# 9.1 Trial Balance

**Key terms & concepts:**

balancing ledger accounts, trial balance, purpose and limitations of trial balance

**By the end of this lesson:**

* All of us will be able to balance ledger accounts and create a trial balance
* Most of us will be able to explain the purpose a trial balance
* Some of us will be able to describe possible limitations

### Balancing procedure

At the end of the reporting period, ledger accounts will balanced. For the purposes of this unit, only the following accounts will be balanced:

* Asset
* Liability
* Owner’s equity

Revenue and expense accounts are closed and this will be covered in Unit 2 Accounting. Closing accounts is not part of this unit of study.

Balancing is a more formal process. **Balancing an account involves the following process:**

1. Total the amounts on each side, and write the larger of these two totals on both sides.
2. This figure should be ‘ruled off’ with a double line to indicate there are no more transactions in that Reporting period that affect the account.
3. This is not the balance of the account – it is the total. At this point, the amounts on only one side will add up to this total.
4. Calculate the balance by deducting the total of the smaller side from the total of the account
5. Enter this balance – as a proper ledger entry with a matching debit and credit – above the total on the smaller side and below the total on the larger side.
6. This entry ‘carries forward’ the balance from the end of one Reporting period to the start of the next reporting period

**Functions of the Trial Balance**

1. To ensure equality of debits and credits
2. To summarise General Ledger balances
3. Aids in the preparation of Financial Statements
4. Helps identify one-sided errors
5. Satisfies the QC: Reliability

Here is a reminder of a balanced ledger account from our earlier studies:

The name of the ledger account

The cross reference:- Name of the other account

The amount of the transaction

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Bank Account** | | | | | |
| **Date** |  | **$** | **Date** |  | **$** |
| June 1 | Balance | 1000 | June 7 | Equipment | 2000 |
| 3 | Loan | 9000 | 7 | Balance | 8000 |
|  |  | **10000** |  |  | **10000** |
| June 7 | Balance | 8000 |  |  |  |

The total debits or credits

The transaction date

The balance at the end is placed above and below the total. What remains is below the total.

## Trial Balance

After completing the ledger and balancing the ledger accounts, a Trial Balance is prepared. A trial balance lists all the balances of the accounts. All debit balances are listed in the debit column and all credit balances are listed in the credit column.

The total of each column will equal or balance provided, when entering transactions in the ledger, a debit was entered for a credit of equal value.

The trial balance therefore is a check on the accuracy of the recording in the ledger but is not fool proof.

However, the trial balance can balance and still have errors in the ledger due to:

* Omission of a transaction.
* Reversing the debits and credits.
* Debiting and crediting the wrong accounts with the correct amount.
* Debiting and crediting the correct accounts with the wrong amount
* Recording a transaction twice

Here is an example of a completed Trial Balance:

|  |  |  |
| --- | --- | --- |
| **Peter Pumpkin**  **Trial Balance as at 7 June 2017** | | |
|  | **Debit ($)** | **Credit ($)** |
| Bank | 29500 |  |
| Stock of Stationery | 5000 |  |
| Vehicles | 30000 |  |
| Drawings | 500 |  |
| Creditors |  | - |
| Loan |  | 25000 |
| Capital |  | 40000 |
|  | **65000** | **65000** |

(Source: Collyer, 2009)

##### **Recap 1: Trial Balance**

Now the interactive activity below- spot the differences between two trial balance:

# 9.2 Connect & Reflect

**Key Ideas:**  
You have reached the end of this topic, which brings us to the end of our introduction to the recording process. Here are the big ideas to help you revise and reflect upon your learning.

If you are a visual learner, you may choose to use these ideas to **develop a mind map** for yourself. Alternatively, auditory learners might work with a partner to share responses and develop ideas, and kinaesthetic learners might choose to go back through class work, highlight key points and create summary notes for this topic.

