement for the year in a multiple-step format.

b. Compute the (1) gross profit rate, (2) net income as a percentage of net sales, (3) return on assets, and (4) return on equity for the year. (Round computations to the nearest one-tenth of one percent.)

(5) In the late 2010th, Gold Star Company was growing fast. Its earnings per share for the three-year period ended December 31, 2021, were as follows:

	2019	**2020**	**2021**
Earnings per share	***L.E.10.96***	***L.E.9.05***	***L.E.6.16***

At the end of 2021, Gold Star's stock was trading at approximately L.E.55 per share.

f. Compute the percentage change in earnings per share in 2020 and in 2021. (Round to one-tenth of one percent.)

g. Compute the p/e ratio of Gold's stock at the end of 2021. (Round to the nearest whole number.)

(6) Shown below are selected data from a recent annual report of **XYZ Communications Corporation.** (Pound amounts are in millions.)

	Beginning Of the Year	**End Of the Year**
Total assets………………	***L.E.5,843***	***L.E.6,338***
Total stockholders' equity	***1,359***	***1,995***
Operating income………		***982***
Net income……………..		***558***

Required:

Compute for the year XYZ's ***(a)*** return on average total assets, and ***(b)*** return on average total stockholders' equity. (Round to the nearest one-tenth of one percent.)

(7) The accounting staff of Cairo Chef has assembled the following information for the year ended December 31, 2021.

Cash, beginning of year …………………	L.E. 380,600
Cash, end of year ………………………..	570,600
Cash paid to acquire plant assets ………..	190,000
Proceeds from short-term borrowing ……	100,000
Loans made to borrowers ………………..	50,000
Collections on loans (excluding interest) ..	40,000
Interest and dividends received ………….	120,000
Cash received from customers …………...	8,150,000
Proceeds from sales of plant assets ………	70,000
Dividends paid ……………………………	800,000
Cash paid to suppliers and employees ……	6,350,000
Interest paid ………………………………	190,000
Income taxes paid ………………………...	710,000

***Required*:**

Using this information, prepare a formal statement of cash flows. Include a proper heading for the financial statement, and classify the given information into the categories of operating activities, investing activities, and financing activities. Place brackets around the pound amounts of all cash disbursements.

(8) **Safeway, Inc.,** is one of the world's largest supermarket chains. Shown below are selected items from a recent Safeway balance sheet. (Amounts are in millions.)

Cash……………………………	L.E. 96.5
Receivables………………………	135.7
Merchandise inventories…………	1,201.7
Prepaid expenses…………………	95.1
Fixtures and equipment…………..	1,668.7
Retained earnings (deficit)……….	(404.9)
Total current liabilities…………...	1,501.8

***Required*:**

a. Using the information above, compute the amounts of Safeway's total current assets and total quick assets.

b. Compute the company's (1) current ratio, (2) quick ratio, and (3) working capital. (Round to one decimal place.)

(9) A recent balance sheet of **Tool Industries** included the following items, among others. (Pound amounts are stated in thousands.)

Cash and cash equivalents ……………… L.E.	995
Investments (in marketable securities) ……..	87,947
Accounts receivable ………………………..	12,889
Inventories ………………………………….	24,845
Prepaid expenses …………………………...	2,989
Retained earnings …………………………..	90,285
Notes payable to banks (due within on year).	253
Accounts payable …………………………..	4,674
Dividends payable …………………………	791
Accrued liabilities (short-term) ……………	13,661
Income taxes payable ……………………...	3,119
Postretirement health care and life insurance benefits (a long-term liability) ……………..	3,976

The company also reported total assets of L.E.222,478, total liabilities of L.E.40,774, and a return on assets of 23.6%.

***Required*:**

a. Compute Tool's (1) quick assets, (2) current assets, and (3) current liabilities.

b. Compute Tool's (1) quick ratio, (2) current ratio, (3) working capital, and (4)debt ratio. (Round to one decimal place.)

