Verification of accounting records

The trial balance

You should be able to prepare a trial balance almost as quickly as you are able to write down the details of each account summarised in the trial balance.

The trial balance is extracted from all the detailed accounts in the ledger(s). It is extracted on one day (usually the final day of the financial year) and so the heading tells us this.

Example: **Mary Marshall. Trial balance at 31 March 2008**

On the debit side of a trial balance you should only include assets and expenses. Examples include:

Assets	Expenses
Machinery	Rent
Vehicles	Motor expenses

On the credit side of a trial balance you should only include liabilities and incomes/benefits. Examples include:

Liabilities	Incomes/benefits
Mortgage	Sales
Bank loan	Discounts received
Capital	Rent received

It is helpful to remember this by using a mnemonic. (e.g. DRASEX — Dr Assets Expenses; CLIB — Cr Liabilities Incomes/benefits).

There are a few exceptions to the assets/expenses and liabilities/incomes or benefits rule — for example returns and drawings.

Returns inwards (goods previously sold but now returned by a customer, i.e. sales returns) will be on the opposite side of the trial balance to sales. Sales are a credit entry so sales returns must be a debit entry in the account and in the trial balance.

Returns outwards (goods previously purchased but now returned to the supplier, i.e. purchase returns) will be on the opposite side of the trial balance to purchases. Purchases are a debit entry so purchases returns must be a credit entry in the account and in the trial balance.

Drawings by the proprietor cause money to go out of a business and should be treated in the trial balance like other transactions that remove money from the business (i.e. expenses). Although the drawings are not a business expense, they are debited in the trial balance.

The trial balance is a summary of all the accounts in all the ledgers. So, an insurance account may look like this:

Dr			**Insurance**	**Cr**
8 January	Bank	127		
13 July	Bank	1386		
2 September	Bank	272		
9 November	Bank	931		

The trial balance would summarise the account and show:

Trial balance at 31 December 2008

	Dr	**Cr**
Insurance	2716	

The amount shown in the trial balance for trade debtors is the total of all the debit balances extracted from the sales ledger. Clearly, to list each individual balance from each account in the sales ledger on the trial balance for a business with many credit customers would result in a trial balance that might have to be written on a sheet of paper as long as a roll of wallpaper. Similarly, to list each trade creditor's balance could also result in a long list.

Why do people prepare a trial balance? The sole function of extracting a trial balance is to check the arithmetic accuracy of all the entries made in the ledgers. Additionally:

- The trial balance can disclose some errors in the double-entry system before the final accounts are prepared. If a trial balance does not balance, the final accounts cannot balance unless there are one or more compensating errors that counteract the discrepancy on the trial balance.
- Using the figures shown in the trial balance is easier than referring back to each individual account in the ledgers.
- It can help to prevent fraud if the ledgers are maintained by someone other than the person responsible for extracting the trial balance.

You must know the six types of error that are *not* revealed by extracting a trial balance that balances. You must also be able to describe an example of each type of error. Learn a mnemonic such as CROPOC. The six types of error are:

(1) Commission — an entry is made in an incorrect account of a similar type. For example, a motor vehicles account is debited with an entry that should have been debited to office equipment or the account of Thomas and Son is credited with credit purchases received from Thompson.

(2) Reversal — a debit entry and credit entry is made which should in fact have been a credit entry and a debit entry. For example, goods for resale purchased on credit from Mansoor is debited to Mansoor and credited to the purchases account.

(3) Omission — neither a debit nor a credit entry is made; there has been no record made in the double-entry system. For example, a purchase invoice has been lost, so no entry is made in the purchase day book. As a result, no entry is made in a personal account in the purchases ledger and no entry is made in the purchases account in the general ledger.

(4) Principle — entries are debited or credited in the wrong class of account. This type of error makes the profit and loss account and the balance sheet incorrect. For example, a van purchased for use in the business is debited to the motor expenses account.

(5) Original entry — an error is made when entering the information from a source document to one of the subsidiary books. For example, goods valued at £123 sold to a credit customer is entered in the sales day book as £132.

(6) Compensating error — error(s) on the debit side of an account(s) equals error(s) on the credit side of an account(s).

Suspense accounts

When a trial balance fails to balance, the difference is placed in a temporary account called a **suspense account**. If the debit side of a trial balance is larger than the credit side, insert a 'suspense' item on the credit side so that the debit and credit columns have the same total. If the credit side of a trial balance is larger than the debit side, insert a 'suspense' item on the debit side so that the debit and credit columns have the same total. When you have corrected the errors given in a question, the suspense item is cancelled out and the trial balance will balance.

Some exam questions do not give the original trial balance difference. You may have to calculate this by entering errors in a suspense account. The figures used in the suspense account will mean that it does not balance. The 'missing figure' is the amount by which the trial balance did not balance before the errors were corrected.

Remember that the trial balance is a summary of all the balances extracted from all of the ledgers. So if you have to add an extra debit in your suspense account to make it balance, this means that there was a missing debit balance, i.e. suspense account debit balance on the trial balance before the errors were discovered.

You must be able to adjust gross profit and net profit figures to take into account any errors corrected. Errors requiring adjustments to:

- sales
- purchases
- sales returns
- purchases returns
- carriage inwards

affect gross profit and net profit figures calculated before the errors were corrected.

Errors requiring adjustments to:

- expenses
- incomes/benefits (discount received, rent received, etc.)

affect net profit only.

Errors requiring adjustments to:

- assets
- liabilities

do not affect gross profit or net profit *unless* the error is an error of principle, such as a new motor van (£36 000) being included as motor expenses. Correction of this error of principle would cause profits to rise by £36 000.

