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Lectures in

FINANCIAL ACCOUNTING 2

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

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

Preface

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

This textbook has been written to provide student with a very comprehensive introduction to Financial Accounting regarding sole proprietorships, which is covered in two issues. The splitting of this textbook between two issues is a recognition of the fact that many students will get all that they require to have a good idea about the nature of accounting and its environment, the theoretical framework of accounting , the accounting cycle and so on, contained in the first issue: Financial Accounting 1.

The second issue: Financial Accounting 2 will be devoted to accounting issues, such as the nature of accounting communication, financial statements in commercial and industrial enterprises, and other accounting problems that pay the students attention to a more advanced stage in studying financial accounting.

Therefore, this textbook is divided into a variety of chapters intended to put the students, who study business, on the right way towards understanding financial accounting. Chapter one of this issue discusses the measurement of business income. Chapter two introduces to the final accounts. Chapter three is entitled adjusting entries.

CHAPTER ONE

COMPLETING THE ACCOUNTING CYCLE: MEASURING BUSINESS INCOME

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1.1 What is Net Income?

Net income is defined as follows: an increase in owner's equity resulting from the profitable operation of the business entity. On the contrary, a decrease in owner's equity resulting from unprofitable operation of the business is termed a net loss. Generally, if you were to organise a business of your own, you would do so with the hope and expectation that the business would operate at a profit, thereby increasing your ownership equity. People who invest in the capital stock of a large corporation also expect the business to earn a profit which will increase the value of their investments.

Commonly, the term income means the reward or payment received in exchange for the production of goods and services. For example, the salary received by an employee is his/her income, since it is the reward received by him/her for his/her service. Similarly, the rent received by the landlord or the owner of a property is his/her income, as it is the reward for the services rendered by him/her through his/her property.

The term income may be of different types, e.g., personal income, national income, business income, gross income, net income, and so on. In accounting, the main concern is with business income, a term which is used as a synonymous with the term business profit. It can be defined as the excess of the revenue over the expenditure incurred by the business entity over a period. The term business income includes realised net income and not income only.

It should be taken into account the fact that net income does not consist of cash or any other specific asset. But, net income is a computation of the overall effects of many business transactions upon owner's equity. The increase in owner's equity resulting from profitable operations usually is accompanied by an increase in total assets, though not necessarily an increase in cash. However, in some cases an increase in owner's equity is accompanied or related by a decrease in total liabilities. The effects of earning net income upon the basic accounting equation could be illustrated as below:

Assets	**= Liabilities**	**+**	**Owner's Equity**	
Increase	**= Decrease**	**+**	**Increase**	

Either (or both) of these Effects occur as net income is earned ……………..

… but <u>this</u> is what *net income* really means.

The main idea is that **net income** represents an ***increase in owner's equity*** and has no direct relationship to the types or amounts of assets on hand. As such, even a business entity operating at a profit may run short of cash and become insolvent. In the **balance sheet**, the changes in owner's equity resulting from profitable or unprofitable operations are reflected in the balance of the **owner's capital account.** The assets of the business enterprise appear in the **assets** section of the balance sheet.

1.2 The Income Statement:

Income Statement (or Profit and Loss Account, as we will explain later) measures the income of a business enterprise during a particular period of time. It is of greater importance than even the **Balance Sheet** because the main objective of running a business enterprise is to maximise business wealth and this depends to a great extent upon the income which a business makes year after year (Maheshwari, 1996).

An ***Income Statement*** is a one-page financial statement which summarises the profitability of the business enterprise over a specific period of time (month, quarter, six months, or a year). In such statement, net income is determined by comparing for the time period:

1. The ***sales price*** of the goods sold and services rendered by the business entity with

2. The ***cost*** to the business entity of goods and services used up in business operations.

Usually, the technical accounting terms used to express of these components of the net income are ***Revenue*** and ***Expenses***. Accordingly, accountants say that net income is equal to **revenue minus expenses** (**revenue – expenses**), as presented in the following income statement:

ENGINEER AUTO SERVICE
Income Statement
For the Month Ended December 31, 2021

Revenue:	L.E.	L.E.
Repair service revenue…		51,900
Expenses:		
Advertising expense……	4,150	
Wages expense…………	24,500	
Supplies expense………	2,000	
Depreciation expense: building	750	
Depreciation expense: tools and equipment	1,000	32,400
Net Income…………………	**..........**	**19,500**

Measuring the **net income** earned by a business entity means that measuring its economic performance-its success or failure as a business enterprise. The users of accounting information, the owner, managers, and major creditors are eager (anxious) to see the latest available income statement and by which judge how well the enterprise is doing. In the following sections we will show how this income statement can be developed. However, this simple illustration will help us in explaining some of the basic concepts involved in measuring business income.

1.2.1 Accounting Periods:

Normally, **Income Must be Related to a Specific Period of Time.** In the above simple illustration, notice that income statement covers a ***period of time***-namely, the month of December. A balance sheet shows the financial position of a business entity at a ***particular date***. On the other hand, an income statement shows the results of business operations over a span or a range of time.

Therefore, we cannot evaluate net income unless it is associated or related with a specific **time period**. For example, if we say that a given business enterprise earns a net income of **L.E.100,000,** the profitability of the business enterprise is unclear. Does it earn **L.E.100,000** per week, per month, or per year?

The period of time covered by an income statement is termed the enterprise's ***accounting period***. To provide the users of financial statements with timely information, net income is measured for relatively short accounting periods of equal length. The concept, called the ***Time Period Principle***, is one of the generally accepted accounting principles (GAAP) that guide the interpretation of financial events and the preparation of financial statements.

On the other hand, the length of an enterprise's accounting period depends greatly on how frequently managers, investors, and other interested parties require information regarding the enterprise's performance. Every business entity prepares annual income statements. The **12-month** accounting period used by an entity is called ***Fiscal Year***. The **fiscal year** used by most business enterprises coincides or agrees with the calendar year and ends on December 31. However, some business enterprises choose to use a fiscal year which ends on some other date.

1.2.2 Revenue:

Revenue **is the price of goods sold and services rendered during a particular accounting period.** Earning revenue causes owner's equity to increase. When a business entity renders services or sells goods (merchandise) to its customers, it usually receives cash or acquires an account receivable (debtors) from the customer. The inflow of cash and receivables from customers **increases** the total

assets of the business entity; on the other side of the accounting equation, the **liabilities** do not change, but **owner's equity increases** to match the increase in total assets. Accordingly, **Revenue** is the **gross increase in owner's equity** resulting from operation of the business.

A variety of account titles are used to describe different types of revenue. For instance, **Engineer Auto Service** records its revenue in an account entitled **Repair Services Revenues.** A business enterprise which sells merchandise rather than services uses the term **Sales** to describe its revenue. In the professional practices (also called Non-Commercial Professions, as you will study in the other accounting subjects) of physicians, certified public accountants (CPAs), and attorneys (Lawyers), revenue usually is called **Fees Earned**. A real estate office might call its revenue **Commissions Earned.**

Moreover, a professional sport team might have separate revenue accounts for **Ticket Sales, Concessions Revenue,** and **Revenue from Television Contracts.** Also, another type of revenue common to most enterprises is **Interest Revenue** (or Interest Earned), emerging from the interest earned on bank deposits, note receivable (Bills receivable), and interest-bearing investments.

1.2.3 The Realization Principle (When to Record Revenue):

It has been discussed that revenue is **the price of goods sold and services rendered during a particular accounting period.** Hence, revenue earned by selling merchandise is recognised **when the goods are sold**. Revenue earned by rendering services to customers is recognised in the period in which the **services are rendered**.

Assume that on July 25, Radio & Television Union (RTU) contracts with Alexandria Oil (AO) to run two hundred 1-minute radio advertisements during August. RTU runs these ads and receives full payment from AO on September 6. In which month should RTU Recognise this advertising revenue-July, August, or September?

According to the above data, the answer is in ***August***-the month in which RTU **rendered the services** which earned the revenue. To sum up, revenue is recognised **when it is earned**, regardless when payment is received. This concept is called the ***Realisation Principle***. Because of the realisation principle, revenue represents the **value of goods and services rendered** during the accounting period, **Not** the amount of cash received. It is, therefore, very important to decide at what time the income or the revenue should be taken as realised.

In practice, there are four distinct alternative regarding recognition of the time when the revenue/income could be considered as realised:

1. **Recognition at the Time of Sale:** This alternative is the most common basis of revenue recognition. The goal of manufacturing or purchasing goods is attained in the business when the goods are sold away. Therefore, income is believed to be realised when a sale in the ordinary course of business is achieved unless the circumstances are such that collection of the sale price is not reasonably assured. From the legal point of view, the sale is considered to be completed when the ownership of goods is transferred from the seller to the purchaser or buyer. However, it should be noted that transfer of ownership does not depend upon delivery of goods or payment of the price. Both of these objectives may be performed also in future.

What is required is that the purchaser should be responsible to take delivery of the goods and make payment of the price for them. Whether, he/she takes delivery of goods or makes payment of the price now or later is immaterial. On the other hand, difficulties arise in recognising revenue in case of those business enterprises which are engaged in providing services rather than selling of goods, especially public utility enterprises such as electricity companies, water, railways, etc. In case of such enterprises, the revenue should be taken to be realised when the invoicing or billing is done for furnishing of services. In such cases, what is called **accrual basis** is the most appropriate basis for recognition of revenue. In practice, there are basically to systems of accounting:

a. **<u>Cash system of accounting</u>:** It is a system in which accounting entries are made only when cash is received or paid. Accordingly, no entry is made when a payment or receipt is merely due. Certain professional people record their income on cash basis, but while recording expenses they take into consideration the outstanding expenses also. In such a case, the financial statement prepared by them for determination of their income is termed as **Receipts and Expenditure Account.**

b. **Mercantile (accrual) system of accounting**: It is a system in which accounting entries are made on the basis of amounts having become due for payment or receipt. This system recognises the fact that if a transaction or an event has occurred, its consequences cannot be avoided and therefore should be brought into book in order to present a meaningful picture of profit earned or loss suffered and also of the financial position of the enterprise concerned.

2. **Recognition at the Time When Sales Value is collected:** Many enterprises use the cash basis for recognising revenue rather than the accrual basis. As shown above, according to accrual basis, revenue is considered to be realised when the payment for goods or services becomes due to the business. In case cash basis is applied, the revenue will be taken to have been realised only when payment for goods or services has been actually received. This basis for recognising revenue is generally followed in case of sale of goods on instalment system (a system where sale value is to be collected in agreed number of instalments). The basis is not very satisfactory because it fails to match cost with the revenue in those cases where there is a considerable time lag between sale of goods or rendering of services and receiving payment for them.

3. **Recognition When the Production is completed:** It is generally recognised that income occurs only at the time of sale and gains should not be anticipated by reflecting assets at their current market price. However, in case of certain industries where products have an immediate marketability at more or less fixed prices, the revenue may be recognised as soon as the production is completed. The amount of income earned is the excess of the estimated sales prices of the products completed over the cost of their production or extraction. Nevertheless, any expenditure incurred in the disposal of these products should be charged to such income and should be disclosed fully in the financial statements. This is especially true in case of precious metals such as gold and silver and extractive industries (oil for example) and

agriculture. In cases of these industries, the inventories are stated at sales prices.

4. **Recognition Proportionately over the Performance of the Contract:** According to this basis, revenue is recognised even in those cases where the work has not been completed in all respects. This is particularly true in case of long term contracts which may take few years to complete. In case of such contracts, revenue is recognised on the basis of the work which has been completed and approved by the contractee (technically known as work certified). This is done on the basis of certain accepted norms, which are given below:

a. When less than one-fourth of the contract is completed, no profit should be taken to the Profit and Loss Account.

b. When one-fourth or more but less than one-half of the contract is completed, one-third of the profit made to date should be taken to the Profit and Loss Account. This may, further, be reduced on the basis of cash received by the contractor from the contractee. This is technically known as reducing profit on cash basis.

c. If half or more of the contract has been completed, two-third of the profit as reduced on cash basis may be taken to the Profit and Loss Account. The degree of completion of the contract is computed by comparing the work certified with the contract price.

1.2.4 Expenses:

The term **Expense** refers to the cost of services and things used for generating revenue. On the other hand, the term **Expenditure** means payment or the incurring of a debt for an asset or an expense. If an asset is acquired or an expense is incurred, expenditure is said to have been made whether or not the cash is paid immediately. Therefore, every expense is expenditure, while each expenditure is not necessarily an expense. For example, the salaries paid to the employees of a business are both expenditure as well as an expense. But, the amount paid for the acquisition of the fixed asset for the business is expenditure but not an expense. While calculating the income or the profit of a business enterprise, for a given period, the revenue earned during the period is to be matched with expense incurred in earning that revenue.

Accordingly, **Expenses are the costs of the goods and services used up or consumed in the process of earning revenue.** Examples include the cost of employees' salaries, advertising, rent, utilities, and the gradual wearing-out (depreciation) of such assets as buildings, automobiles, and office equipment. All these costs are necessary to attract and serve customers and thereby earn revenue.

Expenses are often called the ***costs of doing business***, that is, the cost of the various activities necessary to carry on a business.

As such, **expense** always causes a ***decrease in owner's equity***. The related or accompanying changes in the accounting equation can be either:

(1) A **decrease in assets,** or

(2) An **increase in liabilities.**

An **expense** reduces assets if payment occurs at the time that the **expense** is incurred. If the **expense** will not be paid until later, as, for example, the purchase of advertising services on account, the recording of the **expense** will be accompanied by an increase in liabilities.

1.2.5 The Matching Principle (When to Record Expenses):

An important relationship exists between revenue and expenses. Expenses are incurred for the ***purpose or objective of producing revenue***. In measuring or determining **net income** for a period, revenue should be offset or matched by ***all the expenses incurred in producing that revenue.*** This concept of offsetting expenses against revenue on a basis of **cause and effect** is called the **Matching Principle**. Timing is an important factor in matching (**offsetting**) revenue with the related expenses. For instance, in preparing monthly or yearly income statements, it will be very important to offset this month's or year's expenses against this month's or year's revenue. We should not offset this month's expenses against last month's revenue because there is no cause and effect relationship between the two.

For example, assume that the salaries earned by sales personnel waiting on customers during July are not paid until early August. In which month should these salaries be regarded as an expense? The answer is **July,** as this is the month in which the sales personnel's services **helped to produce revenue**. Furthermore, expenses and cash payments are not identical or the same. The cash payment for an expense may occur before, after, or in the same period that an expense helps to produce revenue. In deciding when to record an expense, the significant question is ***"In what period does this expenditure help to produce revenue?"*** not "When does the cash payment occur?"

1.2.6 Expenditures Benefiting More Than One Accounting Period:

Many items of expenditures; made by a business entity benefit two or more accounting periods. For example, fire insurance policies; usually cover a period of 12 months. If an enterprise prepares monthly income statements, a portion of the cost of such a policy should be allocated to insurance expense each month that the policy is in force or in effect. In this case, apportionment of the cost of the policy by months is an easy matter.

However, not all transactions can be so accurately divided by accounting periods. The purchase of a building, furniture and fixtures, machinery, or a car provides benefits to the business over all the years in which such an asset is used. As such, no one can specify or determine in advance sharply or exactly how many years of services will be got from these long-lived assets. Nevertheless, in measuring the net income of a business entity for a period of one year or, sometimes, less, the competent accountant has to **estimate** what portion of the cost of the long-lived assets is applicable to the current period. Accordingly, since the allocations or apportioning these costs are estimates rather than accurate measurements, it results in that income statements should be regarded as useful **approximations** of net income rather than as absolutely exact measurements.

On the other hand, some expenditures such as advertising expenses or employee training programmes, it is not possible to estimate or determine objectively the number of accounting periods over which revenue is likely to be produced. In such cases, GAAPs require that the expenditure be **charged immediately to expense**. This treatment has its accounting origin. It is based on the accounting principle of ***objectivity*** and the concept of ***conservatism***. Accountants require **objective evidence** that expenditure will produce revenue in future periods before they will view the expenditure as creating an asset. When this **objective evidence** does not exist, they apply the conservative practice of considering or recording the expenditure as an expense. **Conservatism** means applying the accounting treatment which results in the **lowest** or most conservative estimate of net income for the current period.

1.2.7 Debit and Credit Rules for Revenue and Expense:

As highlighted in the previous sections, it was discussed that revenue increases owner's or proprietor's equity and that expenses decrease such equity. The debit and credit rules for recording revenue and expenses in the journal and hence posting to ledger accounts are considered a natural extension of the rules for recording changes in owner's equity. As we stated previously, the rules for recording increases and decreases in owner's equity were as follows:

- **Increases** in owner's equity are recorded by **credits**.
- **Decreases** in owner's equity are recorded by **debits**.

As such, these rules can be extended to cover revenue and expenses as follows:

1- **Revenue** increases owner's equity, thus revenue is recorded by a **credit.**
2- **Expenses** decrease owner's equity, thus expenses are recorded by **debits.**

Regarding ledger accounts for revenue and expenses during a given accounting period, a great many revenue and expense transactions happen in the business. Therefore, to classify and summarise these transactions, a separate ledger account is maintained for each major type of revenue and expense. At the end of the period, all the expenses appear as debit balances. The debit balances of these accounts represent the total expenses of each type of the expenses occurred in the period and are listed in the income statement. On the other hand, revenue accounts are usually much less numerous than expense accounts and they are also listed in the income statement.

1.3 Investments and Withdrawals by the Owner:

At any time, the owner of sole proprietorship may invest assets (add) or withdraw assets from his/her business. Hence, these ***investment transactions*** cause changes in the amount of owner's equity, but they are ***not*** considered revenue or expenses of the business.

Investments of assets in the business entity by the owner are recorded by **debiting** the asset accounts and **crediting** the owner's capital account. This transaction is not regarded as revenue, because the business entity has not sold any merchandise or rendered any service in exchange for the assets acquired or received.

On the other hand, conventionally, the income statement of a sole proprietorship does not include any salary expense representing the managerial services rendered by the owner. In other words, when the sole trader renders his/her service in managing his/her business, no salary expense should be included in the income statement related to the owner's efforts in business. One reason for not including a salary to the owner-manager is that individuals in such positions are able to set their salaries at any amount they choose, as they have the upper hand in the business. The use of an unrealistic salary to the proprietor would tend to destroy or distort the usefulness of the income statement for measuring the profitability of the business.

Therefore, accountants regard the owner-manager as working to earn the **entire net income** of the business entity, rather than as working for a salary (Meigs & Meigs et. al, 1996).

Even though the owner does not technically receive a salary, he/she usually makes ***withdrawals*** of cash or merchandise from time to time for personal use. As a result, these withdrawals reduce the assets and hence, owner's equity of the business, but they are ***not*** considered as expenses. Expenses are incurred or paid for the purpose of **generating revenue**, and withdrawals by the owner do not have this purpose. Withdrawals could be recorded by debiting the owner's capital account, but a clearer record is made if a separate **drawing account** is debited. Therefore, **debits to the owner's drawing account** result from the following such transactions as:

a. Withdrawals of cash.

b. Withdrawals of other assets. The owner of a stationery store may withdraw, for instance, merchandise for his/her personal use. The amount of the debit to drawing account would be for the cost of the goods which were taken or withdrawn.

c. Payment of the owner's personal bills out of entity funds (home electricity bill, telephone bill etc.).

Because **investments** and **withdrawals** by the owner are not classified as revenue and expenses, they are not implied in the income statement. Instead, they are summarised in a different statement called **the Statement of Owner's Equity**, which will be highlighted later.

The **debit-credit** rules related to effects of revenue, expense, and withdrawals on owner's equity can be summarised as follows:

Owner's Equity

-Decreases recorded by **Debits** -Expenses decrease owner's equity **-Expenses** are recorded by **Debits** -Drawings reduce owner's equity **-Drawings** are recorded by **Debits**	***-Increases*** recorded by ***Credits*** -Revenue increases owner's equity ***-Revenue*** is recorded by a ***Credit***

GENERAL ILLUSTRATION ON RECORDING REVENUE AND EXPENSES TRANSACTIONS:

Engineer Auto Service's transactions in December 2021 are recorded explained below, along with an analysis of each transaction and illustrations of the entries made in the enterprise's accounting records:

(1) Dec. 1 Paid Al-Ahram Newspaper L.E.1,800 cash for newspaper advertising.

Analysis

The cost of advertising is an expense. The asset **Cash** is decreased.

Debit-Credit Rules

Expenses decrease owner's equity and are recorded by debits; debit **Advertising Expense Account** L.E.1,800. Decreases in assets are recorded by credits; credit **Cash Account** L.E.1,800.

Journal Entry

Dec. 1 Advertising Expense a/c….1,800

Cash a/c…………………… 1,800

Posting to Ledger Accounts

Dr Cash a/c Cr

Balance30/11/21	**79,000**	Adv. Expense a/c 1/12	1,800

Dr Advertising Expense a/c Cr

Cash a/c 1/12	1,800		

(2) Dec. 2 Purchased radio advertising from R&TU to be aired in December. The cost was L.E.2,350, payable within one month.

Analysis

The cost of advertising is an expense. The liability **Accounts Payable (Creditors)** is incurred.

Debit-Credit Rules

Expenses decrease owner's equity and are recorded by debits; debit **Advertising Expense Account** L.E.2,350. Increases in liabilities are recorded by credits; credit **Accounts Payable** L.E.2,350.

Journal Entry

Dec. 2 Advertising Expense a/c….2,350

Accounts Payable…………...2,350

Posting to Ledger Accounts

Dr Accounts Payable Cr

		Balance 30/11	**35,000**
		Adv. Expense a/c 2/12	2,350

Dr Advertising Expense a/c Cr

Cash a/c 1/12	1,800		
Accounts payable 2/12	2,350		

(3) Dec. 4 Purchased various shop supplies (such as grease, and solvents) from National Auto Parts; cost L.E.7,000, due in thirty days. These supplies are expected to meet Engineer needs for **three or four months.**

Analysis

As these supplies will last for several accounting periods, they are an asset, not an expense of December (Note that if the supplies are expected to be used within the current accounting period-say December for example-their cost is debited directly to the Supplies Expense Account rather than to an asset account.

Debit-Credit Rules

Increases in assets are recorded by debits, debit **Shop Supplies Account** L.E.7,000. Increases in liabilities are recorded by credits; credit **Accounts Payable (Creditors)** L.E.7,000.

Journal Entry

Dec. 4 Shop Supplies a/c………7,000

Accounts Payable………..... 7,000

Posting to Ledger Accounts

Dr Accounts Payable Cr

		Balance 30/11	**35,000**
		Adv. Expense a/c 2/12	2,350
		Shop Supplies a/c 4/12	7,000

Dr Shop Supplies a/c Cr

Balance 30/11	0		
Accounts payable 4/12	7,000		

(4) Dec. 15 Collected L.E.24,900 cash for repairs made to vehicles of Upper Egypt Co.

Analysis

The asset **Cash Account** is increased. **Revenue** has been earned.