• **Source documents**: Invoices, Credit notes, Receipts, Cheques, Memos, Statement of Accounts  
• **Special journals**: CRJ, CPJ, SJ and PJ   
• General journal: For recording infrequent, non-cash transactions (memos & CN)  
• **Debtors subsidiary ledger**: To record individual debtors accounts of the firm   
• **Creditors subsidiary ledger**: To record individual creditors accounts of the firm   
• **Stock cards**: To record individual stock items using FIFO method   
• **Trial Balance**: To check whether the total Debits equal the total Credits

# STUDY AREA 3:

# 10.1 Financial Reports

(or Financial Statements, accounting reports)

**Key terms/ concepts:**

financial reports, balance sheet, income statement, cash flow statement, classification, reporting period, going concern, consistency, conservatism, understandability, comparability

**Learning Outcomes:**

* All of us will be able to identify and define the purpose of financial reports
* Most of us will be able to explain the relationships between reports
* Some of us will be able to prepare classified financial statements

|  |  |  |  |
| --- | --- | --- | --- |
| **TRANSACTION** | **COLLECTION** | **RECORDING** | **REPORTING** |
|  | **Source documents from each transaction** | **Sorting and classifying these documents to record into Special Journals, and posting totals to General & Subsidiary Ledgers** | **Presenting meaningful reports: Income Statement, Balance Sheet & Cash Flow Statement** |

During our last topic of this unit, it is helpful to go back to the very first topic we began with. We have defined Accounting as a process of collecting and recording financial data and reporting meaningful financial information.

The financial information is presented to stakeholders through the preparation of the following Financial Statement:  
• Balance Sheet  
• Income Statement  
• Cash Flow Statement

Preparing financial statements for businesses is standard practice. The statements are prepared following the Accounting Principles and Qualitative Characteristics.

### Balance Sheet

The balance sheet provides an overview of assets, liabilities and owner’s equity as a snapshot in time. The date at the top of the balance sheet tells you when the snapshot was taken, which is the last date of the reporting period.

##### **Recap 1: Reporting Period Principle**

1. What do you know about the Reporting Period Principle?

The ***Reporting Period*** principle recognises that the life of the business must  
be divided into periods of time to allow reports to be prepared.  
b. How does it apply to the preparation of the financial statements? Financial Statements are prepared according to the Reporting Period of the business eg. 12 months, 6 months or 3 months, but not more than 12 months.

The Balance Sheet classifies the assets, liabilities and owner’s equity in a form that is understandable to those using the report. The qualitative characteristic of ‘understandability’ requires the reports be presented in a manner that is clear to those using them. Review the template for the Balance Sheet which was used in Study Area 1.

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Balance Sheet as at 31 March 2017** | | | | | |
| **Current Assets** | $ | $ | **Current Liabilities** | $ | $ |
| Bank | Xx |  | Creditors Control | Xx |  |
| Debtor Control | Xx |  | Sundry Creditors | xx |  |
| Stock Control | Xx |  |  |  | xx |
| Stock of Stationery | xx |  | **Non-Current Liabilities** |  |  |
|  |  | Xx | Loan |  | xx |
|  |  |  | **Owner’s Equity** |  |  |
| **Non-Current Assets** |  |  | Opening Capital | Xx |  |
| Motor Vehicles | Xx |  | + Net Profit | Xx |  |
| Equipment | xx |  | - Drawings | <xx> |  |
|  |  | Xx |  |  | Xx |
|  |  |  |  |  |  |
| Total Assets |  | **xx** | Total Assets |  | **xx** |

### Income Statement

Unlike the balance sheet, the income statement covers a range of time, which is a year for annual financial statements and a quarter for quarterly financial statements. The income statement provides an overview of revenues, expenses, net profit. Revenue and expenses will also be classified to help present the information in a way that is easy to understand by the stakeholders. Look at the template for the preparation of an Income Statement that has been shared online for this course.

**Income Statement for the month ended 31 March 2017**

|  |  |  |
| --- | --- | --- |
| **Revenue** | $ | $ |
| Sales |  | xx |
| (-) Sales returns |  | <xx> |
| Net Sales |  | xx |
| (-) **Cost of Goods Sold:** |  |  |
| Cost of Sales | xx |  |
| Freight inwards | xx | <Xx> |
| **Gross Profit** |  | xx |
| **(+) Other income** |  |  |
| Commission income | Xx |  |
| Discount received | xx | Xx |
|  |  | xx |
| **(-) Expenses:** |  |  |
| Advertising | Xx |  |
| Discount exp | Xx |  |
| Rent | Xx |  |
| Stationery exp | Xx |  |
| Telephone exp | Xx |  |
| Wages | Xx |  |
| Water exp | Xx |  |
| Insurance exp | xx |  |
| Total expenses |  | <Xx> |
| **Net Profit** |  | **xx** |