(10) Some of the accounts appearing in the year-end financial statements of Diet Frozen Foods appear below. This list includes all of the company's current assets and current liabilities.

Sales …………………………………..	L.E.1,980,000
Accumulated depreciation: equipment ..	370,000
Notes payable (due in 90 days) ……….	70,000
Retained earnings ……………………..	221,320
Cash …………………………………...	47,600
Capital stock …………………………..	150,000
Marketable securities ……………..…..	175,040
Accounts payable ……………………...	125,430
Mortgage payable (due in 15 years) …..	320,000
Salaries payable ……………………….	7,570
Dividends ……..……………………..…	25,000
Income taxes payable ……………….…	14,600
Accounts receivable …………………...	230,540
Inventory ……………………………….	179,600
Unearned revenue ……………………..	10,000
Unexpired insurance …………………..	4,500

***Required*:**

a. Prepare a partial balance sheet for Diet Frozen Foods consisting of the current asset section and

the current liability section ***only***. Select the appropriate items from the above list.

b. Compute the current ratio and the amount of working capital. Explain how each of these measurements is computed.

(11) Eastport Department Store has advertised for an accounting student to work in its accounting department during the summer, and you have applied for the job. To determine whether you are familiar with the content of classified financial statements, the controller of Eastport has developed the following problem based upon the store's operations in the year ended December 31, 2021:

Available information (pound amounts in thousands):

Net sales …………………………………..	L.E.10,000
Net income ………………………………..	?
Current liabilities …………………………	2,000
Selling expenses …………………………..	1,000
Long-term liabilities ……………………...	1,600

Total assets (and total liabilities & stockholders'

equity) ……………………………………..	6,800
Stockholders' equity …………………..…..	?
Gross profit ………………………………..	?
Cost of goods sold ………………………...	7,000
Current assets …………………………….	4,000
Income taxes expense and other nonoperating items ……………………………………	220
Operating income ………………………...	?
General and administrative expenses …..….	980
Plant and equipment ……………………..…..	2,600
Other assets ………………………………..	?

Required:

a. Using the captions given above, prepare for Eastport Department Store a condensed:

1. Classified balance sheet at December 31, 2021.

2. Multiple-step income statement for the year ended December 31, 2021. Show supporting computations used in determining any missing amounts. (***Note:*** Your financial statements should include only as much detail as these captions permit. For example, the first asset listed in your balance sheet will be "Current assets…. L.E.4,000.")

b. Compute at year-end the company's:

1. Current ratio.

2. Working capital.

c. Compute for 2021 the company's:

1. Gross profit rate.

2. Return on total assets. (Round to the nearest percent.)

3. Return on total stockholders' equity.

(***Note:*** In the last two computations, use the amounts of total assets and stockholders' equity from your classified balance sheet as a substitute for the average amounts during the year.)

(12) Shown below are selected data from a recent annual report of High Star Corporation. (Pound amounts are stated in thousands.)

	Beginning Of the Year	**End Of the Year**
Total current assets……	***L.E. 54,130***	***L.E. 92,592***
Total current liabilities..	***63,481***	***83,357***
Total assets……………	***234,698***	***417,413***

Total stockholders' equity.	***124,058***	***208,189***
Operating income………		***76,141***
Net income……………..		***44,152***

The company has long-term liabilities which bear interest at annual rates ranging from 11% to 16%.

***Required*:**

a. Compute the company's current ratio at (1) the ***beginning*** of the year and (2) the ***end*** of the year. (carry to two decimal places.)

b. Compute the company's working capital at (1) the beginning of the year, and (2) the end of the year. (Express pound amounts in thousands.)

c. Compute the company's (1) return on average total assets, and (2) return on average stockholders' equity. (Round average assets and average equity to the nearest pound, and final computations to the nearest 1 percent

(13) The following data is adapted from a recent annual report of **Toys Corporation** (pound amounts in millions):