Debit-Credit Rules

Increases in assets are recorded by debits, debit **Cash Account** L.E.24,900. Revenue increases owner's equity and is recorded by a credit; credit **Repair Service Revenue Account** L.E.24,900.

Journal Entry

Dec. 15 Cash a/c……… 24,900

Repair Service Revenue a/c 24,900

Posting to Ledger Accounts

Dr Cash a/c Cr

Balance 30/11/21	**79,000**	Adv. Expense 1/12	1,800
Rep. Ser. Revenue 15/12	24,900		

Dr Repair Service Revenue a/c Cr

		Cash a/c 15/12	24,900

(5) Dec. 23 Ahmed Adel, the owner, withdrew L.E.15,500 cash from the enterprise's bank account for his personal use.

Analysis

Withdrawals of assets by the owner reduce owner's equity. The asset **Cash Account** is decreased.

Debit-Credit Rules

Decreases in owner's equity are recorded by debits; debit **Ahmed, Drawings Account** for L.E.15,500. Decreases in assets are recorded by credits, credit **Cash Account** L.E.15,500.

Journal Entry

Dec. 23 Ahmed, Drawings a/c 15,500

Cash a/c………………… 15,500

Posting to Ledger Accounts

Dr Cash a/c Cr

Balance 30/11/21	**79,000**	Adv. Expense 1/12	1,800
Rep. Ser. Revenue 15/12	24,900	Ahmed, Drawings 23/12	15,500

Dr Ahmed, Drawings a/c Cr

Cash a/c 23/12	15,500		

(6) Dec. 29 Ahmed found that he did not need all of the cash he had withdrawn on December 23, therefore he re-deposited L.E.5,000 in Engineer's bank account.

Analysis

The asset **Cash Account** increased. The owner's equity in the enterprise has been increased.

Debit-Credit Rules

Increase in assets are recorded by debits; debit **Cash Account** L.E.5,000. Increases in owner's equity are recorded by credits; credit Ahmed, **Capital Account**, L.E.5,000

Journal Entry

Dec. 29 Cash a/c……….. 5,000

Ahmed, Capital a/c… 5,000

Posting to Ledger Accounts

Dr Cash a/c Cr

Balance 30/11/21	**79,000**	Adv. Expense 1/12	1,800
Rep. Ser. Revenue 15/12	24,900	Ahmed, Drawings 23/12	15,500
Capital 29/12	5,000		

Dr Ahmed, Capital a/c Cr

		Balance 30/11	**400,000**
		Cash a/c 29/12	5,000

(7) Dec. 31 Sent bill to Upper Egypt Co. of L.E.27,000 for maintenance and repair services rendered during December. The contract with Upper Egypt Co. calls for payment to be received by January 10, 2022.

Analysis

An asset, **Accounts Receivable (Debtors)**, is acquired. Revenue has been earned.

Debit-Credit Rules

Increase in assets are recorded by debits; debit **Accounts Receivable** L.E.27,000. Revenue increases owner's equity and is recorded by a credit; credit **Repair Service Revenue Account** L.E.27,000.

Journal Entry

Dec. 31	Accounts Receivable a/c	27,000	
	Repair Service Revenue a/c		27,000

Posting to Ledger Accounts

Dr — Accounts Receivable a/c — Cr

Balance 30/11	6,000		
Rep. S. Revenue 31/12	27,000		

Dr — Repair Service Revenue a/c — Cr

		Cash a/c 15/12	24,900
		Acc. Receivable 31/12	27,000

(8) Dec. 31 Paid all employees' wages for December, L.E.24,500.

Analysis

Wages (Salaries) to employees are an expense. The asset **Cash Account** is decreased.

Debit-Credit Rules

Expenses decrease owner's equity and are recorded by debits; debit **Wages Expense Account** L.E.24,500. Decreases in assets are recorded by credits; credit **Cash Account** L.E.24,500.

Journal Entry

Dec. 31	Wages Expense a/c	24,500	
	Cash a/c………		24,500

Posting to Ledger Accounts

Dr Cash a/c Cr

Balance 30/11/21	**79,000**	Adv. Expense 1/12	1,800
Rep. Ser. Revenue 15/12	24,900	Ahmed, Drawings 23/12	15,500
Capital 29/12	5,000	Wages Expenses 31/12	24,500

Dr Wages Expense a/c Cr

Cash a/c 31/12	24,500		

The Journal:

In the current illustration, journal entries were presented in a much abbreviated form. The actual entries made in Engineer's General Journal appear below. You will notice that these **formal** journal entries include brief **explanations** of the transaction, which include such details as the terms of credit transactions.

GENERAL JOURNAL

Date	Explanation	L P	Debit	Credit
2021				
Dec.	By Advertising Expense a/c	70	1800	
	To Cash a/c……………	1		1800
1	*Purchased newspaper advertising to run in December.*			
	By Advertising Expense a/c	70	2350	
	To Accounts Payable a/c	32		2350
2	*Purchased radio advertising on account; payment due in 30 days.*			
	By Shop Supplies a/c……	6	7000	
	To Accounts Payable……	32		7000
4	*Purchased shop supplies on account; payment due in 30 days.*			
15	By Cash a/c………………	1	24900	
	To Repair Service Revenue	60		24900
	Repair services rendered.			
23	By Ahmed, Drawing a/c…	52	15500	
	To Cash a/c…………	1		15500
	Owner withdrew cash from enterprise.			
29	By Cash a/c………………	1	5000	
	To Ahmed, Capital a/c…			5000

31	*Owner invested cash in business.*	50		
	By Accounts Receivable…	4	27000	
	To Repair Service Revenue	60		27000
	Billed Upper Egypt Co. for services rendered in December.			
31	By Wages Expense a/c……	72	24500	
	To Cash a/c…………	1		24500
	Paid all wages for December.			

The Ledger:

After the posting of these December transactions, Engineer's ledger accounts appear as shown below.

Dr Cash a/c (1) Cr

Balance 1/12/21	**79900**	Adv. Expense a 1/12	1800
Rep. Ser. Revenue 15/12	24900	Drawings 23/12	15500
Capital a/c 29/12	5000	Wages Exp. 31/12	24500
		Balance 31/12/21	**67100**
	108900		108900
	=====		=====

Dr Accounts Receivable a/c (4) Cr

Balance 1/12/21 L.E.	**6000**	**Balance 31/12/21**	**33000**
Rep. S. Revenue 31/12	27000		
	33000		33000
	======		=====

Dr Shop Supplies a/c (6) Cr

Balance 1/12	**0**	**Balance 31/12/21**	**7000**
Accounts payable 4/12	7000		
	7000		7000
	====		====

Dr Land a/c (20) Cr

Balance 1/12	**260000**	**Balance 31/12/21**	**260000**
	260000		260000
	=====		=====

Dr Building a/c (22) Cr

Balance 1/12 L.E.	**180000**	**Balance 31/12/21**	**180000**
	180000		180000
	=====		=====

Dr Tools and Equipment a/c (25) Cr

Balance 1/12 L.E.	60000	**Balance 31/12/21**	**60000**
	60000		60000
	=====		=====

Dr Notes Payable a/c (30) Cr

Balance 31/12/21 L.E.	150000	**Balance 1/12/21**	**150000**
	150000		150000
	=====		=====

Dr Accounts Payable (32) Cr

Balance 31/12/21	**44350**	**Balance 1/12 L.E**	**35000**
		Adv. Expense a/c 2/12	2350
		Shop Supplies a/c 4/12	7000
	44350		44350
	=====		=====

Dr Ahmed, Capital a/c (50) Cr

Balance 31/12/21	**405000**	**Balance 1/12 L.E.**	**400000**
		Cash a/c 29/12	5000
	405000		405000

Dr Ahmed, Drawings a/c (52) Cr

Cash a/c 23/12	L.E.	15500	**Balance 31/12/21**	**15500**
		15500		15500

Dr Repair Service Revenue a/c (60) Cr

Balance 31/12/21	**51900**	Cash a/c 15/12	L.E.	24900
		Acc. Receivable 31/12		27000
	51900			51900

Dr Advertising Expense a/c (70) Cr

Cash a/c 1/12	L.E.	1800	**Balance 31/12/21**	**4150**
Accounts payable 2/12		2350		
		4150		4150

Dr Wages Expense a/c (72) Cr

Cash a/c 31/12	L.E.	24500	**Balance 31/12/21**	**24500**
		24500		24500

The Trial Balance:

A **Trial Balance** prepared from Engineer's Ledger at December 31, 2021 is shown below:

ENGINEER AUTO SERVICE
Trial Balance
December 31, 2021

Accounts Title	Debit	Credit
Cash ………………… L.E.	67,100	
Accounts Receivable……	33,000	
Shop Supplies……………	7,000	
Land………………………	260,000	
Building…………………..	180,000	
Tools and Equipment……..	60,000	

Notes Payable…………….		150,000
Accounts Payable…………		44,350
Ahmed, Capital……………		405,000
Ahmed, Drawings…………	15,500	
Repair Service Revenue…..		51,900
Advertising Expense………	4,150	
Wages Expense……………	24,500	
Total……	**651,250**	**651,250**

As it has been discussed previously, this **Trial Balance** proves the equality of the debit and credit entries in the enterprise's ledger accounts. Also, notice that the trial balance now includes **Income Statement** accounts as well as **Balance Sheet** accounts.

1.4 Adjusting Entries: An Introduction:

Adjusting entries are considered the next step in the accounting cycle before the preparation of the financial statements. As you will see in the following sections of this Chapter, there is more to the measurement of business entity income than merely recording transactions. In practice, many transactions influence the revenue or expenses of ***two or more*** accounting periods. For instance, an enterprise may buy equipment that will last for many years, an insurance policy that covers twelve months, or enough shop supplies to last for several months.

As an initial step, the costs of such items are **recorded as assets**, since they will benefit the business enterprise in the future accounting periods. Over time, these assets are **used up or consumed,** and their costs **become expenses** of the periods in which the goods or services are used.

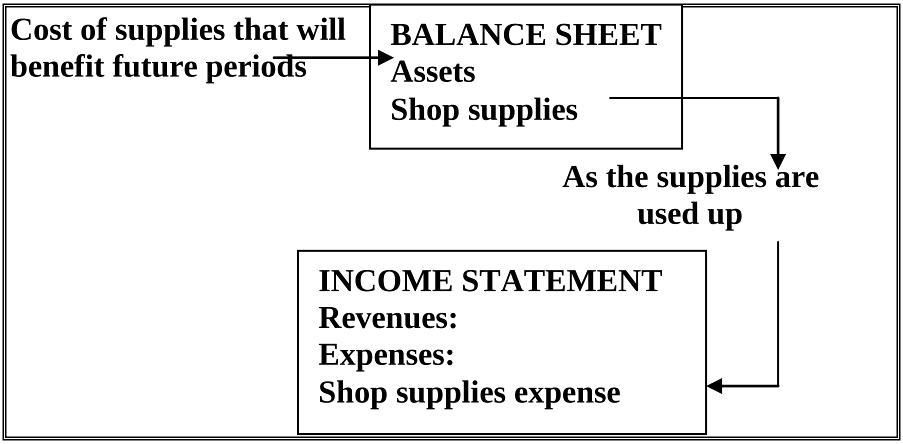
The question which imposes itself at the moment is that: **How do enterprises allocate or apportion the costs of such assets to expense over a span of several accounting periods?** The answer for such question is by making **Adjusting Entries** at the end of each accounting period. The objective beyond of these adjusting entries is to assign or determine to each accounting period the appropriate amounts of revenue and expenses. Such entries ***adjust*** the balances of various ledger accounts. Thus, the name **Adjusting Entries** was originated.

In practice, accountants meet several different types of adjusting entries, some of which affect expenses and others affect revenue. Actually, an enterprise may make a dozen or more adjusting entries in each accounting period. For keeping our example short, it will be assumed that **Engineer's** accounts require only 3 **adjusting entries** at

December 31, 2021, all of which involve the recognition of expenses. Other types of **adjusting entries,** including those influencing revenue, will be highlighted and illustrated later.

Shop Supplies: An Asset That Turns into an Expense:

As we discussed in the general illustration, on December 4, 2021, Engineer Auto Service purchased for L.E.7,000 a quantity of shop supplies expected to continue for 3 or 4 months. At the date of purchase, this L.E.7,000 cost was debited to an asset account, **Shop Supplies Account**, because it was expected to ***benefit future accounting periods.*** However, as these supplies are **used**, this asset gradually **becomes an expense**. This concept can be illustrated in the following diagram:



Now, assume that during the period ended on December 31, **L.E.2,000** worth of **Engineer's shop supplies** was used in business operations, and that nearly **L.E.5,000** worth remains on hand, which available for use in future periods. Accordingly, the L.E.2,000 of supplies **<u>used</u>** during December must be **recognised as expense** in that month; the L.E.5,000 in supplies **<u>still on hand</u>** should be shown in the December 31 balance sheet as an *<u>asset.</u>* To transfer the cost of the supplies used during the month from the asset account to an expense account, **Engineer Auto Service** will make the following **adjusting entry** at December 31:

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Date	Explanation	LP	Debit	Credit
2021 Dec. 31	By Supplies Expense a/c… To Shop Supplies a/c… To recognise as expense the cost of shop supplies used in December.	74 6	2,000	 2,000

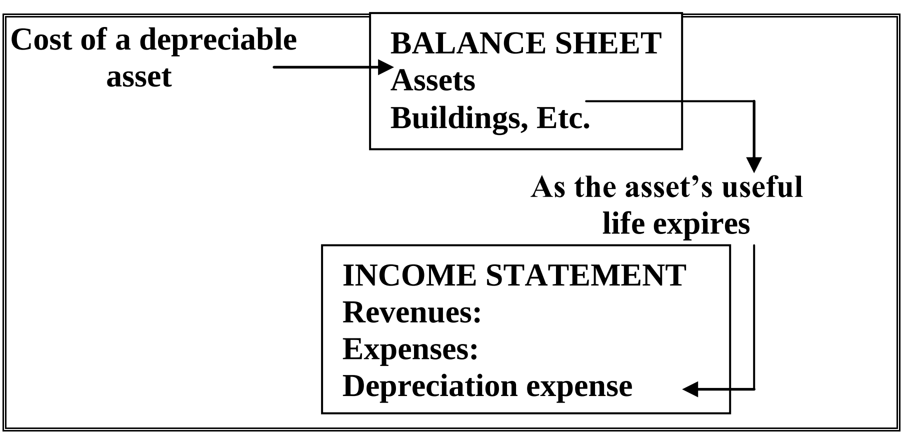
The Concept of Depreciation:

Depreciable Assets are **physical objects** which retain or keep their size and shape, but which finally wear out or become obsolete. In fact, they are not physically consumed, as are assets such as shop supplies, but nevertheless their economic usefulness is **used up** over time. Depreciable assets include several various items, such as buildings and all types of equipment, fixtures, furnishings. On the other hand, **land**, however, is **not regarded**

as a depreciable asset, as it has an **unlimited** useful life.

Thus, each period, a **portion of a depreciable asset's usefulness expires.** Accordingly, matching or corresponding portion of its cost is recognised as **depreciation expense.**

Now, the urgent question is that: ***What Is Depreciation?*** In accounting domain, the term **"Depreciation"** means the ***systematic allocation of the cost of a depreciable asset to expense*** over the asset's useful life. This process can be illustrated as below:



It should be kept in mind the fact that **Depreciation** **<u>is not</u>** an attempt to record changes in the asset's market value. In the short run, the market value of some depreciable assets may even increase, however the process of depreciation continues anyway. Also, the purpose and rationale for depreciation could lie in the **<u>Matching Principle.</u>** So, the objective is to offset or match a reasonable portion of the asset's cost against revenue in each period of the asset's **<u>useful life.</u>**

Normally, **depreciation expense** occurs continuously over the life of the asset; **<u>however</u>** there are **<u>no</u>** daily **<u>depreciation transactions.</u>** In effect, depreciation expense is **paid in advance** when the asset is originally bought. Thus, ***<u>adjusting entries</u>*** are required at the end of each accounting period to **transfer** a proper amount of the asset's **cost** to **depreciation expense.**

On the other hand, it is known that **depreciation is only an estimate.** The **appropriate amount** of depreciation expense, which is taken into account every accounting period, is **only an estimate.** Practically, we cannot look at a car or a piece of equipment and determine exactly how much of its economic usefulness has expired during the current period.

There are a variety of methods which are used to estimate periodic depreciation expense. However, the most widely used means of estimating such expense is the ***Straight-Line Method***. Under the **Straight-Line Approach**, an *equal portion* of the asset's cost is allocated to depreciation expense in every period of the asset's estimated useful life. Depreciation expense can be computed, under the straight-line method, by the following formula:

Depreciation Expense per period = $\frac{\text{Cost of the asset}}{\textit{Estimated useful life}}$

Note that any possible **residual value** which might recover upon selling or disposal of the asset should be taken into account when computing depreciation expense of a period. Therefore, the formula used for computing depreciation expense can be shown as follows:

$$\textbf{Depreciation Expense} = \frac{(Cost\,of\,the\,asset - \mathrm{Re}sidual\,value)}{Estimated\,useful\,life}$$

After all, the use of an **estimated useful life** is the main reason why depreciation expense is **only an estimate.** Mostly, enterprise management does not know in advance precisely how long the asset will remain in use. In their financial statements, most business enterprises determine depreciation expense by the **Straight-Line Method.**

An Illustration for Recording Depreciation Expense:

As it was discussed early, **Engineer Auto Service** owns two types or categories of depreciable assets.

They are building and tools and equipment. Because these categories of assets have different useful lives, depreciation must be computed separately for each category. **Engineer** chooses to compute depreciation expense by the **straight-line method**.

(1) Depreciation on the Building:

Engineer bought its building for **L.E.180,000**. Ahmed Adel, the owner, estimates that the building has useful life of 20 years. Hence, Engineer will recognise annual depreciation expense equal to **1/20** of the building's cost, or **L.E.9,000** (L.E.180,000 cost ÷ 20-year estimated useful life). On a monthly basis, the depreciation expense amounts to **L.E.750** (L.E.180,000 cost ÷ 240 months or L.E.9,000 ÷ 12 months).

Accordingly, the adjusting entry to record depreciation expense on this building for the month of December 2021 is shown below:

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Date	Account Titles and Explanation	LP	Debit	Credit
2021 Dec. 31	Depreciation Expense a/c: Building	76	750	
	Accumulated Dep. Exp.: Building	23		750
	To record one month's depreciation on building (cost, L.E.180,000, divided by estimated useful life, 240 months, equals L.E.750 per month).			

According to this treatment, the ***Depreciation Expense Account*** will be included in **Engineer's income statement** (Profit and Loss Account) for December, along with the other expenses for the month. The **Accumulated Depreciation Account** will appear in the **Balance Sheet** as a deduction from the balance of the **Building Account**, as presented below:

ENGINEER AUTO SERVICE
Partial Balance Sheet
December 31, 2021

Assets		Liabilities & Owner's Equity	
Cash…….. .L.E.	67,100		
Accounts receivable..	33,000		
Shop supplies……	5,000		
Land…………….	260,000		
Building 180,000			
***Less*: Accumulated**			
Depreciation <u>750</u>	**179,250**		

It is appeared that the end result of creating the **Accumulated Depreciation Account: Building Account** is much the same as if the credit has been made to the **Building Account.** In other words, the net amount appeared on the balance sheet for the building is reduced from **L.E.180,000** to **L.E.179,250.** On the other hand, although the credit side of a depreciation entry **<u>could</u>** be made directly to the asset account, it is conventionally and more efficient to record such credits in a separate account entitled **<u>Accumulated</u>**

Depreciation Account. Accordingly, the original cost of the asset and the total amount of depreciation recorded over the years can more easily be determined from the ledger when separate accounts are kept for the asset and for the accumulated depreciation.

(2) Depreciation on the Tools and Equipment:

Engineer Auto Service also must record depreciation on its tools and equipment. These assets cost **L.E.60,000**, and the enterprise management estimates that they will remain in performing their service for about 5 years. Therefore, the monthly computed depreciation expense amounts to **L.E.1,000** (L.E.60,000 cost ÷ 60 months). As such, the adjusting entry to recognise this monthly expense is made as follows:

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Date	Account Titles and Explanation	LP	Debit	Credit
2021 Dec. 31	Depreciation Expense a/c: Tools and Equipment……	78	1,000	
	Accumulated Dep. Exp.: Tools and Equipment……	26		1,000
	To record depreciation on tools and equipment (L.E.60,000 ÷ 60 months).			

In practice, similar adjusting entries to recognise depreciation expense on the building and tools and equipment will be made each month or each year throughout the asset's useful lives. Thus, once the assets have become ***fully depreciated***, that is, their total cost has been recognised as depreciation expense, the recognition of depreciation on assets will stop. On the other hand, **depreciation** begins when the assets are **placed in use** for the intended business purpose. Also, **Depreciation is a *Non-cash* Expense**. As discussed previously, net income **does not** represent an inflow of cash or any other asset. It is a ***computation*** of the overall influence of certain business transactions on owner's equity. The computation and recognition of depreciation expense is an example of such treatment. As depreciable assets **expire**, owner's equity declines; however **there is no corresponding cash expenditure or outlay** in the current period. As a result, depreciation often is called a ***Non-cash*** expense. Often it represents the **largest difference** between net income and the cash flows resulting from business operation.

1.4.1 The Adjusted Trial Balance:

Mostly and after all the required and necessary adjusting entries have been recorded and posted to the related accounts, an **Adjusted Trial Balance** is prepared to demonstrate that the ledger is still in balance. Such trial balance also provides a complete listing of the account balances to be used in preparing the required financial statements. The following adjusted trial balance differs from the trial balance presented previously, as it includes several new account titles, and the balances in some existing accounts have been ***adjusted.***

Finally, once an adjusted trial balance has been prepared, the process of recording changes in financial position regarding this accounting period is complete. As such, **financial statements are prepared directly from adjusted trial balance.** You will note that every account in the adjusted trial balance contains its end-of-the-period balance. This is true for all accounts, ***with the exception of the owner's capital account.***

During the accounting period, several transactions influencing owner's equity were not recorded directly in the owner's capital account. Instead, these transactions were recorded in the various revenue and expense accounts, or in the owner's drawing account. Thus, the balance in the owner's capital account appeared in the **adjusted trial balance** is **Not** completely up to date. But, this will note result in a problem; as we prepare a **set** of financial statements, the amount of the owner's equity at the **end** of the period will become clear.