##### **Recap 2: Classification in the Income Statement**

**How** have **revenue** items been classified? REVENUE OR OTHER REVENUE  
**How** have **expense** items been classified? COST OF GOODS SOLD OR EXPENSES   
**Why** do you think this is done in the Income Statement? TO CALCULATE NET PROFIT

##### **Recap 3: Classification in the Cash Flow Statement**

**How is each area of activity presented?**

The benefit of preparing a classified cash flow statement is **to identify the cause of a cash flow ‘problem’, be it a deficit or a surplus.**

Once the cause is identified, management can take steps to **rectify the problem** to avoid it in the future. Continual deficits will lead to a bank overdraft and there is a limit to how far the overdraft can ‘stretch’.

Alternatively, a surplus if too large is undesirable because the surplus funds could be used to pay off debt or earn a higher rate of interest elsewhere.

### Cash Flow Statement

The cash flow statement is a report that summarises the cash inflows and outflows and calculates the net cash flow and cash balance. Classifying the cash flows makes the report more understandable to those using the report. The cash flows are classified according to the activities – operating, investing and financing activities. Operating activities include cash flows made from regular business operations. Investing activities include cash flows due to the buying and selling of assets such as real estate and equipment. Financing activities include cash flows from debt and equity. This is where analysts can also find the amount of dividends paid and/or dollar value of shares repurchased. Look at the template for the Cash Flow Statement we will be using in this unit of study.

|  |  |  |
| --- | --- | --- |
| **Cash Flow Statement for the month ended 30 June 2017** | | |
| **Cash Flow from Operating Activities** | $ | $ |
| **Inflows** |  |  |
| Cash Sales | Xx |  |
| Receipts from debtors | Xx |  |
| Interest Revenue | xx | Xx |
| **Outflows** |  |  |
| Cash purchase of stock | Xx |  |
| Customs duty | Xx |  |
| Office expenses | Xx |  |
| Payments to Creditors | Xx |  |
| Vehicle expenses | Xx |  |
| Wages | xx | <xx> |
| Net flow from operating activities |  | xx |
| **Cash Flow from Investing Activities** |  |  |
| Proceeds from Sale of NCA | Xx |  |
| Purchase of Equipment | <xx> |  |
| Net flow from investing activities |  | xx |
| **Cash Flow from Financing Activities** |  |  |
| Capital contribution | Xx |  |
| Loan repayment | <xx> |  |
| Drawings | <xx> |  |
| Net flow from financing activities |  | Xx |
| Net increase in cash flow (surplus) |  | Xx |
| (+) Cash at Bank at 1 June 2017 |  | Xx |
| Cash at Bank 30 June 2017 |  | **xx** |

### Cash vs Profit

Cash is the cash on hand, in the bank or other equivalent investments of cash.  
Profit is the result of revenue exceeding expenses.

However, **cash is not the same as profit**. A business may be profitable but suffer from cash flow problems. Or a business may have cash in the bank but is struggling to make a profit.

**How can this be?**List 3 items which are cash inflows but not revenue.  **NEW LOAN, proceeds from sale of NCA, capital contribution**  
List 3 items which are cash outflows but not expenses. **Repayment of loan, purchase of NCA, drawings**   
What is you conclusion about the difference between cash and profit?

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| **Explain** the difference between Cash and Profit. |
| Profit and Cash are two different resources.  Not all revenues are receipts and not all payments are expenses  Some items may affect cash and not affect profit or may affect profit by a different amount.  Alternatively, some items may affect profit but have no or a different impact on cash flow. |
| **Example 1**: Credit sales increase profit and not cash; |
| **Example 2**: Purchase of NCA affects cash not profit; |
| **Or:** Depr exp, bad debts and discounts affect profit not cash,  cash drawings affect cash and not profit. |

# 10.2 Connect & Reflect

**Key Ideas:**  
You have reached the end of this topic. Here are some key ideas to help you revise and reflect upon your learning. If you are a visual learner, you may choose to use these ideas to develop a mind map for yourself. Alternatively, auditory learners might work with a partner to share responses and develop ideas, and kinaesthetic learners might choose to go back through class work, highlight key points and create summary notes for this topic.