	2021	2020
Balance sheet data:		
Quick assets…………… L.E.	486	890
Current assets………….	2,531	2,708
Current liabilities………	2,137	2,075
Average stockholders' equity	3,289	3,019
Average total assets……	6,360	5,736
Income statement data:		
Net sales……………….. L.E.	8,746	7,946
Gross profit……………	2,738	2,451
Operating income……..	912	821
Net income…..…………..	532	483
Cash flow data:		
Net cash provided by operating activities………………. L.E.	589	657

Required:

f. Compute the following for 2021 and 2020 (round to one decimal place):

1. Quick ratio.

2. Current ratio.

3. Working capital.

g. Compute the percentage changes for 2021 in the amounts of net sales and net income.

h. Compute the following for 2021 and 2020 (round to one-tenth of one percent):

1. Gross profit rate.

2. Net income as a percentage of net sales.

3. Return on average assets.

4. Return on average stockholders' equity.

(14) For the last five years, ShowTime Video has successfully operated two video rental stores in Egypt. The company's cash flows for 2021 appear below:

Interest paid ………………………………	L.E. (20,000)
Dividends paid to stockholders …………..	(50,000)
Cash receipts from customers …………….	550,000
Payments to suppliers and employees …….	(370,000)
Purchases of plant assets ………………....	(420,000)
Proceeds from long-term borrowing ……..	300,000
Payment of short-term debt …................…	(25,000)
Interest received from investments ……….	10,000
Income taxes paid ………………………..	(45,000)

At December 31, ***2020***, the company's balance sheet showed cash of L.E.96,000.

Required:

Arrange this information into the format of a statement of cash flows.

(15) Shown below is selected data from the financial statements of Carriage Trade, a retail furniture store.

From the balance sheet:

Cash ……………………………….. L.E.	30,000
Accounts receivable ……………………	150,000
Inventory …………………..................	200,000
Plant assets (net of accumulated depreciation)	500,000
Current liabilities ……………………….	150,000
Total stockholders' equity ………………	300,000
Total assets ……………………………..	1,000,000

From the income statement:

Net sales ……………………………… L.E.	1,500,000
Cost of goods ……………………………	1,080,000
Operating expenses ……………………..	315,000
Interest expense …..……………………..	84,000
Income taxes expense ……………………	6,000
Net income ……………………………..	15,000

From the statement of cash flows:

Net cash provided by operating activities (including interest paid of L.E.79,000) ... L.E.		40,000
Net cash used in investing activities ……..		(46,000)
Financing activities:		
Amounts borrowed ……………	L.E.50,000	

Repayment of amounts borrowed	(14,000)	
Dividends paid …………………	(20,000)	
Net cash provided by financing activities		(16,000)
Net increase in cash during the year L.E.		10,000

Required:

a. Compute the following (round to one decimal place):

1. Current ratio.
2. Quick ratio.
3. Working capital.
4. Debt ratio.

b. Compute the following ratios (assume that the year-end amounts of total assets and stockholders' equity also represent the average amounts throughout the year):

1. Return on assets.
2. Return on equity.

CHAPTER FOUR
MID-TERM TESTS

CHAPTER FOUR

MID-TERM TESTS

4.1 Chapter one's Tests:

QUIZES:

Quiz A

NAME…………………………

NO……………………………..

SECTION………………………

Indicate the best answer for each question in the space provided.

…… *1* Which of the following is ***not*** a characteristic of a sole proprietorship?

a Unlimited personal liability of owner for debts of the business.

b Owner's ability to withdraw assets at will.

c Easy transferability of ownership interest.

d Easy formation of business.

…… *2* An example of an item that could properly appear in the financial statements of both a sole proprietorship and a corporation is:

a Property tax expense.

b Retained earnings.

c Income taxes payable.

d Dividends payable.

…… ***3*** Which of the following statements are characteristics of sole proprietorship businesses? (Indicate all correct answers).

a Owners pay personal income taxes on profits.

b The business entity pays income taxes on its earnings.

c If the business fails, the owners' potential losses are limited to the amounts of their equity.

d Owners receive dividends.