ENGINEER AUTO SERVICE
Adjusted Trial Balance
December 31, 2021

Account Titles	**Debit**	**Credit**
Cash……………………………L.E.	67,100	
Accounts receivable (Debtors)……….	33,000	
Shop supplies………………………..	**5,000**	
Land…………………………………..	260,000	
Building………………………………	180,000	
Accumulated depreciation: building		**750**
Tools and equipment…………………	60,000	
Accumulated depreciation: tools and equipment……………………………..		**1,000**
Notes payable……………………….		150,000
Accounts payable (Creditors)…………		44,350
Ahmed Adel, Capital…………………..		405,000
Ahmed Adel, Drawings………………..	15,500	
Repair service revenue………………..		51,900
Advertising expense…………………..	4,150	
Wages expense………………………..	24,500	
Supplies expense……………………..	**2,000**	
Depreciation expense: building……..	**750**	
Depreciation expense: tools and		

equipment……………………………	**1,000**	
Total	**653,000**	**653,000**

1.4.2 Preparation of a Set of Financial Statements:

To this point, **Engineer Auto Service** has been operating for a month and managers and many of the outside parties will be eager to know more about the business enterprise than just its financial position. For example, they would like to know the **result of operations** (whether the month's activities have been profitable or unprofitable).

For providing such additional information, it will be necessary to prepare a more complete set of financial statements, including an **Income Statement, a Statement of Owner's Equity, and a Balance Sheet.** These financial statements are shown as follows:

ENGINEER AUTO SERVICE
Income Statement
For the Month Ended December 31, 2021

Revenue:	L.E.	L.E.
Repair service revenue……		51,900
Expenses:		
Advertising expense……………	4,150	
Wages expense…………………	24,500	
Supplies expense………………..	2,000	
Depreciation expense: building…	750	
Depreciation expense: tools and equipment……………	1,000	32,400
Net income……………………		***19,500***

ENGINEER AUTO SERVICE
Statement of Owner's Equity
For the Month Ended December 31, 2021

Ahmed, Capital, Dec.1, 2021……….. L.E.	400,000
Add: ***Net income for December…………***	***19,500***
Additional investment by owner…….	5,000
Subtotal…………………………………	424,500
Less: Withdrawals by owner………………	15,500
Ahmed, Capital, Dec. 31, 2021……….	***409,000***

ENGINEER AUTO SERVICE
Balance Sheet
December 31, 2021

Assets		Liabilities & Owner's Equity	
Cash…………..L.E.	67,100	***Liabilities:*** L.E.	
Accounts receivable.	33,000	Notes payable..	150,000
Shop supplies……	5,000	Accounts	
Land…………….	260,000	payable	44,350
Building 180,000		***Total liabilities..***	***194,350***
Less: Accumulated		***Owner's equity***	
Depreciation 750	179,250	**Ahmed, Capital**	
Tools and E. 60,000		**Dec. 31, 2021**	**409,000**
Less: Accumulated			
Depreciation 1,000	59,000		
Total ………………	***603,350***	***Total…………..***	***603,350***

The Income Statement:

As shown above, the **revenue** and **expenses** appeared in the income statement are taken directly from the entity's adjusted trial balance. **Engineer's** income statement for the month of December demonstrates that revenue exceeded the expenses for the month, therefore producing a **net income of L.E.19,500.** The income statement is of great importance and indicates that the new business has been profitable during its first month of operation.

Income statement can be presented under different titles. Alternative titles for the income statement may include **Earnings Statement, Statement of Operations,** and **Profit and Loss statement.** Nevertheless, **Income Statement** is the most popular term for this important financial statement. To sum up, it could be pointed out that an income statement is used to summarise the **operating results** of an enterprise by matching the revenue earned during a specific time period with the expenses incurred in obtaining that revenue.

The Statement of Owner's Equity:

As illustrated above, the ***Statement of Owner's Equity*** summarises the increases and decreases during the accounting period in the amount of owner's equity. Increase, often, result from earning net income and from additional investments by the owner; decreases, on the other hand, result from net losses and from withdrawals of assets by the owner.

In our illustration, the owner's equity at the beginning of the period (**L.E.400,000**) may be obtained from the ledger or from the balance sheet of the preceding accounting period. The amount of net income or net loss for the period is determined in the enterprise's **income statement.** Additional investments by the owner may be determined by reviewing the credit column of the owner's capital account in the ledger. Withdrawals during the period are determined by the balance in the owner's drawing account. By adjusting the beginning amount of owner's equity for the increases and decreases occurring during the accounting period, you are able to determine the owner's equity at the end of the accounting period. In our illustration, this amount, **L.E.409,000**, will also appear in the enterprise's December 31 balance sheet.

The Balance Sheet:

It is known that the **balance sheet** lists the amounts of the enterprise's assets, liabilities, and owner's equity at the ***end*** of the accounting period. The balances of the asset and liability accounts are obtained directly from the **adjusted trial balance**. The amount of owner's equity at the end of the period, **L.E.409,000**, was indicated in the **statement of owner's equity.**

1.5 Closing Entries of the Temporary Equity Accounts:

It has been previously stated that **revenue *increases*** owner's equity, and **expenses** and **withdrawals** by the owner ***decrease*** owner's equity. In practice, we need a variety of financial statements. If the only financial statement which is required by users of information was a **balance sheet,** these changes in owner's equity could be recorded directly in the **proprietor's capital account**. But proprietors, managers, investors and other users of financial information need to know amounts of specific revenues and expenses, and the amount of net income that was earned in a given accounting period. Thus, we keep separate ledger accounts to determine each type of revenue and expense, and the owner's drawings.

The revenue, expense, and drawing accounts are classified under the title **Temporary or Nominal**

Accounts, because they gather the transactions of **only one accounting period.** So, at the end of this accounting period, the changes in owner's equity accumulated in these temporary accounts are transferred to **owner's capital account**. This process performs or serves two important purposes. First of all, it **updates the balance of the owner's capital account** for changes in owner's equity occurring during the accounting period. Second, it **returns the balances of the nominal accounts to zero**, so that they are ready for measuring the revenue, expenses, and drawings of the next accounting period.

Furthermore, we stress again that the owner's capital account and other balance sheet accounts are called **Permanent or Real Accounts,** since their balances continue to exist after the current accounting period. The process used to transfer the balances of the **temporary accounts** to the owner's capital account is called **closing** the accounts. Accordingly, the journal entries made for the purpose of closing the nominal or temporary accounts are practically called ***Closing Entries*.**

As such, revenue and expense accounts are **closed** at the end of each accounting period by the means of **transferring their balances** to a brief or summary account termed ***Income Summary Account***. Hence, when the credit balances of the revenue accounts and the debit balances of the expense accounts have been **transferred** into **one summary account**, the balance of this **Income Summary Account** will be the **Net Income** or **Net Loss** for the period. In other words, if the revenue, which represents credit balances, exceeds the expenses, which represent debit balances, the **Income Summary Account** will have a **credit** balance representing **Net Income**. Conversely, if expenses exceed revenue, the **Income Summary**

Account will have a **debit** balance representing **Net Loss**. This analysis agrees with the rule *that increases in owner's equity are recorded by credits and decreases are recorded by debit.*

In practice, the common treatment is to close the accounts only once a year, however for the purpose of discussion and illustration, the closing of the accounts of **Engineer Auto Service** will be shown at December 31, 2021 after one month of business operation, as demonstrated below:

1.5.1 Closing Entries for Revenue Accounts:

Normally, revenue accounts have credit balances. Thus, closing a revenue account is intended to transfer its credit balance to the **Income Summary Account.** This process is achieved by a journal entry which debits the revenue account in an amount equal to its credit balance, with a compensating credit to the **Income Summary**

Account. Therefore, the debit amount of this closing entry returns the balance of the revenue account to zero; the credit amount transfers the former balance of the revenue account into the **Income Summary Account.**

In our illustration, the only revenue account of **Engineer Auto Service** is *Repair Service Revenue*, which has, of course, a credit balance of **L.E.51,900** at December 31, 2021. The closing entry will appear as follows:

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Date	**Account Titles and Explanation**	**LP**	**Debit**	**Credit**
<u>2021</u> Dec. 31	By Repair Service Revenue a/c……. To Income Summary a/c To close the Repair Service Revenue Account.	60 53	51,900	 51,900

After this closing entry has been posted, the two accounts affected will be show as follows:

Dr Repair Service Revenue a/c (60) Cr

Balance 31/12/21	**51,900**	Cash a/c 15/12	24,900
		Accounts Receivable 31/12	27,000
	51,900		51,900
Income Summary 31/12	**51,900**	**Balance 31/12/21**	**51,900**
	51,900		**51,900**
	======		=====

Dr Income Summary a/c (53) Cr

To Sundries 31/12	**32,400**	**Repair S. R. 31/12**	**51,900**
To Capital 31/12	**19,500**		
	51,900		**51,900**
	=====		=====

1.5.2 Closing Entries for Expense Accounts:

Normally, accounts which represent expenses have debit balances. Thus, closing an expense account means transferring its debit balance to the **Income Summary Account.** Therefore, the journal entry to close an expense account consists of a credit to the expense account in an amount equivalent to its debit balance, with an offsetting debit to the **Income Summary Account**.

Regarding **Engineer Auto Service**, there are 5 expense accounts in its ledger. Accordingly, five separate journal entries could be made to close these five expense accounts. But, the use of one **compound journal entry** can be easier and time-saving method of closing all the existed expense accounts. As we discussed in the previous chapters, a **compound journal entry** is an entry which encompasses debits to more than one account or credits to more than one accounts.

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Date	Account Titles and Explanation	LP	Debit	Credit
2021	By Income Summary a/c…	53	32,400	
Dec.	To Sundries			
31	Advertising Expense a/c…	70		4,150
	Wages Expense a/c……	72		24,500
	Supplies Expense a/c…	74		2,000
	Depreciation Expense: Building	76		750
	Depreciation Expense: Tools and Equipment……	78		1,000
	To close the expense accounts.			

After this closing entry has been posted, the **Income Summary Account** has credit balance of **L.E.19,500,** and the five expense accounts have zero balances, as appears below:

Dr Advertising Expense a/c (70) Cr

Cash a/c 1/12	1,800	**Balance 31/12/21**	**4,150**
Accounts payable 2/12	2,350		
	4,150		4,150
Balance 31/12/21	**4,150**	**Income Summary 31/12**	**4,150**
	====		====

Dr Wages Expense a/c (72) Cr

Cash a/c 31/12	24,500	**Balance 31/12/21**	**24,500**
	24,500		24,500
Balance 31/12/21	**24,500**	**Income Summary 31/12**	**24,500**

Dr Supplies Expense a/c (74) Cr

Shop supplies 31/12	2,000	**Balance 31/12/21**	**2,000**
	2,000		2,000
Balance 31/12/21	**2,000**	**Income Summary 31/12**	**2,000**
	2,000		2,000

Dr Depreciation Expense a/c: Building (76) Cr

Acc. Dep. a/c 31/12	750	**Balance 31/12/21**	**750**
	750		750
Balance 31/12/21	**750**	**Income Summary 31/12**	**750**
	====		====

Dr Depreciation Expense Account: Cr
Tools & Equipment (78)

Acc. Dep. a/c 31/12	1,000	**Balance 31/12/21**	**1,000**
	1,000		1,000
Balance 31/12/21	**1,000** ====	**Income Summary 31/12**	**1,000** ====

1.5.3 Closing the Income Summary Account:

Now, the 5 **expense accounts** have been closed in the **Income Summary Account** and the total amount of **L.E.32,400** formerly contained in these accounts manifests in the debit side of the **Income Summary Account.** On the other hand, the revenue of **L.E.51,900** earned during December manifests or appears in the credit side of the **Income Summary Account.** Since the credit entry of **L.E.51,900** representing December revenue exceeds the debit of **L.E.32,400** representing December expenses, the account (**Income Summary Account**) has a credit balance of

L.E.19,500 (this credit balance represents the **Net Income** for the month of December).

As a result, the **net income** of **L.E.19,500** earned during the month of December causes the **owner's equity** to increase. Therefore, the **credit balance** of the **Income Summary Account** is transferred into the **owner's equity** account by a closing entry shown as follows:

GENERAL JOURNAL

Date	Account Titles and Explanation	LP	Debit	Credit
2021 Dec. 31	By Income Summary a/c… To Ahmed, Capital a/c… To close the Income Summary Account for December by transferring the net income to the owner's capital account.	53 50	19,500	 19,500

As a result, and after this closing entry has been posted to the related accounts, the **Income Summary Account** has a zero balance, and the **net income** for December 2021 will appear as an increase or credit entry in the **Owner's Capital**

Account. This process will be reflected in the involved accounts as appeared below:

Dr Income Summary a/c (53) Cr

To Sundries 31/12	**32,400**	**Repair S. R. 31/12**	**51,900**
To Capital 31/12	**19,500**		
	51,900		**51,900**
	=====		=====

Dr Ahmed, Capital a/c (50) Cr

Balance c/d 31/12/21	**405,000**	Balance b/d 30/11	400,000
		Cash a/c 29/12	5,000
	405,000		405,000
Balance c/d 31/12/21	**424,500**	**Balance b/d 31/12/21**	**405,000**
		Income Summary 31/12	**19,500**
	424,500		**424,500**
	=====		=====

In this simple illustration, **Engineer Auto Service** has operated profitably, since its revenue exceeded its expenses. However, not every business enterprise is so lucky: if the expenses of a business are larger than its revenue, the **Income Summary Account**, in this case, will have a debit balance, which will represent a **Net Loss** for the accounting period. In such case, the closing of the **Income Summary Account** requires a **debit** to the **Owner's Capital Account** and a compensating **credit** to the **Income Summary Account.** Logically, in this case the owner's equity will be **reduced** by the amount of the **loss debited** to the **Capital Account.**

Notice: The **Income Summary Account** is used **only** at the end of the accounting period *when the accounts are being closed.* Hence, the **Income Summary Account** has no entries and no balance throughout the accounting period, except during the process of closing the accounts at the end of the accounting period.

1.5.4 Closing the Owner's Drawing Account:

It was discussed earlier in this chapter that withdrawals of cash or other assets by the owner, for personal use, are not regarded an expense of the business and, hence, are not element in measuring and determining the **net income** for the financial period. Because drawings by the owner do not form an expense, the owner's drawing account is closed not in the **Income Summary Account** but directly to the **Owner's Capital Account.** Accordingly, the **Owner's Drawing Account** will be closed into the **Owner's Capital Account** by the following entry in the books of **Engineer Auto Service** at December 31, 2021:

GENERAL JOURNAL

Date	Account Titles and Explanation	LP	Debit	Credit
2021 Dec. 31	By Ahmed, Capital a/c…… To Ahmed, Drawing a/c… To close the owner's drawing account.	50 52	15,500	 15,500

As a result, and after this closing entry has been posted to the related accounts, the **Drawing Account** will have a zero balance, and the amount withdrawn by **Ahmed** during December 2021 will appear as a deduction or debit in **Ahmed's Capital Account**. This process will be reflected in the involved accounts as appeared below:

Dr Ahmed, Drawings a/c (52) Cr

Cash a/c 23/12	15,500	**Balance c/d 31/12/21**	**15,500**
	15,500		15,500
Balance b/d 31/12/21	**15,500**	**Capital a/c 31/12/21**	**15,500**
	15,500		**15,500**

Dr Ahmed, Capital a/c (50) Cr

Balance c/d 31/12/21	**405,000**	Balance b/d 30/11	400,000
		Cash a/c 29/12	5,000
	405,000		405,000
Drawing a/c 31/12/21	**15,500**	**Balance b/d 31/12/21**	**405,000**
Balance c/d 31/12/21	**409,000**	**Income Summary 31/12**	**19,500**
	424,500		**424,500**
	=====		=====

1.5.5 The Closing Technique: Summary:

In the previous sections the closing process for revenue accounts, expense accounts, income summary account, and drawing account were explained. Now, let us present briefly the process of closing the accounts as follows:

(1) Close the different accounts of **revenue** by transferring their **credit** balances into the **Income Summary Account.**

(2) Close the different accounts of **expenses** by transferring their **debit** balances into the **Income Summary Account.**

(3) Close the **Income Summary Account** by transferring its **credit or/debit** balance into the **Owner's Capital Account.**

(4) Close the **Owner's Drawing account** by transferring its **debit** balance into the **Owner's Capital Account.** (As a result of this process, the balance of the **Owner's Capital Account** in the Ledger will now be the same as the amount of **Owner's Equity** showing in the **Balance Sheet.**)

1.6 The Complete Accounting Cycle: A Final Look:

In Financial Accounting 1, the concept of the **Accounting Cycle** was introduced. Nevertheless, the used illustration was restricted or confined to accounting transactions which affect the **Balance Sheet.** In this textbook, however, a ***Complete Accounting Cycle***, from the initial journalising of transactions to the preparation of a **complete set** of financial statements, has been explained and illustrated.

The logical steps which form this **Cycle** are listed below, and also are shown in the form of diagram (Meigs & Meigs et. al, 1996):

1- **Journalise or Record Transactions.** This step comprises entering all transactions in the **Journal**, therefore creating a **chronological** series or record of events.

2- **Post to Ledger Accounts.** This step includes posting **debits** and **credits** from the **Journal** to the proper **Ledger** accounts, thus creating a **record classified** by accounts.

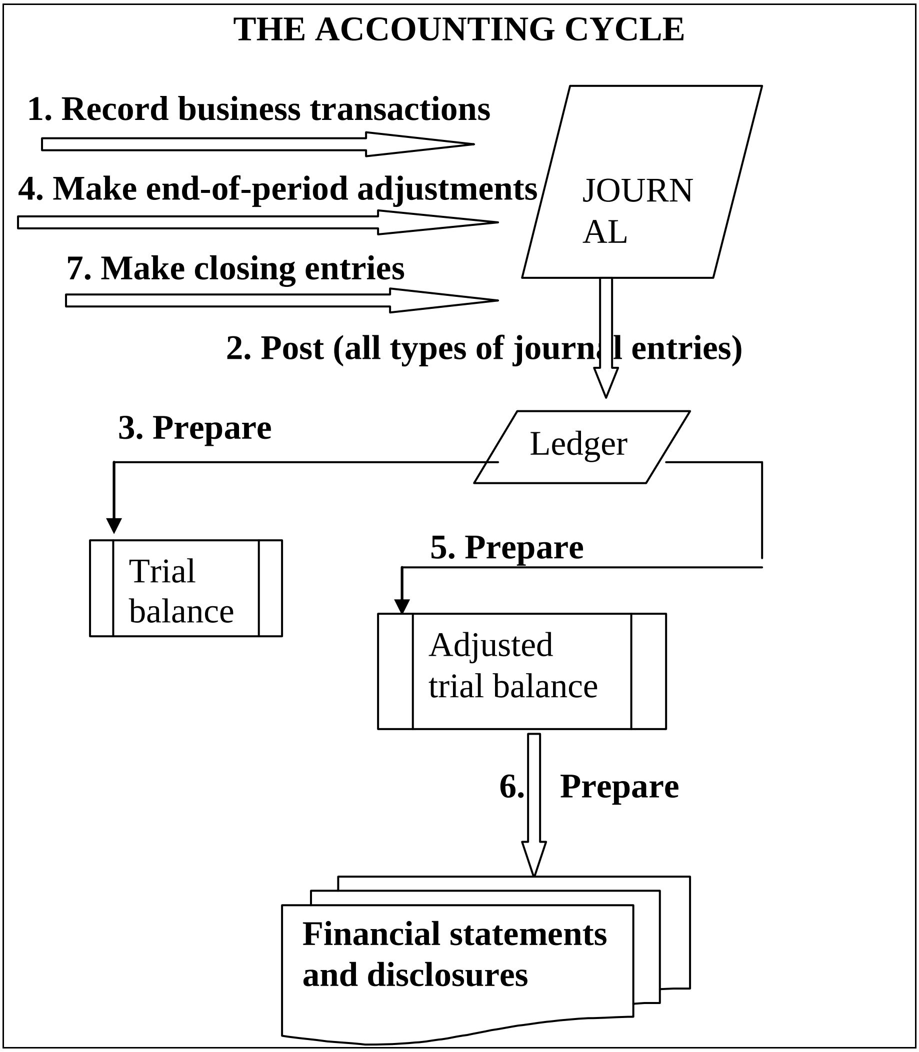
3- **Prepare a Trial Balance.** This step is intended to prove the equality of **debits** and **credits** in the **Ledger.**

4- **Make End-of-Period Adjustments.** This step includes drafting the **adjusting entries** in the **General Journal**, and posting them to the proper **Ledger** accounts.

5- **Prepare an Adjusted Trial Balance.** This step may be an optional step, but it is intended to prove again the equality of **debits** and **credits** in the **Ledger.** In addition, you should take into your consideration that these are the amounts used in the preparation of financial statements.

6- **Prepare Financial Statements and Appropriate Disclosure.** After accomplishing this step you will get a set of financial statements. For instance, an **Income Statement** represents the results of operation **<u>for</u>** a specific accounting period. A **Statement of Owner's equity** shows changes in owner's equity **<u>during</u>** the accounting period. A **Balance Sheet** demonstrates the financial **position** of the business entity **<u>at the end of the accounting period</u>**. Furthermore, **Financial Statements** have to be accompanied by **<u>notes</u>** which disclose facts required for the appropriate *interpretation* of those statements.

7- **Journalise and Post the Closing Entries.** As we have seen, the **Closing Entries** turn the **revenue, expenses,** and **drawing accounts** back to ***<u>zero</u>***, making them ready for recording the transactions of the **next** accounting period. In addition, these entries bring the balance in the **Owner's Capital Account** up-to-date.


THE ACCOUNTING CYCLE
1. Record business transactions
4. Make end-of-period adjustments
7. Make closing entries
JOURNAL
2. Post (all types of journal entries)
3. Prepare
Ledger
Trial balance
5. Prepare
Adjusted trial balance
6. Prepare
Financial statements and disclosures

1.7 The Accrual Basis of Accounting:

At this point, it will be appropriate to highlight an important accounting basis. In practice, the policy applied to recognise revenue in the accounting records when it is **earned**, and to recognise expenses when the related goods or services are **used**, is termed the **Accrual Basis** of accounting. Conventionally, the major purpose of **accrual** accounting is to measure the profitability of the **economic activities performed** during the accounting period.

As we discussed earlier in this textbook, the most important concept involved in *accrual accounting* is the **Matching Principle**. According to this principle, **revenue** is **compensated** or **offset** with all of the expenses incurred or borne in **generating** that **revenue,** hence providing a measure of the overall profitability of the economic activity of the business enterprise.

On the other hand, the **accrual basis** is not the only basis applied in accounting. An **alternative** to the **accrual basis** is something termed **Cash Basis** accounting. As such, under **cash basis** accounting, **revenue** is recognised when cash is received or collected from the customer, rather than when the enterprise sells goods or renders services. Moreover, expenses are only recognised when payment is made, rather than when the related goods or services are used in business operations. Accordingly, the **Cash Basis** of accounting measures the amounts of cash received and paid out during the period. As a result, it does **Not** provide a proper measure of the *profitability of activities* conducted during the accounting period.

1.8 Questions and Exercises:

1.8.1 Questions:

1- What is the effect of operating profitably upon the balance sheet of a business entity?

2- In your opinion, does net income represent a supply of cash which could be withdrawn by the proprietor of an enterprise? Discuss.

