Lesson Six

The Trial Balance

Aims

The aims of this lesson are to enable you to:

- understand the structure, content, uses and limitations of a trial balance
- understand the link between the sources of information for a trial balance and its use as a basic tool in further accounting techniques
- construct a trial balance from a list of balances
- assess the consequences of errors on profit calculations and Statements of Financial Position and correct simple errors, where necessary
- know how a suspense account is used where errors have occurred

Context

This lesson provides a more thorough introduction to the Trial Balance. In the next lesson we look at why company accounts need to be prepared.

Frank Wood & Alan Sangster: *Business Accounting I*, chs. 6 (revision), 17 and 32.

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Working with the Trial Balance

We have already been introduced to the **Trial Balance** in the last lesson or two. Make sure that you understand:

1. What the Trial Balance is and where the figures contained in it come from.
2. Why it is prepared and what its uses are.
3. What its limitations are and what types of errors are not shown up by a Trial Balance.
4. The balances which are entered in the Trial Balance are the outstanding balances which come from the purchases and sales ledgers, the nominal ledger and the cash book.
5. The information contained in the Trial Balance is used as a basis for the preparation of the final accounts, i.e. of the Income Statement and Statement of Financial Position.

Activity 1	Revise Activity 1 in Lesson Four.

As we saw earlier, every so often, perhaps at the end of every month and certainly at the end of the financial year, it is necessary to balance the Ledger, i.e. to see how much in total is owing to creditors, how much is owed by debtors, how much is left in the Cash Book, etc. It is also useful to check the accuracy of the Ledger. The mechanism for doing this is the Trial Balance.

When we have a total or balance for every single account, we can prepare the Trial Balance. It is simply a list of all the debit balances and all the credit balances. Because we have kept the books on the double entry system and because every single transaction has had one debit entry and one credit entry, the list of total debits must equal the list of total credits.

The same thing applies if we list only the balances, because some entries cancel out others. So if we have done our book-keeping correctly, the Trial Balance will agree. It is most satisfying when you get your Trial Balance to agree, especially when you do it for the first time on your own!

The Purposes of the Trial Balance

The purposes of the Trial Balance are therefore:

1. To take stock of the general situation and to find out all the totals and balances on all accounts.

2. To check the accuracy of the Ledger - if the Trial Balance agrees, there is a good chance that everything has been done correctly. (But see the section below).
3. To give us a list of balances which we can subsequently use for preparing the final accounts of the business, i.e. to calculate its profit and to prepare its Statement of Financial Position .

In Lesson Four, we prepared the Ledger Accounts of Arthur Thomas and balanced them off at the end of the period. We can now extract the Trial Balance to check the accuracy of our books. Before you look at the answer, which follows, go back to Arthur Thomas's books and see if you can prepare the Trial Balance. Simply list all the balances, making sure you have put each into the appropriate debit or credit column, and see if you can get the totals to agree.

This is what your Trial Balance should be like:

Trial Balance of Arthur Thomas as at 14.10.X3

	Debit	Credit
Premises	10,000.00	
Equipment	4,000.00	
Motor Vans	3,000.00	
Stock at 1.10.X3	1,570.00	
Capital		19,385.00
Purchases	1,775.00	
Sales		2,436.00
Returns Inwards	14.70	
Returns Outwards		30.00
Wages	80.00	
Rent	250.00	
C. Coleman	3333.80	
S. Hill		1610.00
M. Rogers		768.00
Cash	300.00	
Bank		326.66
Drawings	250.00	
Discount Allowed	3.37	
Discount Received		21.21
TOTALS	**24,576.87**	**24,576.87**

The Limitations of the Trial Balance

Although the Trial Balance is a good way of checking that our Ledger is correct, it is not a foolproof way. There are certain errors which could have been made which will not show up in the Trial Balance, i.e. it will still agree, and yet something could be wrong. We shall consider these errors in Lesson Seven.

Locating Errors

If the Trial Balance is not correct, systematic checking will save time and temper. The following plan is recommended:

1. Add up both sides of the Trial Balance again. You never know; after all, you have been working hard and your anxiety to see whether it balances might have led you astray somewhere. In long Trial Balances, check by adding up only half, then the other half, and total them. No? Well...