…… ***4*** Which of the following is ***not*** a characteristic of the common stock of a large, publicly owned corporation?

a The shares may be transferred from one investor to another without disrupting the continuity of business operations.

b Voting rights in the election of the board of directors.

c Right to participate in management of the business.

d After issuance, the market value of the stock is unrelated to its par value.

…… ***5*** Ahmed and Adel are the only two partners in a partnership. At the beginning of October, the amounts in their capital accounts were L.E.300,000 and L.E.900,000 for Ahmed and Adel, respectively. During the month of October, Ahmed withdrew L.E.90,000 and Adel withdrew L.E.100,000 from the partnership. The net loss of the partnership for the month was L.E.130,000. Assuming that profits and losses are distributed equally, what is the balance in partners' capital accounts at the end of October?

a L.E.500,000 for Ahmed and L.E.1,110,000 for Adel.

b L.E.455,000 for Ahmed and L.E.1,055,000 for Adel.

c L.E.255,000 for Ahmed and L.E.865,000 for Adel.

d L.E.145,000 for Ahmed and L.E.735,000 for Adel.

Quiz B

NAME…………………………

NO……………………………..

SECTION………………………

Indicate the best answer for each question in the space provided.

…… ***1*** A corporation earned L.E.890,000 for the year and declared and paid dividends of L.E.120,000 during the year. What amount of income is taxable to the stockholders for the year?

a None.
b L.E.120,000.
c L.E.770,000.
d L.E.890,000.

…… ***2*** The dividends of a corporation compensate the owners for:

a Services to the business.
b The risks associated with unlimited liability for the business debts.
c The capital provided to the business.
d All of the above.

…… ***3*** Which of the following is ***not*** treated as a going concern for accounting purposes?

a A corporation.

b A sole proprietorship.

c A partnership.

d All of the above are treated as going concerns.

…… ***4*** Which of the following is ***not*** a characteristic of a limited partnership?

a All partners participate in management of the partnership.

b The partnership pays income taxes.

c The partnership has a limited legal life.

d The partners do not necessarily split profit equally.

…… ***5*** Which of the following is ***not*** a characteristic of a corporation?

a Unlimited liability of owners for business debts.

b Continuity of existence.

c Transferability of ownership.

d A legal entity.

Quiz C

NAME…………………………

NO……………………………..

SECTION………………………

Indicate the best answer for each question in the space provided.

…… ***1*** Which of the following characteristics is common to sole proprietorships, partnerships, and corporations?

a Unlimited liability for business debts.

b Treatment as a going concern for accounting purposes.

c Ease of formation.

d Separation of ownership and management.

…… ***2*** Mutual agency is a characteristic that is associated with which of the following forms of business organization?

a A sole proprietorship.

b A partnership.

c A corporation.

d All of the above.

…… ***3*** Salaries paid to stockholders that are employed by a corporation:

a Are deducted from the stockholders' drawing accounts.

b Are treated as dividends to the stockholders.

c Are tax deductible by the corporation.

d Are considered to be illegal.

…… ***4*** Noah, Inc. had retained earnings of L.E.540,000 at the beginning of the current year. During the year, the corporation earned net income of L.E.84,000 and declared dividends in the amount of L.E.30,000. What is the balance of Noah's retained earnings at the end of the year?

a L.E.426,000.

b L.E.486,000.

c L.E.594,000.

d L.E.654,000.

…… ***5*** Which of the following is ***true*** regarding a general partnership?

a A general partnership pays dividends to its owners.

b Any partner may bind the general partnership to a contract.

c A general partnership has at least 40 owners.

d A general partnership is a legal entity separate from its owners.

4.2 Chapter Two's Tests:

QUIZES:

Quiz A

NAME……………………………

NO………………………………..

SECTION………………………

Indicate the best answer for each question in the space provided.