3- Explain the meaning of the term <u>revenue</u>. Does the receipt of cash by an enterprise indicate that revenue has been earned?

4- Explain the meaning of the term <u>expenses</u>. Does the payment of cash by an enterprise indicate that an expense has been incurred?

5- Does a well-prepared **income statement** provide a precise or exact measurement of net income for the accounting period, or does it represent merely an approximation of net income? Discuss.

6- How does depreciation expense differ from other operating expenses?

7- All ledger accounts belong in one of the following five groups: **asset, liability, owner's equity, revenue,** and **expense.** For each of the following accounts, state the group in which it belongs. In addition, indicate whether the normal balance would be a debit or a credit.

a. Depreciation Expense a/c. **b.** Building a/c.

c. Accumulated Depreciation: Building.

d. Fees Earned a/c. **e.** Notes Payable a/c.

f. Ahmed, Capital a/c. **g.** Telephone Expense a/c

h. Supplies Expense ac. **i.** Ahmed, Drawing a/c.

8- For each of the following financial statements, determine whether the statement belongs or relates to a **single** date or to a **period** of time:

a. Income Statement. **b.** Balance Sheet.

c. Statement of owner's equity.

9- You are required to indicate: which of the following accounts are closed at the end of the accounting period?

Cash a/c. Repair Service Earned a/c. Income Summary a/c. Ahmed, Drawing a/c. Ahmed, Capital a/c. Accumulated Depreciation a/c. Accounts Payable (Creditors). Accounts Receivable (Debtors). Electricity Expense a/c. Depreciation Expense a/c.

10- You are required to supply the appropriate term (**debit or credit**) to complete the following statements:

a. When a business enterprise is operating ***profitably***, the journal entry to close the **Income Summary Account** will consist of a __________ to that account and a __________ to the **Owner's Capital Account.**

b. When a business enterprise is operating at ***loss***, the journal entry to close the **Income Summary Account** will consist of a __________ to that account and a __________ to the **Owner's Capital Account.**

c. The journal entry to close the **Owner's Drawing Account** consists of a __________ to that account and a __________ to the **Owner's Capital Account.**

11- Identify any of the following statements that correctly describe **net income.** (Determine all correct answers.) **Net Income:**

a. Is computed in the **Income Statement**, appears in the **Statement of Owner's Equity**, and increases owner's equity in the **Balance Sheet**.

b. Is equal to revenue minus expenses.

c. Is computed in the **Income Statement**, appears in the **Statement of Owner's Equity,** and increases the amount of cash shown in the **Balance Sheet.**

d. Can be determined using the account balances appearing in an adjusted **Trial Balance.**

12- Which of the following are based on the **Realisation Principle** and the **Matching Principle?** (Indicate all correct answers.)

a. Adjusting entries. **b.** Closing entries.

c. The Accrual Basis of Accounting.

d. The measurement of net income under generally accepted accounting principles (GAAP's.)

13- The entry to recognise ***depreciation expense*:** (Indicate all correct answers.)

a. Is an application of the matching principle.

b. Is a closing entry. **c.** Is an adjusting entry.

d. Usually indicates an offsetting credit either to Cash or to Accounts Payable.

14- In the **Accounting Cycle:** (Indicate all correct answers.)

a. Closing entries are made before adjusting entries.

b. Financial statements may be prepared as soon as an adjusted trial balance is complete.

c. The **Owner's Capital Account** is **<u>not</u>** up-to-date until closing entries have been posted.

d. Adjusting entries are made before financial statements are prepared.

15- The balance of **Mohamed, Capital Account** appearing in the May 31 **Balance Sheet** should be:

a. L.E.58,250. **b.** L.E.43,150. **c.** L.E.56,900.

d. Some other amount.

Use the following information in question **15:**

Accounts appearing in the Trial Balance of North Egypt Enterprise at May 31, 2022 are listed below:

Accounts payable L.E.12,250. Equipment L.E.81,000. Accounts Receivable L.E.15,500. Insurance expense L.E.5,000. Accumulated depreciation: equipment L.E.40,500

Advertising expense L.E.750. Cash L.E.14,500. Mohamed, Capital L.E.55,000. Mohamed, Drawing L.E.10,500. Other expenses L.E.4,500. Service revenue L.E.24,000.

1.8.2 Exercises and Problems:

(1) Luxor Travel Agency was organised on September 1, 2021. Suppose that the accounts are closed and financial statements prepared each month. The agency occupies rented office space but owns office equipment estimated to have a useful life of 5 years from date of acquisition, September 1. The **Trial Balance** for Luxor Travel Agency at November 30 is shown below:

LUXOR TRAVEL AGENCY
Trial Balance, November 30, 2021

Account Titles	Debit	Credit
Cash………………………… L.E.	32,825	
Accounts receivable……………..	85,250	
Office supplies…………………..	2,500	
Office equipment………………..	90,000	
Accumulated Dep.: Office Equip.		3,000
Accounts payable……………….		6,300
Mostafa, Capital………………...		175,000
Mostafa, Drawing………………	12,500	
Commission earned……………		77,775
Advertising expense……………	7,000	
Salaries expense………………..	13,000	
Rent expense……………………	19,000	
Total………………	*262,075*	*262,075*

Mostafa estimates that only **L.E.1,500** worth of office supplies remain on hand at November 30.

***Required*:**

a. Prepare adjusting entries at November 30 to reflect the office supplies used in November and depreciation expense for the month.

b. Prepare an **adjusted** trial balance at November 30, 2021.

c. Prepare an **income statement** and **statement of owner's equity** for the month and a **balance sheet** at November 30, 2021.

***Solution*:**

a. Adjusting entries:

General Journal

Date	Account Titles & Explanation	Debit	Credit
2021 Nov. 30	By Supplies Expense a/c……. To Office Supplies a/c……. To recognise cost of supplies used in Nov. (2,500 – 1,500 left).	1,000	 1,000
30	By Depreciation Expense: office Equipment…………… To Accumulated Depreciation: Office Equipment…… To record depreciation for November (90,000 $\div$60 months)	1,500	 1,500

b. Adjusted Trial Balance:

LUXOR TRAVEL AGENCY
Adjusted Trial Balance, November 30, 2021

Account Titles	Debit	Credit
Cash………………………… L.E.	32,825	
Accounts receivable……………..	85,250	
Office supplies…………………..	1,500	
Office equipment………………..	90,000	
Accumulated Dep.: Office Equip.		4,500
Accounts payable……………….		6,300
Mostafa, Capital………………...		175,000
Mostafa, Drawing………………	12,500	
Commission earned…………….		77,775
Advertising expense……………	7,000	
Salaries expense………………..	13,000	
Rent expense……………………	19,000	
Supplies expense……………….	1,000	
Depreciation expense: Office Equip.	1,500	
Total………………	263,575	263,575

c. Preparing required financial statements:

LUXOR TRAVEL AGENCY
Income Statement
For the Month Ended November 30, 2021

Description	L.E.	L.E.
Revenue:		
Commission earned………………….		77,775
Expenses:		
Advertising expense…………………	7,000	
Salaries expense……………………...	13,000	
Rent expense…………………………	19,000	
Supplies expense…………………….	1,000	

Depreciation expense: Office Equip. ..	1,500	41,500
Net income……………………..		36,275

LUXOR TRAVEL AGENCY
Statement of Owner's Equity
For the Month Ended November 30, 2021

Mostafa, Capital, Oct. 31, 2021	L.E.175,000
Net income for the month	36,275
Subtotal…………………	211,275
Less: Withdrawals by owner	12,500
Mostafa, Capital, Nov. 30, 2021	198,775

LUXOR TRAVEL AGENCY
Balance Sheet, November 30, 2021

Assets		Liabilities & Owner's Equity	
Cash……………..L.E.	32,825	Liabilities:	
Accounts receivable….	85,250	Accounts payable	6,300
Office supplies……….	1,500	Owner's equity:	
Office equipment 90,000		Mostafa, Capital	198,775
Less: Acc. Dep. 4,500	85,500		
	205,075		205,075

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(2) Listed below are some technical accounting terms: **Net income. Accounting period. Depreciation. Realisation. Accrual basis of accounting. Expenses. Revenue. Cash basis of accounting. Drawing. Matching. Income statement. Closing entries.**

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

a. The generally accepted accounting principle used in determining when to recognise revenue.

b. Recognising revenue when it is earned and expenses when the related goods or services are used in the effort to obtain revenue.

c. The systematic allocation of the cost of a long-lived asset, such as a building or tools and equipment, to expense over the useful life of the asset.

d. The procedures for transferring the balances of the revenue, expense, Income Summary, and owner's drawing accounts into the **Owner's** Capital Account.

e. The cost of goods and services used up in the process of earning revenue.

f. The span of time covered by an income statement.

g. An increase in owner's equity as a result of earning revenue and incurring expenses.

h. A decrease in owner's equity not reported in the income statement.

i. The generally accepted accounting principle used in determining when expenses should be offset against revenue.

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(3) Total **Assets** and total **Liabilities** of **Mahmoud Enterprise** as shown by the **Balance Sheet** at the beginning and end of the year were provided as follows:

	Beginning of Year	End of Year
Asset………....	*L.E.285,000*	*L.E.370,000*
Liabilities…	*90,000*	*125,000*

You are required to compute the net income or net loss from operations for the year in each of the following different cases:

a. Mahmoud made no withdrawals during the year and no additional investments.

b. Mahmoud made no withdrawals but made an additional capital investment of **L.E.40,000.**

c. Mahmoud made withdrawals of **L.E.30,000** but made no additional investments.

d. Mahmoud made withdrawals of **L.E.40,000** and made an additional capital investment of **L.E.15,000.**

e. Mahmoud made no withdrawals, but made an additional capital investment of **L.E.75,000.**

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(4) Healthy Food Enterprise acquired a delivery truck at a cost of **L.E.72,000.** Estimated life of the truck is four years. Management of Healthy Food

Enterprise chooses to use the straight-line method of depreciation for vehicles.

a. State the amount of depreciation expense per year and per month. Give the adjusting entry to record depreciation on the truck at the end of the first month, and explain where the accounts involved would appear in the financial statements.

b. Assume the delivery truck was acquired on Sep. 1, 2021, and that this vehicle is the only delivery truck owned by the enterprise. Show how this truck would be reported in Healthy Food Enterprise's balance sheet at December 31, 2021.

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(5) Safe Flights provides transportation by helicopter between a major airport and various business centres in Cairo. Among the ledger accounts used by the business enterprise are the following:

Cash a/c, Passenger fare revenue a/c, Accounts payable, Advertising expense a/c, Aircraft a/c, Fuel expense a/c, Accounts receivable, Rent expense a/c, Ibrahim, Capital a/c, Repair & maintenance expense a/c, Ibrahim, Drawing a/c, and Salaries expense a/c.

Some of the January transactions of **Safe Flights** are listed below:

Jan. 3 Paid **L.E.17,600** rent for hangar space during January.

Jan. 4 Placed advertising in local newspapers for publication during January. The agreed price of **L.E.4,300** was payable within 10 days after the end of the month.

Jan. 15 Cash receipts from passengers for the first half of January amounted to **L.E.115,800.**

Jan. 15 Ibrahim, the owner, withdrew **L.E.37,500** cash for personal use.

Jan. 16 Paid salaries to employees for services rendered in the first half of January, **L.E.66,000.**

Jan. 25 Provided transportation for executive of the Dandara Company, a long-time credit customer. Sent bill for **L.E.2,350**, due within 30 days.

Jan. 29 received a bill from Misr Oil Co. for fuel used in January, amounting to **L.E.21,700**, and payable by February 10.

Jan. 31 Paid **L.E.16,860** to General Motors for repair and maintenance work during January.

Required:

a. Prepare a journal entry (including an explanation) for each of the above transactions.

b. Describe the effect of the January 29 transaction involving fuel used in January upon each of the following: assets, liabilities, owner's equity, and net income. For each of the four items, indicate whether the transaction caused an increase, decrease, or no effect.

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(6) Computer World provides consulting and systems design services on both a cash and credit basis. Credit customers are required to pay within 30 days from date of billing. Among the **Ledger Accounts** used by the enterprise are the following accounts:

Cash a/c, Office equipment a/c, Accounts payable, Advertising expense a/c, Consulting fees earned a/c, Accounts receivable, Rent expense a/c, Mosa, Capital a/c, Mosa, Drawing a/c, and Salaries expense a/c.

Among the June transactions were the following:

June 1 Provided consulting services to North Publications, a credit customer. Sent bill for **L.E.16,400.**

June 2 Paid rent for June, **L.E.8,250.**

June 3 Purchased office equipment with estimated life of 5 years for **L.E.15,500** cash.

June 10 Provided consulting for Recovery Hospital and collected in full the charge of **L.E.5,100.**

June 15 Newspaper advertising to be published on June 18 was arranged at a cost of **L.E.3,050.** Received bill from Akhbar Elyom requiring payment within 30 days.

June 18 Received payment in full of the **L.E.16,400** account receivable from North Publications for services provided on June 1.

June 20 Mosa, owner of Computer World, withdrew **L.E.27,500** cash from the enterprise for personal use.

June 30 Paid salaries of **L.E.34,000** to employees for services rendered during June.

<u>Required:</u>

a. Prepare a journal entry (including explanation) for each of the above transactions.

b. How does the transaction on June 20 (withdrawal by owner in the amount of **L.E.27,500**) affect net income of the enterprise for June? What is the immediate influence of this transaction upon the assets, liabilities, and owner's equity of Computer World? (For each of these three items, state increase, decrease, or no effect.)

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(7) In June 2021, Esa organised an enterprise to provide crop dusting services. The enterprise, called **Esa Crop Dusting**, began operations immediately. Transactions during the month of June were as follows:

June 1 Esa deposited **L.E.300,000** cash in a bank account in the name of the business.

June 2 Purchased a crop-dusting aircraft from Egypt Air for **L.E.1,100,000**. Made a **L.E.200,000** cash down payment and issued a note payable for **L.E.900,000.**

June 4 Paid Assiut Airport **L.E.12,500** to rent office and hangar space for the month.

June 15 Billed customers **L.E.41,600** for crop dusting services rendered during the first half of June.

June 15 Paid **L.E.29,400** salaries to employees for services rendered during the first half of June.

June 18 Paid Sohag Hangar **L.E.9,450** for maintenance and repair services.

June 25 Collected **L.E.24,550** of the amounts billed to customers on June 15.

June 30 Billed customers **L.E.82,250** for crop dusting services rendered during the second half of the month.

June 30 Paid **L.E.30,000** salaries to employees for services rendered during the second half of June.

June 30 Received a fuel bill from National Fuel Co. for **L.E.12,550** of aircraft fuel purchased during June. This amount is due by July 10.

June 30 Esa withdrew **L.E.10,000** cash from the business for personal use.

The account titles and numbers used by **Esa Crop Dusting** were:

Cash…1, Accounts receivable….5, Aircraft….15, Notes payable …31, Accounts payable…32, Esa, Capital…40, Esa, Drawing…45, Crop dusting revenue…51, Maintenance expense…61, Fuel expense…62, Salaries expense…63, and Rent expense…64.

Required:

a. Prepare journal entries.

b. Post to ledger accounts.

c. Prepare a trial balance at June 30, 2021.

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(8) Clean Environment Enterprise prepares financial statements and closes its accounts at the end of each calendar year. The following **adjusted** trial balance was prepared at December 31, 2021.

CLEAN ENVIRONMENT ENTERPRISE
Adjusted Trial Balance
December 31, 2021

Accounts Titles	Debit	Credit
Cash…………………L.E.	42,750	
Notes receivable………….	12,740	
Accounts receivable……..	65,090	
Supplies…………………	5,300	
Land……………………	196,000	
Building………………….	126,000	
Accumulated depreciation: building..		33,600
Office equipment…………………	33,600	
Accumulated depreciation: Office Equip. ..		13,440
Notes payable…………………………		112,000
Accounts payable………………………		22,680
Yousif, Capital, December 31, 2020…		230,300
Yousif, Drawing…………………….	70,000	
Consulting fees earned……………….		487,200
Advertising expense………………….	31,500	
Insurance expense…………………….	38,720	
Utilities expense……………………….	15,040	
Salaries expense……………………….	245,280	
Supplies expense………………………	9,640	
Depreciation expense: building………	4,200	
Depreciation expense: office equipment….	3,360	
	---------	---------
Total…………………………………..	899,220	899,220

Required:

a. Prepare an **Income Statement** and a **Statement of Owner's Equity** for the year ended December 31, 2021.

b. Prepare a **Balance Sheet** as of December 31, 2021.

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(9) Using the data shown in the above **adjusted** trial balance in Problem **(8)**: ***Required:***

a. Prepare journal entries to close the accounts. Use four entries: (1) to close the **Revenue Account,** (2) to close the **Expense Accounts,** (3) to close the **Income Summary Account,** and (4) to close the **Owner's Drawing Account.**

b. Does the amount of net income or net loss appear in the closing entries? Explain.

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(10) National Football Enterprises operates several football courses, all of which are located on rented land within city parks. Provided below is the

Enterprises' ***adjusted trial balance*** at December 31, 2021. The business closes its accounts at the end of each calendar year.

NATIONAL FOOTBALL ENTERPRISES
Adjusted Trial Balance
December 31, 2021

Accounts Titles	Debit	Credit
Cash…………………………L.E.	41,100	
Accounts receivable…………	7,800	
Buildings…………………………	180,000	
Accumulated depreciation: buildings….		36,000
Football course structure…. ……	270,000	
Accumulated depreciation: Football C. St		90,000
Accounts payable………………		23,100
Salaries payable……………….		6,900
Nouh, Capital, December 31, 2020..		331,560
Nouh, Drawing……………………	75,000	
Admissions revenue………………		576,000
Advertising expense……………….	45,000	
Rent expense………………………	108,000	
Repairs expense..………………….	15,600	
Salaries expense……………………	237,000	
Light & power expense…..………….	13,500	
Depreciation expense: buildings….....	18,000	
Depreciation expense: football C. St.	45,000	
Insurance expense…………………	7,560	
	------------	-----------
Total…………………………………….....	1,063,560	1,063,560

Required:

a. Prepare an **Income Statement** an a **Statement of Owner's Equity** for the year ended December 31, 2021.

b. Prepare a **Balance Sheet** as of December 31, 2021.

c. Is 2021 the first year of operations for National Football Enterprises? Support your answer.

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(11) Using the adjusted trial balance presented in problem 10, ***Required:***

a. Prepare journal entries to close the accounts. Use four entries: (1) to close the **Revenue Account,** (2) to close the **Expense Accounts,** (3) to close the **Income Summary Account,** and (4) to close the **Owner's Drawing Account.**

b. Assume that in the following year, National Football Enterprises again had **L.E.576,000** of admissions revenue, but that expenses increased to **L.E.600,000**. Assuming that the revenue account and all the expense accounts had been closed into Income Summary Account at December 31, prepare a journal entry to close the Income Summary Account.

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(12) Yahya has a real estate enterprise called **Complete Realty**. The operations of **Complete Realty** consist of obtaining listings of houses being offered for sale by owners, advertising these houses, and showing them to prospective buyers. The enterprise earns revenue in the form of commissions. The building and office equipment used in the business were acquired on January 1 of the current year and were immediately placed in use. Useful life of the building was estimated to be 30 years and that of the office equipment 5 years. The business closes its accounts monthly; on March 31 of the current year, the **Trial Balance** is as follows:

COMPLETE REALTY
Trial Balance
March 31, 2021

Accounts Titles	Debit	Credit
Cash……………………………L.E.	48,750	
Accounts receivable……………	37,500	
Office supplies…………………	4,250	
Land………………………………	150,000	
Building…………………………….	450,000	
Accumulated depreciation: building.….		2,500
Office equipment…………. ………	105,000	
Accumulated depreciation: office Equip.		3,500
Accounts payable………………………		73,750
Yahya, Capital……………………….……..		683,250
Yahya, Drawing…………………………..	22,500	
Commissions earned...……………………		100,000
Advertising expense……………………..	4,500	
Automobile rental expense……………..	2,500	
Salaries expense………………………..	35,000	
Telephone expense………..……………..	3,600	
Total……………………………………….	863,000	863,000

Required:

From the trial balance and supplementary data provided, prepare the following as of March 31, 2021.

a. Adjusting entries for depreciation during March of building and office equipment.

b. Adjusting entry to recognise as expense the cost of office supplies used in March. At the end of March, the supplies on hand are estimated to have a cost of **L.E.2,500.**

c. Adjusted trial balance.

d. **Income Statement** and a **Statement of Owner's Equity** for the month of March, and a **Balance Sheet** at March 31.

e. Closing entries.

CHAPTER TWO

FINAL ACCOUNTS

CHAPTER TWO

FINAL ACCOUNTS

2.1 Introduction:

In the previous chapter (Chapter One), it has been discussed that the accuracy of the books of accounts is specified by means of preparing a sheet termed ***Trial Balance***. On the other hand, having determined the accuracy of the books of accounts, every owner, and other users of accounting information as well, is interested in taking an idea concerning two more facts. These facts are:

(1) Whether he/she has earned a profit or suffered a loss during the accounting period covered by the Trial Balance,

(2) Where does he/she stand at the moment (what is his/her financial position)?

As it has previously been explained, the determination of the business ***Profit*** or ***Loss*** is done by preparing an **Income Statement**, while the financial position is judged by means of preparing a **Balance Sheet** of the enterprise. The two statements, in addition to **Statement of Owner's Equity**, together are termed as **Final Accounts**. In this Chapter, some of those statements will be highlighted again, but under other titles from the point of view of the trader, who purchases and sells goods and the manufacturer, who may manufacture goods by him/herself for selling them at a profit.

2.2 Trading and Profit and Loss Account:

In practice, and from the point of view of the trader, **Income Statement** may be broken down into two parts, which form the **Trading and Profit and Loss Account.** These are: **1. Trading Account, and 2. Profit and Loss Account.** As the term indicates, the Trading and Profit and Loss Account is a final summary of such transactions or accounts that affect the profit or loss position of the enterprise. As such, this account includes the items of **Incomes** and **Expenses** concerning a particular accounting period. The two parts of this final account are explained below.

2.2.1 Trading Account:

As the term indicates, **Trading Account** gives the total or overall result of trading process conducted by the business (purchasing and selling of goods or merchandise). In other words, Trading Account indicates whether purchasing of merchandise and selling it has proved to be profitable process for the enterprise or not. In this account, the cost of goods sold and the value for which they have been sold away will be taken into account. Accordingly, in case the sales value is higher than the cost of goods sold, there will be a profit, while in a reverse case, there will be a loss. Hence, the **profit** declared by the *Trading Account* is called ***Gross Profit***. Similarly, the **loss** disclosed by the *Trading Account* is called ***Gross Loss.*** Therefore, the **Trading Account** can take the following form:

TRADING ENTERPRISE
Trading Account
For the Period Ending December 31, 2021

To Opening Stock	XXXX	By Sales	XXXX
To Purchases	XXXX	By Purchases Returns	XXXX
To Sales Returns	XXXX	By Closing Stock	XXXX
To Direct Expenses	XXXX		
To Gross Profit*	XXXX	By Gross Loss*	XXXX
	XXXX		XXXX

*Note: Only one figure will appear.