2. How much is the difference? Does it strike a chord anywhere? You may have left out a complete account, or have forgotten to complete a double entry. If it is a round figure, it looks like poor arithmetic — an error in a cast in the Trial Balance or on an account.

3. Halve the difference. Does this seem at all familiar? Check up and see if there is an entry for a similar amount anywhere. You may have completed a double entry as two credits or two debits. You may have entered a debit balance on the credit side of the Trial Balance.

4. Check through your work for any alterations or cancellations. Have you altered both items of such transactions in the books?

5. Could you have entered, say, £0.76 as £7.60? Finding this type of error quickly is rather a forlorn hope, but try it. Failing this you must "get down to it" thoroughly and proceed as follows:

6. Check the balancing of each account.

7. Think. You might have one last brilliant idea as to where the error might be. If not...

8. Check all posting to the ledger. If the error is only in the pence column, check all the pence columns first and do not bother about the pounds.

Follow this plan and you must find the error or errors. Follow it step by step and you may save the long arduous checks.

Correcting Profit and Loss

Some errors will affect the profit and others will not, so the first job is to distinguish between the two types. This distinction does not necessarily coincide with the distinction between those errors which affect the trial balance and those which do not.

Where a Trial Balance shows that errors have been made, or indeed if errors are discovered which did not show up in the Trial Balance, these errors must be corrected. In Lesson Four we saw how to correct ledger accounts using the Suspense Account and you should now read this section carefully.

Activity 2	Revise Activity 4 in Lesson Four.

Errors

A Trial Balance is prepared in order to check the accuracy of the Ledger. Checking for errors is most important because any mistakes made in posting purchases, sales, expenses, etc will result in an incorrect profit figure. This could be serious as decisions may be based on this profit - for example, a firm may decide to invest in new machinery thinking that its profits are high, only to find later that the profit had been overstated and that it cannot actually afford the new machinery.

Types of Errors which cause the Trial Balance to disagree

The following are the main types of errors which would cause a disagreement in the totals of the Trial Balance totals. They arise when posting errors and you may be expected to identify them.

Firstly, errors may have been made in the Ledger accounts themselves, either when items were posted from the Books of Original Entry or when the accounts were balanced:

(a) Posting one transaction as two debits or two credits instead of one debit and one credit. For example, a sale of goods to a customer might have been credited to both the Sales Account and to the customer's account. In this case, the customer's account is wrong and it looks as if the customer owes less than he actually does. The Trial Balance will not, of course, agree.

(b) Figures may have been transposed on one side of the double entry, e.g. a purchase of £3,508 may have been correctly posted to the Purchases Account but may have gone into the supplier's account as £5,308.

(c) One side of a transaction may have been completely omitted, e.g. a payment of wages by cheque may have been debited to the Wages Account but left out of the Bank Account.

(d) One or more sides of an account may have been incorrectly totalled.

(e) An error may have been discovered but correction may have been made to only one item of a transaction.

(f) An account may have been incorrectly balanced.

Or errors may have been made in posting correct Ledger balances to the Trial Balance:

(g) An item or items may be incorrect in the Trial Balance, i.e. the account and the balance may have been correct in the Ledger but it was incorrectly transferred to the Trial Balance.

(h) One or more items may have been omitted entirely from the Trial Balance, i.e. one or more account balances may have been completely left out of the Trial Balance.

Types of Errors which do *not* cause the Trial Balance to disagree

There are other errors which do not show up in the Trial Balance, i.e. total debit balances can equal credit balances and yet there can still be mistakes in the account. These errors come under the following headings:

1. **Error of Omission:** A transaction could have been completely left out, i.e. no debit and no credit.

2. **Error of Commission:** A debit and a credit entry could have been correctly made for the transaction, but one of these could have been put into the wrong account, e.g. goods purchased from B John could have been entered into V John's Account. The total amount of creditors would be correct, but we would pay the wrong person, and start receiving letters from an angry B John!

3. **Error of Principle:** A similar thing to the above could have happened whereby one of the entries went into not only the wrong account but also the wrong *type* of account, e.g. a new fax machine could have been purchased and entered into the Purchases Account as a purchase of stock for resale instead of into the Office Equipment Account as a fixed asset.

4. **Error of Original Entry:** This means that the correct accounts were debited and credited, but that the wrong amount was used, e.g. the invoice was wrongly read, and £78 was entered as £87.