…… ***1*** Nile Potters purchased a kiln on February 1 for L.E.72,000 which is guaranteed to have a useful life of 10 years. Assuming adjusting entries are prepared monthly, what is the ***book value*** of the kiln on June 30?

a L.E.64,800.
b L.E.69,000.
c L.E.3,000.
d L.E.72,000.

…… ***2*** Luxor Square Cinema sells books of movie tickets for L.E.1,000, which contain tickets to admission to 20 movies. During July, 50 books of tickets were sold for L.E.50,000 and this amount was credited to Unearned Admissions

Revenue. By the end of July, it was determined that 400 movie tickets had been used by customers who had purchased the tickets books. The July 31 adjusting entry is:

a Debit Admissions Revenue L.E.20,000 and credit Unearned Admissions Revenue L.E.20,000.

b Debit Admissions Revenue L.E.30,000 and credit Unearned Admissions Revenue L.E.30,000.

c Debit Unearned Admissions Revenue L.E.20,000 and credit Admissions Revenue L.E.20,000.

d Debit Unearned Admissions Revenue L.E.40,000 and credit Admissions Revenue L.E.40,000.

…… ***3*** The adjusting entry to recognize interest owed by Key Tools to the bank for May was omitted in month-end procedures. As a result of this error, Key's:

a May net income is understated and May 31 assets overstated.

b May expenses are understated and May 31 assets overstated.

c May expenses are understated and May 31 owner's equity understated.

d May net income is overstated and May 31 liabilities understated.

…… ***4*** Net income of Samara Company was L.E.400,000 before any year-end adjusting entries were made. The following adjustments are necessary: interest accrued on a company savings account, L.E.1,100; portion of insurance expiring, L.E.3,000; portion of fees collected in advance now earned, L.E.24,000. ***Net income*** as shown in the income statement for the current year should be:

a L.E.422,100.
b L.E.419,900.
c L.E.374,100.
d L.E.380,100.

…… ***5*** A December 31 trial balance (before December adjustments) shows Office Supplies of L.E.6,000 and Office Supplies Expense of L.E.10,100. A December adjusting entry recorded office supplies expense of L.E.1,700. After the December adjusting entries have been posted, what is the proper balance in the Office Supplies account on December 31?

a L.E.7,700.

b L.E.11,800.
c L.E.4,300.
d L.E.8,400.

Quiz B

NAME…………………………

NO……………………………..

SECTION………………………

Green Park adjusts its books each month and closes its books on December 31 each year. The trial balance at January 31, 2021, ***before*** adjustments, follows:

	Debit	**Credit**
Cash ……………. L.E.	66,000	
Supplies ……………………	54,000	
Unexpired Insurance ……………	126,000	
Equipment ……………………..	720,000	
Accumulated Depreciation: Equipment		180,000
Unearned Admission Revenue…		120,000
Owner's Capital, December 31, 2020		582,000
Admissions Revenue………..		276,000
Salaries Expense …….	81,000	
Utilities Expense …….	57,000	
Rent Expense ………..	54,000	
L.E.	1,158,000	1,158,000

…… ***1 Refer to the above data***. According to attendance records, L.E.78,000 of the Unearned Admission Revenue has been earned in January. Compute the amount of admissions revenue to be shown in the January ***income statement***:

a L.E.354,000.
b L.E.198,000.
c L.E.78,000.
d L.E.42,000.

…… ***2 Refer to the above data***. At January 31, the amount of supplies on hand is L.E.10,500. What amount is shown on the January income statement for ***supplies expense***?

a L.E.10,500.
b L.E.54,000.
c L.E.64,500.
d L.E.43,500.

…… ***3 Refer to the above data***. The equipment has an original estimated useful life of eight years. Compute the ***book value*** of the equipment at January 31 after the proper January adjustment is recorded:

a L.E.7,500.
b L.E.720,000.
c L.E.532,500.
d L.E.495,000.

…… ***4 Refer to the above data***. Employees are owed L.E.12,000 for services since the last payday in January to be paid the first week of February. No adjustment was made for this item. As a result of this error:

a Assets at January 31 are overstated.
b January net income is overstated.
c Liabilities at January 31 are overstated.
d Owner's equity at January 31 is understated.