When preparing Trading Account, you have to consider the following important points:

2.2.1.1 Stock:

The term **Stock** (Inventory) includes goods remaining unsold on a particular date. As such, the **Stock** may be of two types:

1. Opening Stock. The term “Opening Stock” means goods remaining unsold with the enterprise in the beginning of the accounting year. This is appeared on the debit side of the Trading Account.

2. Closing Stock. The term “Closing Stock” includes goods remaining unsold with the enterprise at the end of the accounting year. It should be noted that stock at the end of the accounting year (period) is taken after the books of accounts have been closed. The following journal entry is passed in the proper journal to journalise the amount of **closing stock**:

By Closing Stock Account…… XXX	
To Trading Account………	XXX

The amount of *closing stock* is shown on the credit (right) side of the ***Trading Account*** and as an **<u>asset</u>** in the ***Balance Sheet***, as it will be explained later. On the other hand, the ***Closing Stock*** at the end of the accounting period will become the ***Opening Stock*** in the next year (period). Therefore, the ***Opening Stock*** is shown on the <u>debit</u> side of the **Trial Balance.**

<u>Valuation of Closing Stock:</u>

As a general rule, the closing stock is valued on the basis of ***"cost or market price whichever is less"*** principle. Hence, it is very important that the cost of the goods remaining unsold should be properly determined. The market value of such goods will also be known on the Balance Sheet date. As such, the *closing stock* will be valued at the lower of the two values. For instance, if the goods remaining unsold at the end of the accounting is **L.E.110,000**, while their market price on the Balance Sheet date amounts to **L.E.100,000**, the closing stock will be valued at **L.E.100,000.** This valuation is done because of the accounting convention of **conservatism**, which requires that expected losses should be taken into consideration, but not expected profits.

2.2.1.2 Purchases:

Practically, the term **"Purchases"** includes both cash and credit purchases of goods. The term **"goods"** means items purchased for ***resale***. As such, **assets** purchased for **permanent** use in the business operations, such as purchase of plant, furniture, …, are **not** included in the purchase of goods. Similarly, purchase of things such as stationery meant for using in the business will also not be included in the item of purchases. On the other hand, in case of a proprietor has himself/herself used certain goods for his/her personal purposes, the value of such goods at cost will be deducted (reduced) from the purchases and included in the Drawings Account of the proprietor. In such a case, the journal entry could be as follows:

By Drawings Account……….	XXX	
To Purchases Account……		XXX

Just the same, in case certain goods are given by way of free samples, the value of such goods should be charged to advertisement account and deducted from purchases. So, the journal entry in such cases could be as follows:

By Advertisement Account………	XXX	
To Purchases Account………..		XXX

Accordingly, the amount of purchases will be the net purchases made by the proprietor. As such, the term **"net purchases"** may represent total purchases of goods made by the enterprise ***less*** the goods that it has returned back (purchases returns) to the suppliers. This means that purchases may be transferred to the **Trading Account** after deducting purchases returns from the gross purchases made during the accounting period.

2.2.1.3 Sales:

Similarly, the term **"Sales"** will encompass both cash and credit sales. The **Gross Sales** may be shown in the inner column of the **Trading Account** out of which **"Sales Returns"** may be deducted. So, the **Net Sales** will then be presented in the outer column of the **Trading Account**. In addition, appropriate care should be taken when recording sale of those goods which have been sold at the end of the accounting period but have not yet been delivered to customers. **Notice** that the sales value of such goods should be included in the sales. Also, proper care should be taken that those goods are not included in the **closing stock** at the end of the accounting period.

On the other hand, **sales of assets**, such as plant, machinery, land, car, and building or such other assets which were purchased for using in the business operations, and not for sale, should not be included in the figure of **"Sales"** to be taken to the **Trading Account**.

2.2.1.4 Customs and Import Duty:

In some cases, the goods are imported from outside the country. When the goods have been imported, customs and import duty may have to paid. The amount of such duty should be charged to the ***Trading Account.***

2.2.1.5 Freight, Carriage and Cartage:

In effect, freight, carriage, and cartage are considered direct expenses incurred on purchasing of the goods. Therefore, those items are taken to the debit (left) side of the **Trading Account.** In practice, the terms **"Freight In", Cartage In"** and **"Carriage In"** have the same meaning. Nevertheless, **"Freight Out", "Cartage Out"** and **"Carriage Out"** are considered to be the expenses incurred on selling the goods. Therefore, they may be charged to the **Profit and Loss Account.**

2.2.2 Profit and Loss Account:

From the preceding section, it is appeared that the **Trading Account** simply gives an indication whether the purchasing and selling of goods by an enterprise results in gross profit or loss. So, it does not take into consideration the other operating expenses incurred by an enterprise during the course of running the business. For instance, the proprietor has to maintain an office for getting orders and executing them, taking policy decisions and achieving them. Such expenses are charged to the **Profit and Loss Account.** Additionally, the proprietor may have other sources of income. For example, he/she may receive rent from some of his/her business properties. Also, he/she may have invested surplus funds of the enterprise in some securities. He/she might be receiving interest or dividends from such investments.

As such, in order to determine the true profit or loss that the business has made during a given accounting period, it will be necessary that all such expenses and incomes must be taken into account. **Profit and Loss Account** takes into consideration all such expenses and incomes and tells about the net profit or net loss suffered by an enterprise during a particular accounting period. Generally, the **Profit and Loss Account** is prepared in form shown below:

TRADING ENTERPRISE
Profit and Loss Account
For the Period Ending on 31/12/2021

To Gross Loss *	XX	By Gross Profit*	XX
To Salaries	XX	By Discount received	XX
To Rent	XX	By Capital (Net Loss)*	XX
To Commission	XX		
To Advertisements	XX		
To Bad Debts	XX		
To Discount allowed	XX		
To Capital (Net Profit)*	XX		
	XX		XX

* Note: Only one figure will appear.

When preparing **Profit and Loss Account,** you have to consider the following important points:

2.2.2.1 Gross Profit or Gross Loss:

Normally, the figure of gross profit or gross loss is brought down from the **Trading Account.** You have to keep in your mind the fact that there will be only one figure, either of gross profit or gross loss.

2.2.2.2 Salaries:

Salaries payable to the employees for the services rendered by them in running the business operations are considered of indirect nature and therefore they should be charged to the **Profit and Loss Account.** On the other hand, in case of employees earning salaries beyond a certain limit, the employer has to deduct at source the income tax from the salaries of such employees. In this situation, the amount of gross salaries should be charged to the **Profit and Loss Account,** while the tax deducted by the employer will be appeared as a liability in the **Balance Sheet** of an enterprise until it is deposited with the Tax Authority.

For example, if salaries paid are **L.E.24,000** after deducting income-tax of **L.E.6,000**, the amount of salaries to be charged to the **Profit and Loss Account** will be a sum of **L.E.30,000.** The amount of tax-deducted at source by the employer

(**L.E.6,000**) will be shown as a liability in the **Balance Sheet.**

2.2.2.3 Interest:

Interest on short-term or long-term loans is an expense of an indirect nature and, hence, is charged to the **Profit and Loss Account.** On the other hand, interest on loans advanced by an enterprise to third-parties is an item of income and will be credited to the **Profit and Loss Account.**

2.2.2.4 Commission:

Of course, commission may be both an item of income and an item of expense. Commission on services or business advanced by agents is considered an item of expense while commission earned by the enterprise for giving business to others is considered an item of incomes. Accordingly, commission to agent is debited to the **Profit and Loss Account** while commission received is credited to the **Profit and Loss Account.**

2.2.2.5 Trade Expenses:

Mostly, trade expenses are expenses which are considered of a miscellaneous nature. They are of small amounts and varied in nature and, therefore, they are not deserved or worthwhile to open separate accounts for each type of such expenses. In practice, you will notice that the term **"Sundry Expenses", "Miscellaneous Expenses"** or **"Petty Expenses"** have also the same meaning. All of such items are charged to the **Profit and Loss Account.** Furthermore, printing and stationery expenses include expenses on printing of bills, invoices, registers, files, letter heads, ink, pencil, paper and other items of stationery. These items also are of indirect nature and should be charged to the **Profit and Loss Account.**

2.2.2.6 Advertisements:

Advertisement expenses are usually incurred for attracting customers to the shop. As such, they are taken as selling expenses. They are debited to the **Profit and Loss Account.**

2.2.2.7 Bad Debts:

Bad debts refer to or denote the amounts lost from debtors to whom the goods were sold on credit. They are considered a loss and hence must be debited to the **Profit and Loss Account.**

2.2.2.8 Depreciation:

It has been explained that depreciation represents decrease in the value of an asset due to wear and tear, lapse of time, obsolescence, exhaustion and accident. For instance, a motor car purchased gets depreciated on account of its constant use. On account of new inventions, old assets become obsolete and they have to be replaced. Mines get exhausted after the minerals are completely taken out of them. An asset may meet an accident and may lose its value. It is necessary that depreciation on account of all these factors is charged to the **Profit and Loss Account** to determine the true profit or loss made by the enterprise.

2.2.3 Closing Entries Regarding Trading and Profit and Loss Account:

As you have studied in the preceding chapter, **Closing Entries** are entries recorded at the end of the accounting period to close different accounts. These entries are passed to close different accounts which relate to **Trading and Profit and Loss Account**. These are pertaining to incomes, expenses, gains, and losses accounts. As such, accounts concerning assets and liabilities are not closed but they are carried forward to the next year. No closing entries, therefore, are to be made regarding such accounts that pertain to the **Balance Sheet.**

In practice, the principle of passing a closing entry is very easy. When an account shows a debit balance, it should be credited in order to close it. For example, **Purchases Account** normally has a debit balance. If it is to be closed, the **Purchases Account** will have to be credited so that it may be closed. Hence, the **Trading Account** will have to be debited.

The different closing entries for preparing a **Trading Account** will be as follows:

The debit side:

By Trading Account………	XXX	
To Sundries:		
Stock Account (Opening)..		XXX
Purchases Account………		XXX
Sales Returns Account…..		XXX
Carriages Account……….		XXX
Customs Duty Account….		XXX

The credit side:

By Sundries:	
Sales Account………………	XXX

Purchases Returns Account...	XXX	
Stock Account (Closing)……	XXX	
To Trading Account……..		XXX

Hence, in case the total of the credit side of the **Trading Account** is greater than the total of the debit side, the **difference** is known as **Gross Profit.** In the reverse case, it will be a **Gross Loss.** Gross Profit or Gross Loss shown by the Trading Account is transferred to the **Profit and Loss Account.**

The different closing entries for preparing a **Profit and Loss Account** will be as follows:

1. For transferring of items of expenses, losses appearing on the debit side of the Trial Balance, they will be entered into the debit side of the **Profit and Loss Account** to be closed, as shown below:

By Profit and Loss Account…….	XXX	
To Sundries:		
Salaries……………………….		XXX
Rent…………………………..		XXX

Commission…………………..	XXX
Advertisements………………	XXX
Bad Debts……………………	XXX
Discount Allowed (given)…..	XXX
Printing and Stationery……...	XXX

2. For transferring of items of incomes, gains appearing on the credit side of the Trial Balance, they will be entered into the credit side of the **Profit and Loss Account** to be closed, as shown below:

By Sundries:		
Interest Account……………….	XXX	
Dividends Account…………….	XXX	
Discount Received Account……	XXX	
To Profit and Loss Account…		XXX

3. For transferring of net profit or net loss disclosed in the **Profit and Loss Account:**

When the total of the credit side of the **Profit and Loss Account** is greater than the debit side, the **difference** is called **Net Profit.** On the contrary, it will be called **Net Loss.** The amount of **Net Profit**

or Net Loss shown by the Profit and Loss Account will be transferred to **Capital Account** (in case of sole proprietary enterprise).

a. For transferring of Net Profit:

By Profit and Loss Account……	XXX	
To Capital Account…………		XXX

b. For transferring of Net Loss:

By Capital Account……………..	XXX	
To Profit and Loss Account…		XXX

2.3 Manufacturing Account:

In the above sections, the preparation of the **Trading and Profit and Loss Account** has been explained from the point of view of a trader; a person who purchases and sells goods. Nevertheless, a person may produce or manufacture goods by himself/herself for selling them at a profit. In such cases, a manufacturer will need to determine the cost of manufacturing the goods. Therefore, the profit or loss made by the manufacturer will be ascertained by preparing the following three accounts:

1. Manufacturing Account:

Manufacturing Account gives the cost of the goods manufactured by a manufacturer during a particular accounting period. A **Manufacturing Account** can take the following form:

MANUFACTURING ENTERPRISE

Manufacturing Account
For the Period Ending 31/12/2021

To Work-in-Process (Open.)		XX	By Work-in-Process (Closing)…….	XX
To Raw Materials consumed:			By Sale of Scrap……	XX
Opening Stock ……	XX		By Cost of Production of finished goods during the period transferred to the Trading Account……	XX
Add Purchases of Raw Materials………….	XX			
Less Closing Stock of Raw Materials…	XX	XX		
To Direct or Productive Wages…….		XX		
To Factory Overheads:				
Power and Fuel……		XX		
Repairs of Plant……		XX		
Depreciation on Plant..		XX		
Factory Rent…………		XX		
		XX		XX

When preparing Manufacturing Account, you have to consider the following important points:

(1) Stocks:

In case of a manufacturing enterprise, there can be stocks of three types:

a. Stock of Raw Materials. This item includes stock of raw materials or finished components which could have been purchased by the manufacturer for using them in the products manufactured but still unsold.

b. Stock of work-in-process. This item also called as stock of work-in-progress. It encompasses goods in semi-finished form.

c. Stock of finished goods. This item includes stock of those goods which have been completely processed and are remaining unsold at the end of a period with the manufacturer. Moreover, it may include stock of those finished goods which have been purchased by a manufacturer-trader from outside parties, but still remaining unsold at the end of the accounting period.

(2) Raw Materials Consumed:

In practice, it is customary to show in the Manufacturing Account the value of raw materials consumed for producing goods during a particular accounting period. Raw materials consumed can be computed as follows:

Opening Stock of Raw Materials	XXX
Add Purchases of Raw Materials	XXX
	XXX
Less Closing Stock of Raw Materials	(XXX)
Raw materials consumed……….	XXX

For instance, if the opening stock of raw materials is **L.E.50,000**, purchases of raw materials is **L.E.200,000** and closing stock of raw materials is **L.E.80,000**, the value of raw materials consumed will be calculated as shown below:

Opening Stock of Raw Materials	L.E. 50,000	
Add Purchase of Raw Materials	200,000	250,000
Less Closing Stock of Raw Materials		80,000
Raw Materials Consumed		170,000

(3) Carriage inwards, and so on:

These items include expenses incurred for bringing the raw materials to the enterprises premises or customs duty paid by the manufacturer on the raw materials purchased or imported. Such will also be charged to **Manufacturing Account.**

(4) Factory Overheads:

Conventionally, the term ***overheads*** includes indirect material, indirect labour and indirect expenses. For example, in case of a manufacturer of furniture, the cost of woods purchased will be considered as raw materials, but the cost of nails used will be considered as indirect material and hence will be taken as an item of **Factory Overheads.** Just the same, the wages paid to the carpenters who have been employed for making furniture will be taken as cost of direct labour because they are actively engaged in manufacturing the furniture.

Nevertheless, the salaries of the supervisor or the wages of the gate-keeper will be considered as indirect labour cost and agrees with the definition of **Factory Overheads**. Similarly, the carriage charges paid for bringing raw materials to the factory are taken as direct charges since they can directly be charged to the raw materials purchased. Nevertheless, the rent for the factory, depreciation of the factory machines, insurance of the factory are all considered to be indirect factory expenses and, hence, fall under the category of **factory overheads**.

<u>(5) Cost of Production:</u>

Normally, the ***Manufacturing Account*** shows the cost of manufacturing the goods during a particular accounting period. Such item is computed by deducting from the total of debit side of the ***Manufacturing Account***, the total of the various item appearing on the credit side of the **Manufacturing Account.**

<u>(6) Sale of Scrap:</u>

In manufacturing operations, certain scrap is unavoidable. This item may or may not have any sales value. So, in order to compute the real cost of manufacturing the goods, it is important that the money realised on account of sale of scrap (or realisable value of the scrap in case it has not been sold) must be taken into consideration. Accordingly, the amount of scrap is credited to the **Manufacturing Account.**

2. Trading Account:

Trading Account presents information regarding the gross profit or loss achieved by a manufacturer in selling the manufactured goods. When a manufacturer also functions a trader, besides manufacturing and selling goods of his/her own, he/she also purchases and sells goods of others, he/she will be a manufacturer-trader. In such a case, his/her **Trading Account** will release not only the profit achieved by him/her on selling his/her manufactured goods, but also the profit made by him/her in selling the goods purchased from others. The **Trading Account** in case of a manufacturer will show as follows:

MANUFACTURING ENTERPRISE
Trading Account
For the Period Ending 31/12/2021

To Opening Stock of Finished Goods……….	xx	By Sales……	xx
To Cost of Production of finished goods transferred from Manufacturing Account.........	xx	By purchases Returns	xx
To Purchases of Finished Goods ….	xx	By Closing Stock of Finished Goods……	xx
To Sales Returns…	xx		xx
To Carriage Charges on goods purchased…..	xx	By Gross Loss c/d*	xx
To Gross Profit c/d*	xx		
	xx		xx

* Note: Only one figure will appear.

The **Gross Profit or Loss** disclosed by the **Trading Account** will be transferred to the **Profit and Loss Account** that will usually be prepared as explained in the preceding sections.

3. Balance Sheet:

After the preparation of the **Manufacturing, Trading** and **Profit and Loss Account,** the owner (s) will like to have an idea about the enterprise's financial position. For this reason, the business prepares a statement of its assets and liabilities as on a particular date. As you studied before, this statement is called **Balance Sheet.** Hence, a **Balance Sheet** is not an account but only a statement containing the assets and liabilities of a business on a given date. In other words, it is a classified summary of the various remaining accounts after accounts concerning *Incomes and Expenses* have been closed by transferring them into **Manufacturing, Trading** and **Profit and Loss Accounts.**

Usually, **Balance Sheet** has two sides. On the left hand side (or debit side), the assets of the business will be shown. On the right hand side (or credit side), the liabilities of the enterprise will appear. For a sole proprietorship, there is no specific or prescribed form of **Balance Sheet**. But, the assets and liabilities may be shown in any of the following two orders:

(1) Liquidity Order.

When there is concern to adopt liquidity order, the assets which are more readily convertible into cash come first and those which cannot be so readily converted; come next, et cetera (etc). Correspondingly, those liabilities which are payable first come first, and those payable later, come next and so on. An example regarding this order is given below.

ELSHOROK ENTERPRISE

Balance Sheet

Assets As on December 31, 2021 L & O E

Cash in hand…….	xx	Bank Overdraft…	xx
Prepaid Expenses…	xx	Outstanding Expenses	xx
Bills Receivable…	xx	Bills Payable……..	xx
Sundry Debtors….	xx	Sundry Creditors…	xx
Closing Stock:		Long-term Loans…	xx

Raw Materials xx		Capital………	xx
Work-in-progress xx			
Finished goods xx	xx		
Furniture………….	xx		
Plant & Machinery...	xx		
Buildings………….	xx		
Land………………	xx		
Goodwill………….	xx		
Total……..	xx	*Total………*	xx

(2) Permanency Order.

With respect to permanency order, assets which are more permanent come first, less permanent come next, etc. In other words, assets which will be sold in the last or liabilities will be paid in the last come first and vice versa. This order is applied both for all assets and liabilities.

When preparing **Balance Sheet ,** you have to consider the following important points:

a. Liabilities. As it was explained in first version of this textbook, the term ***Liabilities*** refers to claims against assets of an enterprise whether those of owners of the firm or of the creditors. Liabilities can be classified into the following two categories:

1- Current Liabilities:

"***Current Liabilities***" is the term used for such liabilities which are payable within a year from the date of the Balance Sheet either out of current assets or by creation of current liabilities. The broad categories of current liabilities may include the following:

- Accounts payable, such as bills payable and trade creditors.
- Outstanding expenses, expenses for which services have been received by the firm but for which payments have not been made.
- Bank Overdraft.
- Short Term Loans, such as loans from bank which are payable within one year from the date of the Balance Sheet.

- Advance Payments received by the business for the services to be rendered or goods to be supplied in the near future.

2- Long Term or Fixed Liabilities:
Fixed liabilities are all liabilities other than Current Liabilities. These liabilities are liabilities which do not become due for payment in one year and which don’t require current assets for their payment.

b. Assets. This term refers to resources required by an enterprise from the funds made available either by the owners of the business or others. Thus, assets include all rights of properties which a firm own. Cash, investments, bills receivable, debtors, stock of raw materials, work-in-progress and finished goods, land, buildings, machinery, trade marks, patient rights, and so on, are example of assets. But generally, assets may be classified into the following categories:

1- Current Assets:

Current assets are often those items which are acquired with the intention of converting them into cash during the normal business operations of an enterprise. Accordingly, the term ***Current Assets*** encompasses cash and bank balances, stocks of raw materials, work-in-progress and finished goods, debtors, bills receivable, short investments, prepaid expenses, etc.

2- Liquid Assets:

Liquid Assets are a part of current assets, but are those assets which are immediately convertible into cash without much loss. In considering liquid assets, stock of raw materials, work-in-progress and finished goods and prepaid expenses are excluded while all other current assets are taken.

3- Fixed Assets:

In general, fixed assets are those assets which are acquired for relatively long period for carrying on the business of the enterprise. They are not intended for resale. Examples of these assets may include land and building, machinery, furniture, cars, and so on.

4- Intangible Assets:
Normally, intangible assets are those assets that cannot be seen or touched. Goodwill, patents, and trade marks are examples of such assets.

Illustration 2.1:
The following balances are extracted from the books of **An Enterprise**, on December 31, 2021

	L.E.		**L.E.**
Opening Stock	62,500	Plant and Machinery	311,500
Sales	590,000	Returns Outwards	69,000
Depreciation	33,350	Cash in hand	44,750
Commission(Cr)	10,550	Salaries	37,500
Insurance	19,000	Debtors	95,250
Carriage Inwards	15,000	Discount (Dr)	16,400
Furniture	33,500	Bills Receivable	136,500
Printing Charges	24,050	Purchases expenses	79,450
Carriage Outwards	10,000	Returns Inwards	82,950
Capital	461,400	Bank Overdraft	200,000
Creditors	89,000	Purchases	433,950
Bills Payable	27,050	Petty Cash in hand	2,350
Bad Debts	9,000		

The value of stock on 31st December 2021 was **L.E.185,000.**

<u>Required</u>:

Pass the necessary closing entries; prepare a Trading and Profit and Loss Account and a Balance Sheet.