5. **Compensating Errors:** This is a bit of a coincidence, but it can happen. Two separate and independent errors are made and they cancel each other out, e.g. the Wages Account could have been overcast by £200 and the Rent Account could have been undercast by £200; or again, the Wages Account could

have been overcast by £200 and the Sales Account could also have been overcast by the same amount.

6. **Complete Reversal of Entries:** Both debit and credit entries for a transaction could have been entered in the right amount in the right accounts but the entries transposed e.g. the Purchases Account might appear as a credit and the creditor's account as a debit.

The Effect of Errors on Profit or Loss

Not only do errors affect the ledger accounts and the Trial Balance but they also affect the firm's profit or loss if they have not been located and corrected before the final accounts are prepared. An examination question might give you a number of errors which were not corrected, tell you what the profit was and ask you to calculate the correct profit, taking into account the errors. Not all errors affect profit. Those which do are errors which affect the size of the amounts of those accounts which are included in the Trading and Profit and Loss Account, e.g. purchases, sales, expenses etc. In each case you have to decide:

1. Whether the error will affect the gross profit or the net profit or both:

   (a) errors affecting sales, purchases, sales or purchases returns, opening or closing stock, carriage inwards or any other trading expense will affect firstly the gross profit and also the net profit to the same extent and in the same direction.

   (b) errors affecting any other type of receipt which is added to net profit or any other type of expense which is deducted from net profit will affect net profit only. Remember that purchases of fixed assets do not affect profit but that depreciation provisions for the year do.

2. In what direction the profit will be affected. You should be able to work this out from your knowledge of Trading and Profit and Loss Accounts but here are the main things you will probably meet:

   (a) an overcasting of sales (or an undercasting of purchases) will make the gross profit bigger than it should have been, and you will have to reduce it by the required amount; overcasting or undercasting of sales and purchases returns will work in the opposite direction.

   (b) an undercasting of sales (or an overcasting of purchases) will make the gross profit (and thus the net profit) smaller than it should have been, and you will have to increase it by the required amount; undercasting or overcasting of sales and purchases returns will work in the opposite direction.

(c) an overcasting of miscellaneous receipts (or an undercasting of expenses) will make the net profit bigger than it should have been, and you will have to reduce it accordingly;

(d) an undercasting of miscellaneous receipts (or an overcasting of expenses) will make the net profit smaller than it should have been, and you will have to increase it accordingly.

3. Errors which affect items in the Statement of Financial Position do not affect profit unless they were items which were the subject of adjustments given outside the Trial Balance. For example, anything affecting the total of fixed assets, creditors, debtors, bank balance, capital etc does not normally affect profit. However, if one of these items had been changed as a result of an adjustment, both the profit and the Statement of Financial Position would be affected. For example:

   (a) if the closing stock were found to have been overstated, gross (and net) profit would be too big and so would the stock figure in the Statement of Financial Position . The situation would be vice versa for an understated closing stock.

   (b) if an expense owing had been overstated or a prepayment had been understated, profit would be too small and the current liability or current asset in the Statement of Financial Position would also need to be changed (and vice versa for receipts).

   (c) if an expense owing had been understated or a prepayment had been overstated, profit would be too big and the current liability or current asset in the Statement of Financial Position would also need to be changed (and vice versa for receipts).

   If you think you have understood the above, work through the following example. Even better, try it yourself first and then consult the answer afterwards.

Activity 3

Snakes and Ladders Income Statement for the year ended 31 December 1999 showed their net trading profit to be £46,156. The following errors and omissions were then discovered:

(a) A Sales Invoice for £1,308 had been completely omitted.
(b) Snakes and Ladders learned on 31 December 1999, when it was too late to adjust their Final Accounts, that Dice Ltd, a debtor, had gone into liquidation and that the amount owed by them of £864 was completely unrecoverable.
(c) Another customer, Board & Co, had been included in the list of debtors which had appeared in Snakes and Ladder's Statement of Financial Position , but it was later discovered that the £290 which they had owed had in fact been paid by them on 30 December 1999.
(d) An amount of £145 which had been paid for insurance on the delivery van had been included in the Insurance A/c instead of in the Motor Expenses A/c.
(e) A new piece of machinery which had cost £5,000, had been purchased during the year and this had been debited to the Purchases A/c instead of to the Machinery A/c.