…… ***5 Refer to the above data***. On August 1, 2020, the park purchased a 12-month insurance policy. The necessary adjusting entry at January 31 includes which of the following entries? (Hint: The company has adjusted its books ***monthly***.)

a A debit to Insurance Expense for L.E.10,500.
b A credit to Unexpired Insurance for L.E.115,500.
c A credit to Unexpired Insurance for L.E.18,000.
d A debit to Unexpired Insurance for L.E.108,000.

Quiz C

NAME…………………………

NO……………………………..

SECTION………………………

Green Park adjusts its books each month and closes its books on December 31 each year. The trial balance at January 31, 2021, ***before*** adjustments, follows:

	Debit	Credit
Cash ……………. L.E.	44,000	
Supplies ……………………	36,000	
Unexpired Insurance ……………	84,000	
Equipment ……………………..	480,000	
Accumulated Depreciation: Equipment		120,000
Unearned Admission Revenue…		80,000
Owner's Capital, December 31, 2020		388,000
Admissions Revenue………..		184,000
Salaries Expense …….	54,000	
Utilities Expense …….	38,000	
Rent Expense ………..	36,000	
	L.E. 772,000	772,000

1 Refer to the above data. According to attendance records, L.E.52,000 of the Unearned Admission Revenue has been earned in January. Compute the balance in the following accounts after the proper adjustment is made.

Unearned Admission Revenue account balance

L.E._____

Admission Revenue account balance L.E._____

2 ***Refer to the above data.*** At January 31, the amount of supplies still on hand was determined to be L.E.7,000. What amount should be reported in the January income statement for ***supplies expense***? L.E._____

3 ***Refer to the above data.*** The equipment has an original useful life of eight years. Compute the ***book value*** of the equipment at January 31 ***after*** the proper adjustment is recorded. L.E._____

4 ***Refer to the above data.*** L.E.8,000 is owed to employees for work since the last payday in January, to be paid the first week of February. What is the effect on ***January net income*** if the accountant fails to make any January 31 adjustment for this item? January net income will be overstated or understated by L.E.______

5 ***Refer to the above data.*** On June 1, 2020, the park purchased a 12-month insurance policy. Give the adjusting entry to record insurance coverage expiring in January. (Hint: The Company adjusts its books ***monthly.***)

Quiz D

NAME…………………………

NO……………………………..

SECTION………………………

The accountant for Systems Consulting prepared the following ***adjusted*** trial balance at January 31, 2021, after ***one month*** of operations:

	Debit	Credit
Cash ……………. L.E.	54,000	
Accounts Receivable…………..	42,000	
Unexpired Insurance ……………	18,000	
Office Equipment ………………	180,000	
Accumulated Depreciation: Equipment		3,000
Unearned Consulting Fees…..…		30,000
Owner's Capital ……………….		150,000
Owner's Drawings……………..	30,000	
Consulting Fees Earned …..……..		250,000
Salaries Expense …….	74,000	
Utilities Expense …….	14,000	
Rent Expense …………………	18,000	
Depreciation Expense ………..	3,000	
L.E.	433,000	433,000

Although most adjustments have been recorded, the accountant ***forgot*** the following items:

a. Consulting services rendered to a client in January, not yet billed or recorded, L.E.19,000.

b. Portion of insurance expiring in January, L.E.1,500.

Instruction: Assuming the adjustments for the above two items are made properly, prepare the four closing entries at January 31, 2021. (Hint: Adjustments for the above two items may change some amounts shown in the trial balance.) Omit explanations.

	Closing Entries		
Jan. 31	……………………………....		
	………………………………		
	………………………………		
	………………………………		
	………………………………		
	………………………………		
	………………………………		
	………………………………		
	………………………………		
	………………………………		
	………………………………		
	………………………………		
	………………………………		
	………………………………		
	………………………………		
	………………………………		
	………………………………		
	………………………………		

4.3 Chapter Three's Tests:

QUIZES:

Quiz A

NAME…………………………

NO……………………………..