Solution:

Journal

Description	Dr L.E.	Cr L.E.
By Trading Account……………	673,850	
<u>To Sundries:</u>		
Opening Stock a/c…………..		62,500
Purchases a/c……………….		433,950
Purchases expenses a/c……..		79,450
Returns Inwards a/c…………		82,950
Carriage Inwards a/c………..		15,000
For closing all accounts to be debited to the Trading Account.		
<u>By Sundries:</u>		
Sales a/c…………………………	590,000	
Returns Outwards a/c……………	69,000	
To Trading a/c………………....		659,000
For closing all accounts to be credited to the Trading Account.		
By Trading Account…………….	170,150	
To Profit and Loss Account….		170,150
For transfer of Gross Profit.		

By Profit and Loss Account……..	149,300	
To Sundries:		33,350
Depreciation a/c………………		19,000
Insurance a/c………………….		24,050
Printing Charges a/c…………		10,000
Carriage Outwards a/c………..		37,500
Salaries a/c…………………..		16,400
Discount a/c………………..		9,000
Bad Debts a/c………………		
For closing all indirect and selling expenses accounts.		
By Commission a/c………………	10,550	10,550
To Profit and Loss a/c………..		
For closing commission account.		
By Closing Stock a/c……………	185,000	
To Trading Account…………		185,000
To record closing stock.		
By Profit and Loss a/c…………..	31,400	
To Capital a/c………………		31,400
For transferring Net Profit to Capital Account.		

XXX ENTERPRISE
Trading and Profit & Loss Account
For the Year Ending December 31, 2021

Opening Stock	62,500	Sales	590,000
Purchases	433,950	Returns Outwards	69,000
Returns Inwards	72,990	Closing Stock	185,000
Purchases Exp.	79,450		
Carriage Inwards	15,000		
Gross Profit c/d	170,150		
	844,000		844,000
Depreciation	33,350	Gross Profit	170,150
Insurance	19,000	By Commission	10,550
Printing Charges	24,050		
Carriage Outwards	10,000		
Salaries	37,500		
Discount	16,400		
Bad Debts	9,000		
Net Profit	31,400		
	180,700		180,700

XXX ENTERPRISE
Balance Sheet
Assets As on December 31, 2021 Liabilities

Cash…………	44,750	Bills Payable	27,050
Petty Cash…..	2,350	Creditors………	89,000
Bills Receivable.	136,500	Bank Overdraft…	200,000
Debtors……..	95,250	Capital 461,400	
Closing Stock.	185,000	*Add:* Net Profit	
Plant & Machinery	311,500	31,400	492,800
Furniture………	33,500		
	808,850		808,850

<u>Illustration 2.2</u>:

You are given the following Trial Balance of **XXX Factory.** You are ***required*** to prepare the **Manufacturing Account, the Trading and Profit and Loss Account** for the year ending March 31, 2021 and the **Balance Sheet** as on that date.

Account Titles	Dr L.E.	Cr L.E.
Capital Account….		410,000
Drawing Account..	61,000	
Loan Account…………………..		40,000
Sundry Creditors………………		450,000
Cash in hand…………………..	2,500	
Cash at Bank…………………..	40,000	
Sundry Debtors………………..	405,000	
Patents…………………………	20,000	
Plant and Machinery…………..	200,000	
Land and Buildings……………	260,000	
Purchases of raw materials……	350,000	
Raw Material, 1/4/2020………	35,000	
Work-in-process, 1/4/2020……	20,000	
Finished Stock, 1/4/2020……....	180,000	
Carriage Inwards………………	11,000	
Wages…………………………	270,000	
Salary of Works Manager…….	56,000	
Factory Expenses……………..	34,000	
Factory Rent and Taxes………	25,000	
Sales (less Returns)…………..		1,234,000
Advertising…………………..	42,000	
Office Rent and Insurance……	48,000	
Printing and Stationery………	10,000	

Office Expenses………………	58,000	
Carriage Outwards……………	6,000	
Discounts……………………..	14,000	21,000
Bad Debts…………………….	7,500	
	2,155,000	2,155,000

The Stock on March 31st, 2021 was as follows: **L.E.40,000** Raw Materials, **L.E.45,000** Work-in-progress, and **L.E.280,000** Finished Goods.

Solution:

XXX FACTORY

Manufacturing Account

Fro the Year Ending March 31, 2021

Opening Work-in-process	20,000	By Trading Account (transferring of cost of finished goods produced)	716,000
Raw Materials used:		Closing Work-in-process……	45,000
Opening Stock 35,000			
Add: Purchases 350,000			
385,000			
Less Closing Stock 40,000	345,000		
Carriage Inwards	11,000		
Wages………	270,000		
Salary of Work's Manager…..	56,000		
Factory Expenses..	34,000		
To Factory Rent & Taxes……………..	25,000		
	761,000		761,000

XXX FACTORY

Trading and Profit & Loss Account

Fro the Year Ending March 31, 2021

Opening Stock of finished goods…….	180,000	Sales …….	1,234,000
Manufacturing a/c (Cost of goods produced)…………	716,000	Closing Stock of finished goods..	280,000
Gross Profit….	618,000		
	1,514,000		1,514,000
	=======		=======
Advertising……	42,000	Gross Profit b/d	618,000
Office Rent and Insurance…………	48,000	Discount Received………	21,000
Printing and Stationery…………	10,000		
Office Expenses..	58,000		
Carriage Outwards	6,000		
To Bad Debts……	7,500		
Discount Allowed	14,000		
Net Profit (carried to Capital Account)	453,500		
	639,000		639,000

XXX FACTORY
Balance Sheet
Assets As on March 31, 2021 Liabilities

Current Assets:		Sundry Creditors	450,000
Cash in hand……	2,500	Loans…………	40,000
Cash at Bank……	40,000	Capital:	
Sundry Debtors…	405,000	Balance on	
Closing Stock:		1/4/2020 410,000	
R Materials 40,000		(+)Profit 453,500	
Work in		863,500	
Process 45,000		(−)Drawings	
Finished Goods		61,000	802,500
280,000	365,000		
Fixed Assets:			
Patents………….	20,000		
Plants & Machinery	200,000		
Land & Buildings	260,000		
	1,292,500		1,292,500

2.4 Final Accounts and Adjustment Entries:

In Chapter One of this textbook, adjusting entries were highlighted. In the preceding pages of this Chapter, the preparation of the Final Accounts has been explained without taking adjustments into consideration. It was assumed that the accountant has taken into account all necessary facts before closing the books of accounts. Nevertheless, this may not always happen in the real world. The accountant may want to know about certain adjustments to be conducted in the books of accounts to give a real picture of the state of affairs of the enterprise after closing the books of accounts and preparing the Trial Balance. Therefore, in the following sections, adjustments will be stressed in detail.

In practice, adjustments may usually relate to many issues which include the following:

1. Closing stock.
2. Outstanding (Accrued) expenses.
3. Prepaid (Advanced) expenses.
4. Outstanding or accrued income (revenue).
5. Income received in advance or unearned income.
6. Depreciation.
7. Bad Debts.
8. Provision (Allowance) for bad debts.
9. Provision (Allowance) for discount on debtors.
10. Interest on capital.
11. Interest on Drawings.

1. Closing Stock:

The treatment of the stock at the end of the accounting period has already been explained while discussing **Final Accounts** in the preceding sections. At the end of the accounting period, the journal entry required for recording unsold stock is made as below:

By Closing Stock a/c……….	XXX	
To Trading a/c…….		XXX

As such, the ending or closing stock will appear in the **Balance Sheet** at the end of the accounting period and its balance is carried forward to the next accounting period. So, it is shown as opening stock in the **Trial Balance** of the next period and is transferred to the **Trading Account** on the *debit* side. Hence, **Trading Account** is *debited* and the stock in the beginning of the accounting period (that was **Closing Stock** last period) is *credited* and **Stock Account** is thus closed.

On the other hand, sometimes the value of the stock at the end of the accounting period is given in the Trial Balance. In such cases, the **Closing Stock** will be shown **only** in the **Balance Sheet.** This is because that the **Closing Stock** has already been considered while computing the cost of goods sold.

Example:

Trial Balance

Account Titles	Dr. L.E.	Cr. L.E.
Opening Stock…………	100,000	
Purchases………………	300,000	
Sales……………………		400,000

Stock at the end of the accounting period is **L.E.150,000.**

In this situation, the **Closing Stock** has been given outside the **Trial Balance** and, hence, the different items will be shown in the final accounts as presented below:

Dr. Trading Account Cr.

Opening Stock	100,000	Sales……..	400,000
Purchases	300,000	Closing Stock	150,000
Gross Profit taken to Profit and Loss Account….	150,000		
	550,000		550,000

Assets Balance Sheet Liabilities

Closing Stock….	150,000		

On the other hand, the **Opening** and **Closing Stock** may both be adjusted with purchases and the cost of sales may be found out separately. As such, the items in the **Trial Balance** will be shown as below:

Trial Balance

Account Titles	Dr. L.E.	Cr. L.E.
Cost of Sales (Adjusted Purchases)………………	250,000	
Sales…………………….		400,000
Closing Stock…………...	150,0000	

Now, the various items will appear in the final accounts as follows:

Dr. Trading Account Cr.

Cost of Sales (or Adjusted Purchases)	250,000	Sales…	400,000
Gross Profit taken to Profit and Loss Account….	150,000		
	400,000		400,000

Assets		Balance Sheet	Liabilities
Closing Stock…	150,000		

2. Outstanding Expenses:

Generally, **Outstanding Expenses** refer to expenses that have become due during the accounting period for which the *Final Accounts* have been prepared, but have not yet been paid. This may occur specifically regarding those expenses which accrue from day to day business but that are recorded only when they are paid. Such expenses include, for example, rent, salaries, interest, and so on. Some of these expenses may have remained unpaid at the end of the accounting period and, hence, no entry might have been recorded in the books of accounts.

For example, if the salary for the month of December has not yet been paid, no entry might have been passed in the books for the salary remaining outstanding on 31st December.

Notwithstanding, in order to determine the real profit or loss made during the accounting period ending on December 31st, it is necessary that such outstanding salaries are taken into consideration. Thus, the journal entry required to record such outstanding expenses will be as follows:

By Salaries a/c…………….….	XXX	
To Outstanding Salaries a/c (or Salaries Payable a/c)………………		XXX

Salaries Account is an expense account and, hence, it should be charged to the **Profit and Loss Account**, while the **Outstanding Salaries Account** is a personal account representing the persons (employees) to whom the salary has to be paid. Therefore, **Outstanding Salaries Account** is shown in the *Balance Sheet* on the liabilities side.

Illustration 2.3:

The following data are extracted from the **Trial Balance** of an enterprise on December 31st, 2021:

Trial Balance
As on December 31st, 2021

Account Titles	Dr. L.E.	Cr. L.E.
Salaries…………………	100,000	
Rent…………………….	50,000	

Other Data:

a. Salary for the month of December **L.E.20,000** has not yet been paid.

b. Rent amounting to **L.E.10,000** is remaining outstanding.

Required:

Pass the necessary adjusting entries and show how the above items will appear in the enterprise's final accounts.

Solution:

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Explanation	Dr. L.E.	Cr. L.E.
By Salaries a/c…………………..	20,000	
To Outstanding Salaries a/c…..		20,000
To record due salaries but not paid.		
By Rent a/c………………………	10,000	
To Outstanding Rent a/c……..		10,000
To record due rent but not paid		

The above items will be shown in the final accounts as below:

Profit and Loss Account

To Salaries a/c (100,000 + 20,000)…	120,000		
To Rent a/c (50,000 + 10,000)…………….	60,000		

Assets Balance Sheet Liabilities

		Outstanding Expenses: Salaries 20,000 Rent 10,000	30,000

Moreover, before closing the books of accounts, the **Salaries Accounts** and **Outstanding Salaries Account, Rent Account** and **Outstanding Rent**

Account could have appeared in the **Ledger** as follows:

Dr. Salaries Account Cr.

To Bank a/c……..	100,000	Balance c/d	120,000
To Outstanding Salaries a/c……	20,000		
	120,000		120,000
Balance b/d	120,000	By Profit & Loss a/c	120,000
	120,000		120,000

Dr. Outstanding Salaries Account Cr.

Balance c/d	20,000	By Salaries a/c	20,000
	20,000		20,000

Dr. Rent Account Cr.

To Bank a/c……..	50,000	Balance c/d	60,000
To Outstanding Rent	10,000		
	60,000		60,000
	=====		=====
Balance b/d	60,000	By Profit & Loss a/c	60,000
	60,000		60,000

Dr. Outstanding Rent Account Cr.

Balance c/d…….	10,000	By Rent Account…	10,000
	10,000		10,000

The above balances would have appeared in the **Adjusted Trial Balance** as follows:

Adjusted Trial Balance
As on December 31st, 2021

Account Titles	Dr. L.E.	Cr. L.E.
Salaries…………………	120,000	
Rent……………………	60,000	
Outstanding Salaries…..		20,000
Outstanding Rent………		10,000

3. Prepaid Expenses:

Expenses which have been paid in advance for receiving services in the near future are called **Prepaid Expenses**. In other words, prepaid expenses are the expenses which have been paid during the accounting period for which the final accounts are being prepared, but they belong to the next accounting period. For instance, during the accounting period ending on December 31st, 2021, insurance premium for the accounting period ending December 31st, 2022 might have been paid.

Therefore, in order to determine true profit or loss, only expenses concerning the accounting period should be charged to the **Profit and Loss Account** and any expenses paid in advance must be carried forward to the next year, using the following journal entry:

By Prepaid Expenses a/c…….	XXX	
To Expenses a/c…………		XXX

Furthermore, *Expenses Account* is a temporal account, and, hence, its balance should be credited to the *Profit and Loss Account*. On the other hand, *Prepaid Expense Account* is an asset account which represents the account of the person to whom payment has been made in advance. Accordingly, *Prepaid Expense Account* appears on the *Balance Sheet* on the assets side.

Illustration 2.4:

The following data are extracted from the *Trial Balance* of an enterprise as on December 31st, 2021.

Trial Balance
As on December 31st, 2021

Account Titles	Dr. L.E.	Cr. L.E.
Insurance…………………	80,000	
Rent………………………	40,000	

Other Data:

a. Insurance premium has been paid in advance amounting to **L.E.10,000** for the next year.

b. Rent of **L.E.5,000** has been paid for the next year.

Required:

Prepare the necessary adjusting entries and show how the items will appear in the enterprise's final accounts.

Solution:

JOURNAL

Explanation	Dr. L.E.	Cr. L.E.
By Prepaid Insurance a/c…….	10,000	
To Insurance a/c………….		10,000
Being Insurance premium paid in advance.		
By Prepaid Rent a/c………….	5,000	
To Rent a/c………………..		5,000
Being rent paid in advance.		

Profit and Loss Account

For the period ending on December 31st, 2021

Dr. Cr.

To Insurance a/c To Rent a/c	70,000 35,000		

Balance Sheet

As on December 31st, 2021

Assets Liabilities

Prepaid Insurance.. Prepaid Rent…	10,000 5,000		

4. Outstanding Income and Accrued Income:

Income which has become due during the accounting period, but that has not yet been received, is called **Outstanding Income.** On the other hand, **Accrued Income** means income which has been earned by an enterprise during the accounting period, but which has not yet become due and, hence, has not been received or collected. To determine the real profit or loss about the accounting period, adjustments for such income should be made in the final accounts of the firm. The adjusting entry for such income will be passed as follows:

By Outstanding (Accrued) Income a/c	XXX	
To Income a/c……………		XXX

However, a distinction between *Accrued Income* and *Outstanding Income* has to be made. Although both the incomes have been earned by the enterprise and not yet received or collected, in case of *Accrued Income*, the income has not become due to the enterprise, while *Outstanding Income* is an income which has become due to the enterprise.

For example, if a loan of **L.E.100,000** has been given at **12%** annually and interest is payable monthly, if interest for one month (**L.E.1,000**) has not been received by the enterprise, the income will be called an **Outstanding Income** since interest has become due but it has not yet been received by the enterprise. Nevertheless, in case of those securities where interest is payable on determined dates, interest may have been earned by the enterprise, but it will become due not earlier than the determined date. For instance, if a firm has purchased **6%** Government Securities of **L.E.100,000** on which interest is payable on March 31^{st} and September 30^{th},for the accounting period ending on December 31^{st} interest for three months (**L.E.1,500** for October, November and December) will be considered as *accrued* interest and not an *outstanding* interest. This is because interest will become due after September 30th, only on March 31st and not earlier.

Illustration 2.5:
The following data are extracted from the Trial Balance of an enterprise on December 31st, 2021 and you are required to pass adjusting entries and to show how the items will appear in the final accounts.

Trial Balance
As on December 31st, 2021

Account Titles	Dr. L.E.	Cr. L.E.
6% Loan………………………	200,000	
Investments in 6% Government Bonds (Interest payable on March 31st and September 30th)……………….	300,000	
Interest on loan received up to October 31st, 2021……………		10,000
Interest on Investments……….		9,000

Solution:
In the above illustration, interest on loan for a period of two months is still *outstanding*. The

amount of such interest is **L.E.2,000** (200,000 × 6% = 12,000 − 10,000). In case of Government Bonds, interest for three months has been earned by the enterprise, but is has not become due. Therefore, the amount of *accrued* interest comes to **L.E.4,500** (300,000 × 6% × $\frac{3}{12}$ = 4,500).

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Explanation	Dr. L.E.	Cr. L.E.
By Outstanding Interest a/c……	2,000	
To Interest on Loan a/c…….		2,000
To record interest on loan due but not received.		
By Accrued Interest a/c……….	4,500	
To Interest on Investment a/c..		4,500
To record interest earned, but not due and not received.		

Outstanding Interest Account and **Accrued Interest Account** are asset accounts since they represent the accounts of persons from whom the interest has to be collected. Therefore, they will be shown on the *assets side* in the **Balance Sheet**. On the other hand, **Interest Account** is a revenue account and it has been credited. Accordingly, the amount of interest will be added to the amount of interest already appearing in the **Trial Balance.** The above items will appear in the enterprise's final accounts as follows:

Profit and Loss Account

Dr. For the year ending December 31st, 2021 Cr.

		By Interest on Loan (10,000 + 2,000)	12,000
		By Interest on Investments (9,000 + 4,500)	13,500

Balance Sheet

Assets As on December 31st, 2021 Liabilities

Outstanding Interest	2,000		
Accrued Interest	4,500		

5. Income Received in Advance:

Income which has been collected by the enterprise before it being earned; is called **Income Received in Advance.** Such items include certain prepayments which the enterprise may receive during the accounting period. In order to determine the real profit or loss, it is important that such income is not taken into consideration while preparing the *Profit and Loss Account* for the year. The following adjusting entry is made to record such income:

By Income a/c…………….	XXX	
To Income Received in Advance a/c		XXX

<u>Illustration 2.6</u>:
The following data are extracted from the Trial Balance of an enterprise on December 31st, 2021and you are required to record the necessary adjusting entries and show how the different items will appear in the enterprise's final accounts.

Trial Balance
As on December 31st, 2021

Account Titles	Dr. L.E.	Cr. L.E.
Rent received for 12 months ending March 31st, 2022………		12,000
Interest on Loan………………..		20,000

<u>Other Data</u>:

Interest on Loans has been received in advance to the extent of **L.E.5,000.**

Solution:

JOURNAL

Explanation	Dr. L.E.	Cr. L.E.
By Rent a/c………………..	3,000	
To Rent Received in Advance a/c		3,000
To record rent received in advance for 3 months (12,000 × $\frac{3}{12}$ = 3,000)		
By Interest a/c…………………..	5,000	
To Interest Received in Advance a/c		5,000
To record interest received in advance.		

Profit and Loss Account

Dr. For the year ending December 31st, 2021 Cr.

		By Interest a/c….. (20,000 − 5,000)	15,000
		By Rent a/c……. (12,000 − 3,000)	9,000

Balance Sheet

Assets As on December 31st, 2021 Liabilities

		Rent Received in Advance…	3,000
		Interest Received in Advance……	5,000

6. Depreciation:

As it has been explained in another chapter, **Depreciation** refers to decrease in the value of an asset due to wear and tear, lapse of time, obsolescence, exhaustion, and accident. So, in order to determine the true profit or loss for the business, it is necessary that depreciation is charged on the fixed assets of an enterprise. To record the depreciation of a particular period, the following entry should be passed:

By Depreciation Expense a/c…….	XXX
To Accumulated Depreciation a/c: An asset	XXX

Illustration 2.7:

The following data are extracted from the Trial Balance of an enterprise and you are required to prepare adjusting entries and show the items in the enterprise's final accounts:

Trial Balance
As on December 31st, 2021

Account Titles	Dr. L.E.	Cr. L.E.
Plant………………………	300,000	
Buildings…………………	500,000	

Other Data:

a. Charge depreciation on plant at 10% per annum (Yearly).

b. Charge depreciation on buildings at 5% per annum.

Solution:

JOURNAL

Explanation	Dr. L.E.	Cr. L.E.
By Depreciation Expense a/c:		
Plant……………………………	30,000	
Buildings………………………	25,000	
To Accumulated Depreciation a/c:		
Plant………………………..		30,000
Buildings……………………		25,000
To record depreciation charged on Plant (300,000 × 10%) and Buildings (500,000 × 5%).		

Profit and Loss Account

Dr. For the Year Ending December 31st, 2021 Cr.

To Depreciation:			
Plant…………..	30,000		
Buildings……..	25,000		

Balance Sheet

Assets As on December 31st, 2021 Liabilities

Plant………… 300,000			
Less Accumulated			
Depreciation….. 30,000	270,000		
Buildings…… 500,000			
Less Accumulated			
Depreciation…. 25,000	475,000		

***Depreciation on Assets acquired (purchased) during the accounting year:**

Sometimes fixed assets are acquired during the accounting period. In such situations, a problem may arise about whether depreciation expense must be charged for the full accounting period or it must be charged only for a part of the accounting period. In such case and in the absence of any specific instruction in the question on hand, it will be appropriate to charge depreciation for the full year even in respect of those assets which have been purchased during the accounting period. Nevertheless, where depreciation rate has been provided as per year and the date of acquisition of the fixed assets has been given, it will be proper to charge depreciation only for the remaining part of the accounting period.

Illustration 2.8:

The following data are extracted from the Trial Balance of an enterprise:

Trial Balance
As on December 31st, 2021

Account Titles	Dr. L.E.	Cr. L.E.
Furniture and Fixtures…..	100,000	
Plant and Machinery……	400,000	

Other Data:

a. Furniture of **L.E.50,000** was purchased on July 1st, 2021. Charge depreciation at 10% p.a. (per annum).

b. Plant of **L.E.100,000** was acquired on July 1st, 2021. Charge depreciation at 20%.