Calculate the corrected Net Profit after these errors and omissions had been taken into account.

Errors affecting the Statement of Financial Position (Balance Sheet)

These are the main points to note:

1. Most errors affect the Statement of Financial Position (Balance Sheet). The main ones which do not are those which involve errors of classification of expenses. For example, if the insurance has been included with the office expenses, only the sizes of those two accounts will be affected as total expenses will remain the same. Again, there may be errors concerning specific debtors or creditors, e.g. where an entry has been made in the wrong debtor's or creditor's account; the individual people's accounts will be wrong (and this could certainly be serious) but the totals will remain the same; in neither of these cases will the profit or the Balance Sheet be affected.

2. Any error which affects the net profit will also affect the Statement of Financial Position since the net profit is transferred to the capital section of the Statement of Financial Position.

3. As we saw above, any error affecting an adjustment written outside the trial balance affects both the profit and some item in the Statement of Financial Position.

4. Any error affecting an item you would normally expect to see in the Statement of Financial Position will thus affect it and must be adjusted; this is so whether profit is affected or not.

Activity 4	Work through the items in the Snakes and Ladders question and state how the Statement of Financial Position will be affected in each case - you cannot prepare a complete Statement of Financial Position as there is not enough information.
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Such questions come up at 'A' Level - you would normally be asked to prepare journal entries to correct errors, to write up a suspense account and to prepare a statement of corrected net profit.

Self-Assessment Test (Lesson Six)

Mickey Tyson prepared the following Statement of Financial Position at 31 October 20X0:

Statement of Financial Position as at 31 October 20X0

	£		£
Equipment	6,600	Capital 1.11.99	28,000
Inventory (Stock)	18,400	Net profit	20,400
Trade Receivables (Debtors)	14,600	Drawings	(16,000)
Cash and Cash Equivalents (Bank)	9,600		32,400
		Creditors	16,800
	49,200		49,200

After checking the books, Mickey found the following errors:

1. Debtors of £320 should be written off as bad debts.
2. The stock had been overestimated by £200.
3. Equipment with a book value of £240 had been sold for £340 cash. The entries made to record this were a debit of £340 in the cash account and a credit of £340 in the sales account.
4. Goods costing £460 were sold on 31 October 20X0 for collection by the customer. Correct accounting entries were made but the customer did not collect the goods until the following week and the value of the goods was included in the stock valuation at 31 October.

   (a) Prepare a statement to show the correct net profit or loss for the year ending 31 October 20X0.
   (b) Prepare a corrected Statement of Financial Position as at 31 October 20X0.

Suggested Answers to Activities

Activities One and Two

See answers to Activities 1 and 4 in Lesson Four.

Activity Three

(a) This means that the sales and thus the gross and net profit were too small and so we add £1,308 to the net profit.
(b) This is classed as a Bad Debt and must be deducted from the net profit.
(c) This makes no difference to profit. The fact that the customer had not been recorded as having paid affects the balance of the debtors and that of the cash or bank.
(d) This does not affect profit either since it is simply a question of which account the expenditure should have been placed in. The £145 was deducted from profit and we have no further adjustment to make.
(e) This was a piece of capital expenditure which was wrongly classed as revenue expenditure. Since the £5,000 has been deducted from profit we must now add it back again.

All of the above can be summarised in a Statement of Corrected Net Profit and this is how you should set out your answer to such a question:

Statement of Corrected Net Profit for Snakes and Ladders

Profit as per Income Statement	46,156
Add omitted Sales Invoice	1,308
Less Bad Debt	(864)
Add fixed asset wrongly debited to Purchases A/c	5,000
Corrected Net Profit	51,600

Activity Four

Items (a), (b) and (e) affected the Net Profit and the first step is to include the corrected net profit in the capital section. Now let us take the points one by one and see what else needs to be changed:

(a) as a sales invoice was omitted, the debtors must be increased by £1,308
(b) the bad debt of £864 must be deducted from debtors
(c) this does not affect the overall balancing of the Statement of Financial Position but it does affect two individual items in the Current Assets. A debtor has been converted into cash and we must deduct £290 from debtors and add it to the bank account
(d) this affects no part of the final accounts
(e) machinery must be increased by £5,000.