SECTION………………………

Indicate the best answer for each question in the space provided.

…… ***1*** The quick ratio is considered more useful than the current ratio for

a Evaluating the profitability of a business that sells inventory very quickly, such as a restaurant.

b Evaluating the solvency of a business that turns inventory into cash very slowly, such as a shipbuilder.

c Evaluating long-term credit risk.

d Evaluating investors' expectations concerning future earnings.

…… ***2*** The debt ratio is a measure of:

a Net cash flows relating to financing activities.

b Long-term credit risk.

c Short-term solvency.

d Profitability, independent of the manner in which assets are financed.

…… ***3*** In the long-run, it is most important for a business to generate an inflow of cash from its:

a Operating activities.

b Stockholders.

c Investing activities.

d Creditors.

…… ***4*** Return on assets measures the efficiency with which management:

a Generates earnings from the assets under its control, regardless of how these assets are financed.

b Generates earnings from the assets under its control, giving consideration to any costs of financing these assets.

c Generates earnings from the assets under its control, regardless of accrual-based measures of profitability.

d Converts its current assets into cash.

…… ***5*** A transaction which will increase the quick ratio but cause the current ratio to decline is:

a Short-term borrowing.

b Investing cash in plant assets.

c Sale of inventory at a price below cost.

d Collection of an account receivable.

Quiz B

NAME…………………………

NO……………………………..

SECTION………………………

Shown below are data taken from a recent annual report of a corporation. (Pound amounts in millions.)

	Beginning of Year	End of Year
Balance sheet data:		
Current assets ……….……….	L.E. 714	784
Total assets ……………………...	1,063	1,166
Current liabilities …….…………	256	203
Total liabilities …………………..	372	322
Total stockholders' equity ………	691	844
Income statement data:		
Net sales ……………………….		1,822
Gross profit …………………….		750
Operating income ……………….		293
Net income ……………………...		175

Based upon the above information, indicate the best answer in the space provided.

…… ***1*** The current ratio at year-end (rounded to the nearest tenth) is:

a 2.4 to 1.

b .7 to 1.

c 3.9 to 1.

d Some other answer.

…… ***2*** The amount of working capital at the ***beginning*** of the year (in millions) was:

a L.E.581.

b L.E.691.

c L.E.342.

d Some other answer.

…… ***3*** The gross profit rate for the year (rounded to the nearest 1 percent) was:

a 41%.

b 59%.

c 64%.

d Some other answer.

…… ***4*** The return on average total assets during the year (rounded to the nearest percent) was:

a 16%.

b 26%.

c 67%.

d Some other answer.

…… ***5*** The return on average total stockholders' equity during the year (rounded to the nearest 1 percent) was:

a 98%.

b 38%.

c 23%.

d Some other answer.

Quiz C

NAME…………………………

NO………………………………..

SECTION………………………

Shown below are data taken from a recent annual report of a corporation. (Pound amounts in millions.)

		Beginning of Year	End of Year
Balance sheet data:			
Current assets ………..……….	L.E.	714	784
Total assets ……………………...		1,063	1,166
Current liabilities …….…………		256	203
Total liabilities …………………..		372	322
Total stockholders' equity ………		691	844
Income statement data:			
Net sales …………………………			1,822
Gross profit ………………………			750
Operating income ……………….			293
Net income …………………….....			175

Instructions: Compute the following.

a Current ratio at ***year-end*** (round to nearest tenth).

_____to 1

b Working capital at the ***beginning*** of the year (in millions). L.E._____

c Gross profit rate for the year (round to the nearest 1 percent). _____%

d Return on average total assets for the year (round to the nearest 1 percent). ______%

e Return on average total equity for the year (round to the nearest 1 percent). ______%

Quiz D

NAME…………………………

NO……………………………..