Required:

Record the necessary journal entries and show how the items will appear in the enterprise's final accounts.

Solution:

JOURNAL

Explanation	Dr. L.E.	Cr. L.E.
By Depreciation Expenses a/c:		
Furniture and Fixtures………….	7,500	
Plant and Machinery…………..	70,000	
To Accumulated Depreciation:		
Furniture and Fixtures………		7,500
Plant and Machinery………..		70,000
Being depreciation charged on furniture and fixtures and plant and machinery including additions.		

Profit and Loss Account

Dr. For the Year Ending December 31st, 2021 Cr.

To Depreciation Exp.: Furniture & Fixtures 7,500 Plant & Machinery 70,000	77,500		

Balance Sheet

Assets As on December 31st, 2021 Liabilities

Furniture & Fixtures	100,000			
Less Accumulated Depreciation	7,500	92,500		
Plant & Machinery	400,000			
Less Accumulated Depreciation	70,000	330,000		

Notes:

(a) Depreciation on furniture and fixtures: for full year has been charged for **L.E.50,000** = 50,000 × 10% = 5,000 and for only 6 months has been charged for furniture acquired on July 1st, = 50,000 × 10% × $\frac{6}{12}$ = 2,500. Total depreciation on furniture and fixtures = 5,000 + 2,500.

(b) Depreciation on plant and machinery: for full year has been charged for **L.E.300,000** = 300,000 × 20% = 60,000 and for only 6 months has been charged for plant acquired on July 1st, = 100,000 ×

$20\% \times \frac{6}{12}$ = 10,000. Total depreciation on plant and machinery = 60,000 + 10,000.

7. Bad Debts:

In effect, credit sales have become necessary these days. Such transactions may result in some losses to the seller. In other words, bad debts can occur when there are credit sales. **Bad Debt** is a loss to the business and a gain to the debtor. Anyway, the following journal entry should be passed in the event of a debt becoming bad.

By Bad Debts a/c………………	XXX	
To Debtors (Accounts Receivable) a/c		XXX

Illustration 2.9:

The following data are extracted from the Trial Balance of a firm:

Trial Balance
As on December 31st, 2021

Account Titles	Dr. L.E.	Cr. L.E.
Sundry Debtors………………..	50,000	
Bad Debts……………………..	5,000	

***Other Data*:**

Maher, one of the debtors became insolvent (unable to pay his debt when it became due) and it was learnt, on December 31st, that out of the total debt of **L.E.5,000**, only **L.E.2,500** will be recovered from him. No adjustment has to date been made.

***Required*:**

Prepare necessary adjusting entries and show how the information will appear in the final accounts of the firm.

Solution:

Journal

Explanation	Dr. L.E.	Cr. L.E.
By Bad Debt a/c……………......	2,500	
To Maher a/c…………….		2,500
Being L.E.2,500 became irrecoverable.		

Profit and Loss Account

Dr. For the Year Ending December 31st, 2021 Cr.

To Bad Debts… (5,000 + 2,500)	7,500		

Balance Sheet

Assets	As on December 31st, 2021		Liabilities
Sundry Debtors 50,000 *Less* Bad Debts 2,500	47,500		

8. Provision (Allowance) for Bad Debts:

It has already explained that in accounting we observe the ***"Convention of Conservatism"*** while recording business transactions. This will lead to making provision or allowance for expected losses. Nevertheless, we do not take credit for expected profits. Accordingly, an enterprise makes provision at the end of the accounting period for probable bad debts which may happen during the next year.

One simple reason for this is that if out of credit sales made during a particular period some sales are probably to become bad in the next accounting year, the appropriate action would be to charge the same accounting year with such likely bad debts in which the sales have been made, because the profit on such sales has been considered in the year in which the sales have been made.

In such a case, the following journal entry is made for creating a provision (allowance) for bad debts:

Profit and Loss Account…………	XXX	
To Provision (Allowance) for Bad Debts		XXX
Or		
Uncollectible Accounts Expenses….	XXX	
To Allowance for Doubtful Debts…..		XXX

The allowance or provision for bad debts is charged to the *Profit and Loss Account* and is deducted from debtors in the *Balance Sheet.*

<u>Illustration 2.10</u>:

The following data are extracted the Trial Balance of an enterprise:

Trial Balance

As on December 31st, 2021

Account Titles	Dr. L.E.	Cr. L.E.
Sundry Debtors…………..	30,000	
Bad Debts………………..	5,000	

***Additional Information*:**

(a) After preparing the Trial Balance, it is learnt that a debtor Ramiz has become insolvent and, therefore, the entire amount of **L.E.3,000** due from him was irrecoverable.

(b) Create 10% provision for bad and doubtful debts.

***Required*:**

Prepare necessary adjusting entries and show how the items will appear in the enterprise's final accounts.

Solution:

JOURNAL

Description	Dr. L.E.	Cr. L.E.
Bad Debts a/c……………	3,000	
Ramiz (Debtors) a/c….		3,000
Amount due from Ramiz proved to be bad.		
Profit & Loss a/c…………….	2,700	
Provision for Bad and Doubtful Debts		2,700
Creating provision for bad debts.		

Profit and Loss Account
For the Year Ending December 31st, 2021

Dr. Cr.

To Bad Debts….. (5,000 + 3,000)	8,000		
To Provision for Bad and Doubtful Debts….	2,700		

Balance Sheet

Assets As on December 31st, 2021 Liabilities

Sundry Debtors (30,000 − 3,000)	27,000			
Less Provision for Bad and Doubtful Debts	2,700	24,300		

Note: Provision for bad and doubtful debts should be computed on the balance of debtors at the end of the accounting period after taken into account the bad debts occurred at the end of the accounting year. In other words, bad debts learnt about at the end of the accounting year should be deducted first from the debtors before computing the provision for bad and doubtful debts. Accordingly, the above provision was calculated as follows:

Debtors **L.E.30,000** − Bad Debts on December 31st **L.E.3,000** = **L.E.27,000 × 10%** = **L.E.2,700.**

On the other hand, the provision for bad and doubtful debts created at the end of the accounting year is carried forward to the next year and the bad debts occurring during the next year are covered or met out of this provision. At the end of the next accounting year, relevant adjusting entry must be made for keeping the provision for doubtful debts at an appropriate amount to be carried forward. This will be clear from the following illustration.

Illustration 2.11:

The following data are extracted from the Trial Balance of an enterprise:

Trial Balance
As on December 31st, 2021

Account Titles	Dr. L.E.	Cr. L.E.
Sundry Debtors…………	50,000	
Provision for Doubtful Debts……………………		5,000
Bad Debts………………	3,000	

Other Data:

1. Additional bad debts **L.E.3,000.**

2. Keep the provision for bad debts at 10% on debtors.

Required:

Prepare the necessary journal entries and prepare Provision for Doubtful Debts Account and show how the different items will appear in the enterprise's final accounts.

Solution:

JOURNAL

Description	Dr. L.E.	Cr. L.E.
By Bad Debts a/c……………… To Sundry Debtors a/c……… Journalizing additional bad debts of L.E.3,000.	3,000	3,000
By Provision for Bad Debts a/c… To Bad Debts a/c……………. Transferring bad debts to Provision for Bad Debts (L.E.3,000 appearing in the Trial Balance + L.E.3,000 additional bad debts).	6,000	6,000
By Profit and Loss a/c…………… To Provision for Bad Debts a/c.. Amount charged from P. & L. Account to keep provision for bad	5,700	5,700

debts at 10% on debtors.		

Note: Provision for Bad Debts on debtors concerning the current period is calculated as follows:

Net Debtors on December 31st, 2021 = 50,000 − 3,000 additional bad debts = L.E.47,000.

Provision for Bad Debts on 31/12/2021 = 47,000 × 10% = L.E.4,700.

Dr. Provision for Bad Debts Account Cr.

To Bad Debts 31/12/2021……	6,000	Balance b/d 1/1/2021…..	5,000
Balance c/d 31/12/2021……	4,700	By Profit & Loss 31/12/2021….	5,700
	10,700 =====		10,700 =====
		Balance b/d 1/1/2022……….	4,700

Profit And Loss Account

Dr. As on December 31st, 2021 Cr.

To Provision for Bad Debts…………….	5,700		

Balance Sheet

Assets As on December 31st, 2021 Liabilities

Sundry Debtors.. 47,000 *Less* Provision for Bad Debts…. 4,700	42,300		

9. Provision for Discount on Debtors:

In practice, discount may have to be allowed to the debtors because of their making prompt (instant) payments. When discount is allowed, the following journal entry is made:

By Discount Allowed (Given) a/c…	XXX	
To Debtors a/c……………		XXX

Additionally, at the end of the accounting period, the enterprise also estimates the amount of discount which it may have to be given to the debtors outstanding at the end of the accounting period in the course of (during) the next year. This can be done by creating a provision for discount on debtors. As such, the following journal entry is made:

By Profit & Loss a/c………	XXX	
To Provision for Discount a/c…		XXX

However, it should be taken into account that *"Provision for Discount"* will be created only on good debtors. Accordingly, provision for discount must be made after deducting bad debts and provision for bad debts from the debtors' balances.

Illustration 2.12:

The following data are extracted from the Trial Balance of an enterprise.

Trial Balance
As on December 31st, 2021

Account Titles	Dr. L.E.	Cr .L.E.
Sundry Debtors…………	50,000	
Bad Debts………………	3,000	
Discount……………….	2,000	

Other Data:

1. Create a provision for doubtful debts at 10% on debtors.

2. Create a provision for discount on debtors at 5% on debtors.

3. Additional discount given to the debtors of **L.E.1,000.**

Required:

Prepare the necessary journal entries and show how the different items will appear in the final accounts.

Solution:

JOURNAL

Explanation	Dr. L.E.	Cr. L.E.
By Discount Allowed a/c…….	1,000	
To Sundry Debtors a/c…….		1,000
Discount allowed to debtors.		
By Profit & Loss a/c………..	4,900	
To Provision for Bad Debts a/c		4,900
Provision for bad debts created at the rate of 10% on debtors of L.E.49,000 (50,000 − 1,000).		
By Profit & Loss a/c ………..	2,205	
To Provision for Discount a/c..		2,205
Provision for discount created at the rate of 5% on good debtors of L.E.44,100 (L.E.49,000 − 4,900).		

Profit and Loss Account

Dr. For the Year Ending December 31st, 2021 Cr.

To Bad Debts…….	3,000		
To Provision for Bad Debts	4,900		
To Discount Allowed…… (2,000 + 1,000)	3,000		
To Provision for Discount..	2,205		

Balance Sheet

Assets As on December 31st, 2021 Liabilities

Debtors ……	49,000			
Less Provision for Bad Debts..	4,900			
	44,100			
Less Provision for Discount….	2,205	41,895		

Illustration 2.13:

The following data are extracted from the Trial Balance of a firm:

Trial Balance
As on December 31, 2021

Account Titles	Dr. L.E.	Cr. L.E.
Sundry Debtors…………	50,000	
Provision for Bad Debts..		5,000
Provision for Discount…		2,000
Bad Debts………………	3,000	
Discount………………..	1,000	

Other Data:

a. Additional Bad Debts L.E.1,000.

b. Additional Discount L.E.500.

c. Create a provision for bad debts at 10% on debtors.

d. Create a provision for discount at 5% on debtors.

Required:

Prepare the necessary journal entries, prepare Provision for Bad Debts Account and Provision for Discount on Debtors Account, and show how the different items will appear in the final accounts.

Solution:

JOURNAL

Explanation	Dr. L.E.	Cr. L.E.
By Sundries:		
Bad Debts a/c……………………	1,000	
Discount Allowed a/c……………	500	
To Debtors a/c………………..		1,500
Additional bad debts and additional discount on debtors.		
By Provision for Bad Debts a/c….	4,000	
To Bad Debts a/c……………		4,000
Bad debts written off (omitted)		

from Provision for Bad Debts.		
By Provision for Discount on Debtors To Discount Allowed a/c….. Discount Allowed written off from Provision for Discount on Debtors.	1,500	1,500
By Profit & Loss a/c………….. To Provision for Bad Debts a/c.. Amount charged from P&L a/c to maintain a provision for bad debts at the rate of 10% on debtors amounting to L.E.48,500 (50,000 − [1,000 + 500]).	3,850	3,850
By Profit and Loss a/c………. To Provision for Discount a/c.. Amount charged from P&L a/c for keeping the provision for discount at 5% on good debtors amounting to L.E.43,650 (48,500 − 4,850).	1,683	1,683

Dr. Provision for Bad Debts Account Cr.

To Bad Debts a/c 31/12/2021…… [3,000 + 1,000]	4,000	Balance b/d 1/1/2021 ………	5,000
Balance c/d 31/12/2021…..	4,850	By Profit & Loss a/c 31/12/2021…	3,850
	8,850		8,850

Dr. Provision for Discount Account Cr.

To Discount a/c 31/12/2021……		Balance b/d 1/1/2021………	2,000

[1,000 + 500]	1,500	by Profit & Loss a/c 31/12/2021…	1,683
Balance c/d 31/12/2021…..	2,183		
	3,683		3,683

Profit and Loss Account

Dr. For the Year Ending December 31st, 2021 Cr.

To Provision for Bad Debts a/c…………	3,850		
To Provision for Discount a/c……..	1,683		

Balance Sheet

Assets As on December 31st, 2021 Liabilities

Sundry Debtors	48,500			
Less Provision for Bad Debts……..	4,850			
	43,650			
Less Provision for Discount………	2,183	41,467		

10. Interest on Capital:

As it has been explained before, funds provided by the owner to run the business is called **"Capital"**. Sometimes and in order to ascertain the true profit or loss made by the business, it is necessary that the profit (or loss) must be determined after deducting interest on such funds, which the owner could have earned. As such, the entry for interest on owner's capital is mad as below:

By Interest on Capital a/c…………	XXX	
To Capital a/c…………………		XXX

Moreover, interest on capital is allowed on the balance of the **Capital Account** in the beginning of the accounting year. Nevertheless, in case the owner has introduced further funds during the accounting year, interest on such capital will also be allowed from the date on which such additional capital was introduced till the end of the accounting year.

Illustration 2.14:

Following are the extracts from the Trial Balance of a particular firm:

Trial Balance
As on December 31st, 2021

Account Titles	Dr. L.E.	Cr. L.E.
Ramiz, Capital…………		50,000

<u>Additional Information</u>:

1- Interest on capital is to be allowed at 10% per annum.

2- Ramiz introduced additional capital amounting to L.E.5,000 on July 1st, 2021.

<u>Required</u>:

Pass the necessary journal entries and show how the various items will appear in the Firm's final accounts.

Solution:

<u>Calculations:</u>

Interest on Capital:

a. For full year = 45,000 (50,000 − 5,000) × 10%= 4,500.

b. For 6 months = 5,000 × 10% × $\frac{6}{12}$ = 250.

Total interest on capital = 4,500 + 250 = 4,750.

JOURNAL

Explanation	Dr. L.E.	Cr. L.E.
By Interest on Capital a/c……	4,750	
To Capital a/c……………..		4,750
Interest on capital allowed to Ramiz on L.E.45,000 for full year		

and on L.E.5,000 for 6 months.		

Profit and Loss Account

Dr. For the Year Ending December 31st, 2021 Cr.

To Interest on Capital a/c…………	4,750		

Balance Sheet

Assets As on December 31st, 2021 Liabilities

		Ramiz, Capital.. 50,000 *Add* Interest on Capital….. 4,750	54,750

11. Interest on Drawings:

Generally, drawings represent the money which is withdrawn by the proprietor from the business for personal use. In case interest is allowed to the owner on his/her capital, it will be usual practice to charge interest on his/her drawings. In such cases, the journal entry for recording interest on drawings will be as follows:

By Capital a/c ……………………	XXX	
To Interest on Drawings a/c…		XXX

Calculation of Interest on Drawings:

In practice, there is difference between the method of computation of interest on capital and computation of interest on drawings. Mostly, interest on capital is charged on the opening balance in the Capital Account. Nevertheless, in case of additional capital introduced during the year by the owner, interest may be charged from the date of introducing additional capital until the end of the accounting year. This does not create much problem. However, regarding drawings, the situation may be different. The proprietor does not usually make the entire amount of drawings on a particular date for the whole accounting period. For example, if the owner has withdrawn **L.E.10,000** from the business, it is cannot properly be assumed that he/she must have withdrawn the entire amount in the beginning of the accounting period.

Because the interest is to be charged on the amount withdrawn by the owner from the date on which he/she withdrew the amount from the business to the end of the accounting year, it is necessary to compute interest on each withdrawal made by the owner separately. But, in the absence of information, it can appropriately be assumed that the drawings were made evenly during the year. Furthermore, for computation of interest, it can be assumed that the owner has withdrawn the money on the 15th of each month. In such situation, interest should be charged on the total amount of drawings for 6 months.

Illustration 2.15:

Following are the extracts from the Trial Balance of an enterprise:

Trial Balance
As on December 31st, 2021

Account Titles	Dr. L.E.	Cr. L.E.
Capital……………………		50,000

Drawings…………………	9,000	

Other Data:

1- Interest on capital is to be allowed at 10% yearly on the opening balance.

2- Interest on drawings is to be charged at 12% yearly.

Required:

Prepare the necessary journal entries and show how the different items will appear in the enterprise's final accounts. You can assume that the drawings were made evenly during the year on the 15th of each month.

Solution:

JOURNAL

Explanation	Dr. L.E.	Cr. L.E.
By Interest on Capital a/c….. To Capital a/c…………… Interest on capital at 10% yearly.	5,000	 5,000
By Capital a/c……………… To Interest on Drawings a/c.. Interest on drawings charged for 6 months at 12% yearly on the total amount.	540	 540

Profit and Loss Account

Dr. For the Year Ending December 31st, 2021 Cr.

To Interest on Capital a/c……	5,000	By Interest on Drawings a/c…...	540

Balance Sheet

Assets As on December 31st, 2021 Liabilities

		Capital……..	50,000	
		Add Interest on Capital………...	5,000	
			55,000	
		Less Drawings…	9,000	
			46,000	
		Less Interest on Drawings…….	540	45,460

Illustration 2.16:

The following data are concerning A's Factory:

Items	L.E.
Capital as at 1/1/2021……………..	250,000
Drawings………………………….	70,000
Sundry Creditors………………….	80,000
Discount Received………………..	7,020
Cairo Bank (Cr.)………………….	40,000
Provision for Bad and Doubtful Debts	6,000
Purchases Returns………………….	5,300
Sales……………………………….	675,000
Sales Returns………………………	860
Stock as at 1/1/2021………………	90,000

Plant and Machinery (including Machinery for L.E.50,000 purchased on 1/10/2021)	170,000
Furniture…………………………..	15,000
Buildings………………………….	150,000
Purchases………………………….	302,300
Sundry Debtors…………………….	110,000
Manufacturing Wages…………….	60,000
Manufacturing Expenses………….	50,000
Carriage Inwards………………….	4,000
Carriage Outwards………………..	4,200
Bad Debts………………………….	1,500
Salaries…………………………….	28,000
Interest and Bank Charges (Dr.)….	1,260
Discount Allowed………………..	1,500
Insurance (Dr.)…………………..	3,000
Bank (Dr)………………………….	1,400
Cash on Hand…………………….	300
Stock as at 31/12/2021…………..	75,500

Adjustments:

1. Interest on capital at 10% per annum (no interest is to be provided on drawings).
2. Outstanding Expenses:

-Salaries L.E.1,000

-Manufacturing Wages 500

-Interest on Bank Loan 1,000

3. Depreciation on:

-Machinery at 10% per annum

-Furniture at 10% per annum

-Buildings at 2.5% per annum

4. Prepaid expenses:

-Insurance	L.E.1,000
-Salary	500

5. Provision for Bad and Doubtful Debts at 10% of Debtors.

Furniture costing L.E.5,000 was sold for L.E.3,500 on 1/1/2021 and this amount was latter credited to Furniture Account.

Required:

Prepare the Manufacturing, Trading and Profit and Loss Account for the year ended 31/12/2021 and Balance Sheet as at that date after making the necessary adjustments.

***Solution*:**

Manufacturing, Trading and Profit & Loss Account

Dr. For the year ending December 31, 2021 Cr.

To Purchases *Less* Returns*……….	297,000	By Trading a/c (transferring of Cost of Goods Produced)……….	424,750
To Carriage Inwards	4,000		
To Manufacturing Wages (60,000 + 500)……………..	60,500		
To Manufacturing Expenses……….	50,000		
To Depreciation on Machinery*………	13,250		
	424,750		424,750
	======		======
To Opening Stock..	90,000	By Sales *Less* Returns*………..	674,140
To Manufacturing a/c (Cost of goods produced)……….	424,750	By Closing Stock..	75,500
To Profit & Loss a/c (Gross Profit)……	234,890		
	749,640		749,640
	======		======
To Salaries (28,000 + 1,000 − 500)…	28,500	By Trading a/c (Gross Profit)….	234,890
To Interest and bank charges (1,260 + 1,000)…………	2,260	By Discount Received……….	7,020
To Discount Allowed……	1,500		
To Insurance (3,000 − 1,000)………..	2,000		
To Carriage Outwards…..	4,200		

To Provision for bad and doubtful debts *	6,500		
To Loss on sale of furniture……….	1,500		
To Depreciation*:			
Buildings 3,750			
Furniture 1,350	5,100		
To Interest on Capital………….	25,000		
To Capital (Net Profit)…………..	165,350		
	241,910		241,910

Notes*:

-Net Purchases = 302,300 − 5,300 = 297,000

-Depreciation on Machinery:

for full year = 120, 000 × 10% = 12,000 + (for 3 months 50,000 × 10% × $\frac{3}{12}$) 1,250 = 13,250.

-Net Sales = 675,000 − 860= 674,140.

-Provision for Bad Debts:

Provision Required = 110,000 × 10% = 11,000	
(+) Bad Debts	1,500
	12,500
(−) Opening balance	6,000
	6,500

-Depreciation on Buildings = 150,000 × 2.5% = 3,750.

-Depreciation on Furniture:

Balance as on 1/1/2021 (15,000 + 3,500)= 18,500

(−) Cost of furniture disposed off on 1/1/2021 5,000

13,500

Depreciation = 13,500 × 10% = 1,350.