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| * 1. **Define, describe and prepare** a fully classified Balance Sheet (review) |
| The Balance Sheet is report which shows the financial position of a business at a point in time identifying the Assets, Liabilities and Owner’s Equity of a business. It is often describe as taking a photo of the business on a particular date, because the positions of assets, liabilities or owner’s equity might have been different the day before, and may also change the next day. |
| It is an accounting report that states the assets, liabilities and owner’s equity of a business at a particular point in time. |

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| * 1. On what basis are the elements in the Balance Sheet classified? |
| Assets will be classified as Current or Non-current. A Current Asset is a resource controlled by the entity as a result of past events, and from which future economic benefits are expected to flow to the entity, within the next 12 months. Non-current Assets are resources controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity beyond the next 12 months. |

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| * 1. How do we classify **revenue accounts**? |
| Revenue is an inflow of economic benefits (or savings in outflows) in the form of increases in assets (or decreases in liabilities) that **increase (profit) Owner’s Equity**, except for capital contributions by the owner. |

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| * 1. How do we classify **expense accounts**? |
| Expenses, on the other hand, are an outflow, consumption or loss of economic benefits (or reductions in inflows) in the form of decreases in assets (or increases in liabilities) that **decrease (profit) Owner’s Equity,** except for drawings by the owner. |

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| * 1. Define the purpose of the **Income Statement**. |
| An Income Statement is an accounting report that shows the revenues, expenses and net profit or loss of a business  for the reporting period. Revenues less Expenses will determine whether the business has been successful (profit) or failed (loss). |

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| * 1. **How** are the Financial Reports connected to each other? |
| **Income Statement** summarizes the revenue earned and the expenses incurred for a reporting period. |
| **Cash Flow Statement** classifies all the sources of cash inflows and outflows of the business |
| Therefore Income Statement does NOT include many cash flows such as contributions from the owner, proceeds of loans, and the cash flow does not reflect the impact of credit sales or purchases of stock |
| **Profits are derived from income statement** which is prepared based on Accrual accounting i.e. revenue earned less expenses incurred, and not revenue received or expenses paid.  On the other hand, **Cash at Bank is derived based on cash inflows and outflows.** Inflows and outflows are NOT matched to the current accounting period. Thus, profits may NOT equal Cash at Bank.  The Balance Sheet is an accounting report that states the assets, liabilities and owner’s equity of a business at a particular point in time. |
| Explanation of difference between the Income Statement & CFS may include   * **Credit Sales /Discount Revenue** will increase revenues and profit but have no effect on the cash flow because there is no cash inflow/outflow * **Discount Expense** is reported in the Income Statement but will NOT be in the cash Flow Statement as there is no cash outflow. * **proceeds from the Loan** is not a result of trading and will not be reported in the Income Statement but will be a cash inflow under Financing Activities in the Cash flow Statement. * **Drawings of cash** is NOT an expense in the Income Statement but is a cash outflow under Financing activities in the Cash flow Statement. |

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| **Define** the following terms: |
| **Accrual accounting:** Accrual accounting is a system of recording and reporting financial information where each transaction is recorded when it occurs. This means revenue is recorded when earned, not just when cash is received and expenses are recorded when occurred, not just when cash is paid. |
| **Double entry accounting:** A system of recording transactions that requires two entries to be made into the accounts of a business. For every transaction there is a debit entry in the accounts and a corresponding credit entry in another account. |
| **Perpetual inventory system:** Perpetual inventory system is a method of recording stock movements so a continuous record is kept. The cost price of stock is known and recorded for each sale. Individual stock records are kept using stock cards. |

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| * 1. **Identify & apply** appropriate accounting principles & qualitative characteristics(Consistency/ Monetary Unit/ Conservatism) |
| **Accounting Principle:** CONSISTENCY |
| The principle of ***Consistency*** requires that the accounting methods should be applied in a consistent manner to ensure that reports are comparable from one reporting period to another. |
| **Accounting Principle:** MONETARY UNIT |
| The ***Monetary Unit*** principle states all transactions must be recorded and reported in the currency of the country of location in which the reports are being prepared. |
| **Accounting Principle:** CONSERVATISM |
| The principle of ***Conservatism*** means that losses should be recorded when probable but gains should only be recorded when certain, so that liabilities and expenses are not understated and assets and revenues are not overstated. |