SECTION………………………

Listed below are the cash flows of a company (pound amounts in thousands):

Cash receipts:

Cash collected from customers …………	L.E.6,500
Proceeds from sales of investments …….	400
Proceeds from borrowing ……………….	1,700
Proceeds from issuing capital stock …….	2,400
Interest and dividends received …………	550

Cash payments:

Cash paid to suppliers and employees ….	5,900
Purchases of plant and equipment ………	4,200
Repayment of amounts borrowed ………	640
Interest paid ……………………………..	175
Income taxes paid ……………………….	240
Dividends paid …………………………..	550

Compute the net cash flows for the three activities listed below. Place parentheses around any dollar amounts representing net ***uses*** of cash.

a Investing activities L.E.________

b Financing activities L.E.________

c Operating activities L.E.________

REFERANCES

Accounting Standards Steering Committee-ASSC (1975), *The Corporate Report*, London: The Institute Chartered Accountants in England and Wales.

American Accounting Association-AAA (1966), *A Statement of Basic Accounting Theory*, Evanston, Illinois: AAA.

American Institute of Certified Public Accountants-AICPA (1982), Accounting Terminology Bulletin No.1, 1968, in FASB, *Accounting Standards, Original Pronouncements as of June1,* volume 1, Stamford: FASB, pp.5005-5019.

American Institute of Certified Public Accountants-AICPA, (1999), *Comprehensive Report of the Special Committee on Financial Reporting: Improving Business Reporting- A Customer Focus*, [On Line]. Available: http://www.aicpa.org/index.htm [Accessed on 27/4/2000].

Baker, R.E., Lembke, V.C. and King, T.E. (2005), *Advanced financial accounting*, 6th Edition, New York: McGraw-Hill/Irwin.

Berry, A. and Jarvis, R. (1997), *Accounting in a business Context*, London: International Thomson Business Press.

Enthoven, A.J.H. (1973), *Accounting and Economic Development Policy*, Amsterdam: North-Holland Publishing Company.

Ezzamel, M. (1994), “The Emergence of the ‘Accountant’ in the Institutions of Ancient Egypt”, *Management Accounting Research,* Vol.5, No.3-4, pp.221-246.

Financial Accounting Standards Board-FASB (1999), *Statement of Financial Accounting Concepts*, No.1, 1978, “Objectives of Financial Reporting by Business Enterprises”, 1998/99 Edition, New York: John Wiley & Sons, Inc.

Glautier, M.W.E. and Underdown, B. (1987), *Accounting Theory and Practice*, London: Pitman Publishing.

Hartley, W.C.F. (1987), *An Introduction to Business Accounting for Managers*, Oxford, England: Pergamon Press.

Kimmel, P.D., Weygandt, J.J. and Kieso, D.E. (2011), *Financial Accounting-Tools for Business Decision Making,* John Wiley &Sons (Asia) Pte Ltd.

Larsen, E.J. (2000), *Modern advanced accounting*, 8th Edition, New York: McGraw-Hill/Irwin.

Maheshwari, S.N. (1996), *Advanced Accountancy,* India: VIKAS PUBLISHING HOUSE PVT LTD.

Meigs, R.E., et. Al. (1996), *Accounting: the Basis for Business Decisions*, New York: The McGraw-Hill Companies, Inc.

Moonitz, M. (1961), *The Basic Postulate of Accounting*, Accounting Research Study No. 1, New York: AICPA.

Radebaugh, L.H. and Gray, S.J. (1997), *International Accounting and Multinational Enterprises*, New York: John Wiley & Sons, Inc.

Rawy, A.A. (2004), *Financial Reporting and Contemporary Changes in the Egyptian Environment*, Ph.D. Thesis, the University of Hull, U.K.

Van Greuning, H. and Koen, M. (2001), *International Accounting Standards: A Practical Guide*, Washington, D.C.: The World Bank.

Wood, F. (1993), *Business Accounting 1*, London: PITMAN PUBLISHING.