Balance Sheet

Assets As on December 31st, 2021 Liabilities

Fixed Assets:		Capital:	
Buildings 150,000		Opening Balance	
(−) Accumulated		250,000	
Depreciation 3,750	146,250	(+) Interest 25,000	
Plant &		(+) Profit 165,350	
Machinery 170,000		440,350	
(−) Accumulated		(−) Drawings	
Depreciation 13,250	56,750	70,000	370,350
Furniture 13,500		Liabilities:	
(−) Accumulated		Bank Loan (Cairo	
Depreciation 1,350	12,150	Bank)………….	40,000
Current Assets:		Sundry Creditors..	80,000
Closing Stock…..	75,500	Outstanding	
Debtors 110,000		Expenses:	
(−) Provision		Salaries 1,000	

for bad &doubtful debts	11,000	99,000	M. Wages	500	
Cash in hand		300	Interest on Bank Loan………	1,000	2,500
Cash at Bank		1,400			
Prepaid Expenses:					
Insurance	1,000				
Salary	500	1,500			
		492,850			492,850

Illustration 2.17:

The Trial Balance of XXX Manufacturing Firm as on December 31st, 2021 is shown below:

Account Titles		Dr. L.E.	Cr. L.E.
Capital (including L.E.50,000 introduced on 1/7/2021)…..			225,000
Stock as on 1/1/2021:….			
Finished Goods	35,000		
Work-in-progress	70,000		
Raw Materials	30,000	135,000	
Purchase of Raw Materials….		705,000	
Machinery………..		225,000	
Sales……………..			1,262,250
Carriage Inwards…….		7,500	
Carriage Outwards…..		4,500	
Rent (including L.E.4,500 for the Factory premises)……		13,500	
Rebates & Discount Allowed..		1,050	
Fire Insurance (for Machinery).		2,100	
Sundry Debtors……..		189,000	
Sundry Creditors……			51,000

Provision for Bad and Doubtful Debts………		600
Printing and Stationery…..	1,800	
Miscellaneous Expenses……	8,400	
Advertisement………	45,000	
Drawings…………..	18,000	
Office Salaries……..	54,000	
Manufacturing Wages…..	60,000	
Furniture and Fixtures…..	22,500	
Factory Power and Fuel….	3,000	
Cash on hand…………….	6,000	
Cash at Bank…………….	37,500	
	1,538,850	1,538,850

<u>Adjustments</u>:

(1) Interest at 10% per annum on capital. (No interest on drawings.)

(2) A motor car purchased on 1/7/2021 for L.E.60,000 has been included in **Purchases.**

(3) Depreciation: Machinery at 10% p.a., Motor Car at 10% p.a., and Furniture and Fixtures at 10% p.a.

(4) A portion of the office was sub-let at L.E.500 per month from 1/7/2021.

(5) Sundry Debtors include bad debts of L.E.4,000, which must be written off.

(6) Provision for Bad and Doubtful Debts as on 31/12/2021 should be maintained at 10% of the Debtors.

(7) A sum of L.E.20,000, transferred from the Current Account with the bank to Fixed Deposit Account on 1/5/2021 has not been passed through boos. Make suitable adjustments and prepare accrued interest at 6% p.a.

(8) Stock as on 31/12/2021: Finished goods L.E.50,000, Raw Materials L.E.10,000, and Work-in-progress L.E.55,000.

***Required*:**

Prepare the Manufacturing, Trading and Profit and Loss Account for the year ended 31/12/2021 and the Balance Sheet as on that date after making the necessary adjustments (Journal entries for adjustments are not required).

Solution:

XXX MANUFACTURING FIRM

Manufacturing Account

Dr. For the year ending December 31st, 2021 Cr.

To Work-in-progress 1/1/021..		70,000	By Trading a/c (Cost of Manufactured goods)…………	779,600
To Materials Used:			By Work-in-progress 31/12/021……..	55,000
Op. Stock	30,000			
Purchases (705,000 −60,000)	645,000			
	675,000			
Less C. Stock	10,000	665,000		
To Carriage Inwards		7,500		
To Factory Power and Fuel………		3,000		
To Manufacturing Wages……..		60,000		
To Factory Rent…		4,500		
To Fire Insurance for Machinery………		2,100		
To Depreciation for Machinery*………		22,500		
		834,600		834,600

XXX MANUFACTURING FIRM
Trading and Profit and Loss Account
Dr. For the year ending December 31st, 2021 Cr.

To Opening Stock….	35,000	By Sales a/c	1,262,250
To Manufacturing a/c (Cost of Goods transferred from Manufacturing a/c)…	779,600	By Closing Stock………	50,000
To Profit and Loss a/c (Gross Profit)……..	497,650		
	1,312,250		1,312,250
	=======		=======
To Office Salaries…	54,000	By Trading a/c (Gross Profit)..	497,650
To Rent (13,500 − 4,500)………….	9,000	By Rent Revenue a/c*..	3,000
To Advertisement….	45,000	By Bank Interest a/c*..	800
To Carriage Outward	4,500		
To Rebates and Discounts……….	1,050		
To Provision for Bad and Doubtful Debts*..	21,900		
To Printing and Stationery ……….	1,800		
To Miscellaneous Ex.	8,400		
To Depreciation*: Furniture 2,250; Motor Car 3,000	5,250		
To Interest on Capital*………….	20,000		
To Capital a/c (Net Profit)…………….	330,550		
	501,450		501,450

Notes*:

-Provision For Bad and Doubtful Debts:

Net Debtors=189,000−4,000 (bad debts) = 185,000

Bad Debts	4,000
(+) New provision = 185,000 × 10% =	<u>18,500</u>
	22,500
(−) Old provision	<u>(600)</u>
Debited to Profit & Loss Account on 31/12/2021	<u>21,900</u>

-Depreciation:

Furniture & Fixtures = 22,500 × 10% = 2,250

Motor Car = 60,000 × 10% × $\frac{6}{12}$ = 3,000

-Interest on Capital:

For full year =175,000(225,000−50,000) ×10% =	17,500
(+) for 6 months 50,000×10%× $\frac{6}{12}$ =	<u>2,500</u>
	20,000
-Rent Revenue = 500 × 6 mns =	3,000
-Bank Interest = 20,000 × 6% × $\frac{8}{12}$ =	800

XXX MANUFACTURING FIRM
Balance Sheet
Assets As on December 31st, 2021 Liabilities

Machinery 225,000		Capital 225,000	
(−) Acc. Dep 22,500	202,500	(+):	
Motor Car 60,000		Net Profit 330,550	
(−) Acc. Dep. 3,000	57,000	Interest 20,000	
Furniture & Fixtures		575,550	
22,500		(−) Drawings 18,000	557,550
(−) Acc. Dep. 2,250	20,250	Sundry Creditors…	51,000
Closing Stock:			
Finished Goods	50,000		
Work-in-progress	55,000		
Raw Materials	10,000		
Sundry Debtors:			
185,000			
(−) Provision			
for Bad Debts 18,500	166,500		
Fixed Deposit with			
Bank……………	20,000		
Cash at Bank…..	17,500		
Cash on hand…..	6,000		
Rent Revenue			
Accrued…………	3,000		
Interest Accrued…	800		
	608,550		608,550

2.5 Questions and Exercises:

2.5.1 Questions:

1. Indicate whether each of the following statements is ***True (T)*** or ***False (F)***:

(a) The term **"Current Liabilities"** is used to refer to those liabilities which are payable after a year.

(b) The term **"Current Assets"** and **"Liquid Assets"** have synonymous meanings.

(c) Creating reserve for discount on creditors is not strictly according to the principle of *Conservatism*.

(d) Stock at the end (closing stock) if appears in the Trial Balance, is taken only to the Balance Sheet.

(e) Goods taken out by the owner from the business for his/her personal use are credited to Sales Account.

(f) "Salary paid in advance" is not an expense because it neither reduces assets nor increases liabilities.

(g) The term "Accrued Income" and "Outstanding Income" have synonymous meanings.

(h) Premium paid on the life policy of the owner is debited to the Profit and Loss Account.

2. Select the best answer for the following items:

(1) Sales are equal to

a. Cost of goods sold + Profit.

b. Cost of goods sold − Gross Profit.

c. Gross Profit − Cost of goods sold.

(2) Interest on Drawings is

a. Expenditure for the business.

b. Expense for the business.

c. Gain for the business.

(3) Goods given as samples should be credited to

a. Advertisement Account.

b. Sales account.

c. Purchases Account.

(4) Outstanding Salaries are shown as

a. an expense.

b. a liability.

c. an asset.

(5) Income Tax paid by a sole proprietor on his/her business income should be

a. Debited to the Trading Account.

b. Debited to the Profit and Loss Account.

c. Deducted from the Capital Account in the Balance Sheet.

<u>Answers to Question</u> 1.[(a) False, (b) False, (c) True, (d) True, (e) False, (f) True, (g) False, and (h) False.

<u>Answers to Question</u> 2. {(1) a, (2) c, (3) c, (4) b, and (5) c.

3. What are the Final Accounts? What purpose do they serve?

4. Differentiate between:

(a) Outstanding Expense and Prepaid Expense.

(b) Outstanding Income and Accrued Income.

(c) Interest on Capital and Interest on Drawings.

5. Why adjusting entries are required to be made at the time of preparing Final Accounts? Give illustrative examples of any four of such adjusting entries.

6. Write brief notes on:

(a) Closing Entries.

(b) Trading Account.

(c) Manufacturing Account.

2.5.2 Exercises:

1. From the following Trial Balance, you are ***required*** to prepare a Manufacturing, Trading and Profit and Loss Account and also the Balance Sheet as on December 31st, 2021.

TRIAL BALANCE
As on December 31st, 2021

Account Titles	Dr. L.E.	Cr. L.E.
Stock on 1/1/2021:		
Raw Materials……………	20,000	
Work-in-progress………..	50,000	
Finished Goods………….	100,000	
Manufacturing Wages…..	100,000	
Purchases of Raw Materials…	300,000	

Factory Rent……………..	50,000	
Carriage of Raw Materials…	30,000	
Salary of the Works Manager..	20,000	
Office Rent………………	20,000	
Printing and Stationery….	10,000	
Bad Debts……………….	10,000	
Sales…………………….		600,000
Land and Buildings………	300,000	
Plant and Machinery (net)..	200,000	
Depreciation on Plant……	20,000	
Sundry Debtors………….	50,000	
Sundry Creditors………..		300,000
Cash on hand……………	50,000	
Capital………………….		430,000
Total……………………	1,330,000	1,330,000

Closing Stock on December 31st, 2021 was as follows:

	L.E.
Raw Materials	50,000
Work-in-progress	40,000
Finished Goods	100,000

{ Answer clews: Cost of Production of L.E.500,000, Gross Profit of L.E.100,000, Net

Profit of L.E.60,000, and Total of Balance Sheet of L.E.790,000.}

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2. From the following Trial Balance, you are **required** to prepare Manufacturing, Trading and Profit and Loss Account for the year ended December 31st, 2021 and the Balance Sheet as at the end of the year.

TRAIL BALANCE
As on December 31st, 2021

Account Titles	Dr. L.E.	Cr. L.E.`
Opening Stock:		
Raw Materials……….	300,000	
Finished Goods………	160,000	
Work-in-progress……	50,000	
Capital…………………		720,000
Purchases of Raw Materials..	2,500,000	
Sales……………………...		4,000,000
Purchases of Finished goods..	80,000	
Carriage Inwards…………	40,000	
Wages…………………..	500,000	
Salaries (75% Factory)…..	260,000	
Commission…………….	30,000	
Bad Debts………………	20,000	
Insurance………………	40,000	
Rent, Rates and Taxes (50% Factory)…………………	120,000	

Postage and Telegram….	28,000	
Tea and Food…………..	16,000	
Travelling and Conveyance		
(25% Factory)…………	35,000	
Carriage Outwards…….	26,000	
Machinery…………….	400,000	
Furniture………………	50,000	
Debtors………………..	600,000	
Creditors………………		535,000
Total……………………	5,255,000	5,255,000

Closing Stocks are as follows:

	L.E.
Raw Materials	400,000
Work-in-progress	120,000
Finished Goods	80,000

[Answer Clews: Cost of Production of L.E.3,133,750, Gross Profit of L.E.706,250, Net Profit of L.E.395,000, and Balance Sheet Total of L.E.1,650,000.]

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3. The following are the Trading and Profit & Loss Account and Balance Sheet of an enterprise as on

December 31st, 2021. You are required to redraw them in an appropriate form, giving reasons for your corrections.

Trading and Profit and Loss Account

Dr. For the year ending December 31st, 2021 Cr.

Purchases……	4,668,000	Sales…………	5,599,000
Stock………..	551,100	Profit on	
Salaries……..	110,100	Consignment to A	
Drawings…….	191,700	& Co…………	190,800
Wages………..	655,900	Interest on Capital	75,000
Rent………….	22,500	Stock (Jan. 1st)….	503,100
General Expenses	174,700	Commission	
Interest on Loan..	30,000	received………	279,900
Bad Debts…….	118,900	Discount Received	112,500
Net Profit………	237,400		
	6,760,300		6,760,300

Balance Sheet

Assets As on December 31st, 2021 Liabilities

Creditors………	1,950,700	Debtors……….	2,615,800
Bills Receivable..	1,301,400	Cash………….	9,600
Capital 1/1/2021	1,500,000	Bank…………	522,100
Net Profit……..	237,400	Loan from Bank.	750,000
		Stock (31/12/021)	551,100
		Bills Payable…..	540,900
	4,989,500		4,989,500

[Answer Clews: Gross Profit L.E.323,100, Net Profit L.E.375,100 and Balance Sheet Total L.E.5,000,000].

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4. Indicate how the following must be dealt with in the final accounts of an enterprise for the accounting period ended on December 31st, 2021, giving reasons shortly:

(1) Advertisement expenditure of L.E.100,000 paid on December 30th, 2021, the advertisement in respect of which has appeared in the Ahram Newspaper only in January 2022.

(2) Cost of temporary exhibition constructed on July 1st, 2021, the exhibition being expected to finish by June 2022, of L.E.170,000.

(3) Cost of a second-hand Car purchased on October 1st, 2021 for L.E.25,000, which was totally destroyed in an accident on November

30th, 2021, the insurance company paying L.E.10,000 in full settlement in January 2022.

(4) Petrol expenses of L.E.4,200 paid for the car of the proprietor for an official visit, the car not being an asset of the enterprise.

(5) Hire charges of L.E.10,000 for a compressor, when the enterprise's own compressor was under break-down.

[Answer clews: (1) Prepaid Expense, (2)Charge L.E.85,000 to Profit & Loss a/c in 2021 and carry forward the balance to 2022, (3) Write off (deduct) L.E.15,000 from Profit & Loss a/c, (4) Charge Profit & Loss a/c as a travelling expense, and (5)Charge Manufacturing (if prepared) or Profit & Loss a/c.]

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5. An enterprise had the following Balances on January 1st, 2021:

(a) Provision for Bad and Doubtful Debts L.E.25,000

(b) Provision for Discount on Debtors L.E.12,000.

During the year, Bad Debts amounted to L.E.20,000, Discounts Allowed were L.E.1,000. During 2022, Bad Debts amounting to L.E.10,000 were written off while Discounts Allowed were L.E.20,000.

Total Debtors on December 31st, 2021 were L.E.480,000 before writing off Bad Debts, but after allowing Discounts. On December 31st, 2022, their amount was L.E.190,000 after writing off the Bad Debts, but before allowing Discounts.

It is the enterprise's policy to maintain a provision of 5% against Bad and Doubtful Debts and 2% for Discount on Debtors.

Required:

Show the accounts relating to Provision on Debtors for the year 2021 and 2022.

{Answer Clews: Balances on December 31st, 20X1: Bad debts Provision L.E.8,500, Provision for Discount on Debtors L.E.3,230.}

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6. An enterprise makes provision for doubtful debts at the end of each year against specific debtors. On June 30th, 2021, the following debtors' balances were considered doubtful and should be considered when making provision:

Ramadan	L.E.15,000
Jaser	4,000
Nagib	2,500
Sharbat	5,000

The following information is regarding the year ended June 30th, 2022:

(a) Bad Debts written off:

Ramadan	L.E.12,000

Sharbat	3,500
Galal	3,000
Ramiz	2,000
Ahmed	1,500

(b) Amounts realized against debts written off in earlier years:

Hossain	L.E.3,500
Karima	1,750
Dianna	2,250

(c) Debts considered doubtful (after taking into account all realizations during the year) at the end of the year:

Ibrahim	L.E.1,800
Gabber	2,300
Joseph	3,750
Randa	4,700

***Required*:**

Draw up:

1- Bad Debts Account

2- Provision for Doubtful Debts Account and to show the relevant amounts in the Profit and Loss Account for the year ended June 30th, 20X1.

{Answer Clews: Amount charged from Profit and Loss a/c for Bad Debts Provision :L.E.8,050, Bad Debts Recovered L.E.7,500 credited to P & L a/c.}

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7. The Accountant of a firm extracted the following Trial Balance as on December 31st, 2021:

Account Titles	Dr. L.E.	Cr. L.E.
Capital……………………		1,000,000
Drawings…………………		180,000
Buildings………………..	150,000	
Furniture and Fittings……	75,000	
Motor Van………………	250,000	
Loan at 12% interest……	150,000	
Interest paid on above…..	4,500	
Sales…………………….		1,000,000
Purchases……………….	750,000	
Stock as at 1/1/2021…..	250,000	
Stock as at 31/12/2022…		320,000
Establishment Expenses..	150,000	
Freight Inwards…………	20,000	
Freight Outwards………..		10,000
Commission received……		75,000
Sundry Debtors…………	281,000	

Bank Balance…………..	205,000	
Sundry Creditors………..		100,000
	2,285,500	2,685,000

The Accountant located the following errors but is unable to proceed any further:

(a) A totalling error in bank column of payment side of Cash Book whereby the column was under totalled by L.E.5,000.

(b) Interest on loan paid for the quarter ending September 30th, 2021, of L.E.4,500 was omitted to be posted in the ledger. There was no further payment of interest.

***Required*:**

Set right the Trial Balance and prepare the Trading and Profit and Loss Account for the year ended December 31st, 2021 and the Balance Sheet as at that date after carrying out the following:

1- Depreciation is to be provided on the assets as follows:

Buildings	2.5% p.a.
Furniture & Fittings	10% p.a.
Motor Van	25% p.a.

2- Balance of interest due on the loan is also to be determined.

[Answer Clews: Correct Trial Balance Total of L.E.2,325,000, Gross Profit L.E.300,000, Net Profit L.E.127,750, and Balance Sheet Total L.E.1,202,250.]

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8. The following is the Schedule of balances as on December 31st, 2021, extracted from the books of an enterprise:

Account Titles	Dr. L.E.	Cr. L.E.
Cash in hand……………….	14,000	
Cash at bank……………….	26,000	
Sundry Debtors……………	860,000	
Stock as on 1/1/2021……..	620,000	
Furniture & Fixtures………	214,000	
Office Equipment…………	160,000	
Buildings………………….	600,000	
Motor Car…………………	200,000	
Sundry Creditors…………		430,000

Loan………………………		300,000
Provision for Bad Debts…		30,000
Purchases…………………	1,400,000	
Purchases Returns………..		26,000
Sales………………………		2,300,000
Sales Returns……………..	42,000	
Salaries……………………	110,000	
Rent for godown (storage)..	55,000	
Interest on loan…………..	27,000	
Taxes and Rates……………	21,000	
Discount allowed to Debtors..	24,000	
Discount received from Creditors.		16,000
Freight on Purchases…………	12,000	
Carriage Outwards…………..	20,000	
Drawings……………………	120,000	
Printing & Stationery……….	18,000	
Electric Charges…………….	22,000	
Insurance premium…………	55,000	
General office expenses……	30,000	
Bad Debts………………….	20,000	
Bank Charges……………..	16,000	
Motor Car Expenses……….	36,000	
Capital……………………..		1,620,000
	4,722,000	4,722,000

<u>Adjusting Information</u>:

1- Depreciation: (a) Buildings used for business at 5%; (b) Furniture and Fixtures at 10%- one steel table purchased during the year for L.E.14,000 was sold for same price but the sale proceeds were wrongly credited to sales account; Office Equipment at 15%- Purchase of a Computers during the year for L.E.40,000 has been wrongly debited to purchases; and Motor Car at 20%.

2- Value of stock at the close of year was L.E.440,000.

3- One month rent for godown is outstanding.

4- One month salary is outstanding.

5- Interest on Loan is payable at 12% per annum. This loan was taken on 1/2/2021.

6- Provision for Bad Debts is to be maintained at 5% of Sundry Debtors.

7- Insurance Premium includes L.E.40,000 paid towards owner’s Life Insurance Policy and the balance of the insurance charges cover the period from 1/1/2021 to 31/3/2022.

8- Half of the buildings are used for residential purposes of the owner.

Required:

Prepare Trading and Profit & Loss Account for the year ended December 31st, 2021 and the Balance Sheet as at that date.

{Answer Clews: Gross Profit L.E.718,000; Net Profit L.E.184,000; and Balance Sheet Total L.E.2,380,000.}

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9. The following are the balances extracted from the ledger of an enterprise for the year ended December 31st, 2021:

Capital…………………………	L.E. 2,250,000
Sales……………………………	15,256,000
Purchases……………………	10,006,500
Factory Salaries and Wages…	1,356,800
Carriage Inwards…………	102,000
Discounts received…………	45,600
Office Salaries (including	

L.E.60,000 to the owner)	257,200
Sundry Creditors……………	238,400
Factory Insurance……………	26,000
Electricity……………………	252,000
Office Rent………………….	122,000
Discounts Paid………………	15,200
Postage & Telegrams…………	20,500
General Reserve……………	2,200,000
Sundry Expenses……………	22,000
Printing & Stationery…………	26,000
Insurance………………………	24,000
Sundry Debtors…………………	355,000
Plant & Machinery………………	405,000
Furniture & Fixtures……………	105,000
Provision for Doubtful Debts…	6,000
Investments (4%)………………	200,000
Advertisements…………………	1,022,500
Factory Buildings………………	1,450,000
Opening Stock:	

Raw Materials……………	2,138,000
Finished Goods……………	910,800
Cash Drawings…………………	240,000
Interest received on Investments	4,000
Cash at Bank……………………	72,500
Carriage Outwards……………	163,400
Cash at hand……………………	707,300

Additional Information:

(1) The closing stock comprised of Raw Materials L.E.1,803,000 and Finished Goods L.E.960,800.

(2) Sums aggregating L.E.20,000 have to be written off as Bad Debts and the provision for Doubtful Debts has to be maintained at 5% of the Sundry Debtors at close.

(3) The following items were utilized by the owner for personal use:

a. Raw Materials	L.E.34,550
b. Finished Goods	50,000

c. Electricity	16,400
d. Rent	24,000
e. Printing and Stationery	3,800
f. Postage	5,800

(4) Depreciation has to be accounted for at the following rates per annum:

On Furniture at 10%

On Plant & Machinery at 5%

On Buildings 2.5%

No depreciation need to be accounted for regarding assets sold during the year.

(5) Insurance Premiums were found to have been paid up to March 31st, 2022. It was the first time that insurance was taken out on April 1st, 2021.

(6) Electricity includes L.E.198,000 towards Factory Power.

(7) General Reserve is to be raised to L.E.3,000,000.

(8) Make provision in respect of the following liabilities outstanding as at December 31st, 2021:

Office Salaries	L.E.25,000
Office Rent	11,000
Advertisement	9,000
Sundry Expenses	5,000

Required:

Prepare the Manufacturing Account, the Trading Account, Profit & Loss Account and the Balance Sheet.

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