Bank reconciliation statements

This is a popular topic with examiners. It is less popular with candidates.

When a business has a current account with a bank, the owners of that business keep a record of dealings using the bank account. The bank also keeps a record of the same transactions in its ledger. The bank sends a copy of its record in the form of a bank statement at intervals agreed with the customer. When a bank statement is received from a bank, a trader compares this copy of the bank's records with his/her own records shown in the bank columns of his/her cash book.

The purpose of preparing a bank reconciliation statement is to check the accuracy of the entries in the bank columns of the cash book by using an independently prepared document (the bank statement). The two balances should agree because they are both prepared using the same amounts. However, the balance shown in a trader's cash book (bank columns) may not agree with the balance shown on the bank statement on the same date (see below).

Remember that a debit bank balance given in a trader's cash book shows that a trader has money in the bank, and a credit balance means that the business has an overdraft. However, because a bank statement is a copy of the bank's records, the opposite is true. A debit balance on a bank statement means the account is overdrawn and a credit balance shows that the business has money in the bank account.

Remember that the cash book balance is the one that is used in the trial balance and in the business balance sheet.

You should know and remember the reasons why the two balances might not agree.

Possible cash book balance errors

The balance in a trader's books of accounts may not agree with the balance in the bank's records for two reasons:

(1) Time differences in recording transactions:

- When a trader lodges money in the bank, the transaction is recorded immediately in the trader's cash book using the paying-in slip counterfoil as the source document. The bank may not credit the trader's account until a couple of days later.
- When a trader writes out a cheque, it is recorded immediately in the trader's

cash book using the cheque counterfoil as the source document. The bank does not credit the account until the cheque is presented for payment.

(2) Lack of knowledge by the trader:
- The bank debits a trader's account with bank charges, interest etc., but the trader remains unaware of the amounts until the appropriate bank statement is received.
- The bank may credit a trader's account with counter credits or payments made directly into the account without the trader's knowledge. The trader may be unaware of the amounts until either a bank statement or notification is received.
- The bank may dishonour a cheque. The trader would be unaware of this until a bank statement or notification is received.

General errors

It is now rare for banks to make the following errors. The major error made by banks is to debit or credit an amount that should be entered in another business account. Nevertheless, you should be aware of the possibility of:
- casting errors in the cash book
- entering incorrect amounts in the cash book
- entering items on the wrong side of the cash book

Procedure used to answer a question

In order to answer an examination question, you are generally required to prepare two elements:
- You must update the cash book since this is part of the business records.
- You must then prepare the actual reconciliation statement.

A good procedure to follow is:

(1) Balance the bank columns of the cash book and carry the balance down.

(2) Compare the bank columns of the cash book with the entries shown on the bank statement.

(3) Bring the cash book up to date by:
- **(a)** entering payments shown as paid by the bank that have not been entered in the credit bank column of the cash book
- **(b)** entering any amounts received by the bank that have not been entered in the debit bank column of the cash book.

(4) Correct any errors discovered in the bank columns of the cash book. (Remember that, when comparing the cash book entries with the bank statement entries, the bank statement entries are always assumed to be correct.)

(5) If the bank statement contains errors, inform the bank and ask for an adjusted bank statement balance.

(6) Prepare the bank reconciliation statement.

Learn the layout of a bank reconciliation statement and always use a heading. An example is given on p. 20:

T. Relph. Bank reconciliation statement at 30 June 2008

		£	£
Balance at bank as per cash book			582
Add unpresented cheques			
	cheque number 137	42	
	cheque number 151	28	
	cheque number 165	37	
			107
			689
Less lodgements not yet credited			416
Balance at bank as per bank statement			273

If there is more than one unpresented cheque then it is safer to list these in the reconciliation statement. If you add them on your calculator and you make an error the examiner cannot award any part marks.

Sales and purchases ledger control accounts

Control accounts only verify the arithmetic accuracy of the entries in the ledger being checked. There could be errors in the control account that remain undetected. These are errors of:

- commission
- reversal
- omission
- original entry
- compensating errors

These errors are the same as those detailed in the errors not affecting the balancing of a trial balance (see pp. 16–17). You must learn them.

The type of error missing is errors of principle. Why would an error of principle not be revealed when you prepare a ledger control account? Answer: an error of principle would be an entry in the wrong class of account in the general ledger. Neither entry would, generally, be entered in a personal ledger.

Set-offs or contra items

A business may be both a supplier and customer to another business. For example, Ash & Co sells timber valued at £1200 on credit to C. Hair, a furniture manufacturer. Ash purchases four office desks on credit for £800 from Hair. The entries in the ledgers of Ash would show:

Purchases ledger page 42

Dr	Hair		Cr
		Office equipment	800

Sales ledger page 61

Dr	Hair		Cr
Sales	1200		

Note that the descriptions tell us where the opposite entry is to be located. There is a debit entry of £800 in the office equipment account in the general ledger. There is a credit entry of £1200 in the sales account in the general ledger.

It would not be sensible for Ash to demand £1200 payment from Hair and to send Hair a cheque for £800. As the amount due to Ash is greater than the amount owed by Ash, it would seem sensible to set off the amount owed to Ash against the amount owed by Ash.

Purchases ledger

Dr	Hair	Cr
Transfer to sales ledger 800		

Sales ledger

Dr	Hair		Cr
		Transfer from purchases ledger	800

This transaction would be recorded in the journal as the appropriate subsidiary book.

Transfer of credit balance in Hair's account in the purchases ledger to Hair's account in the sales ledger:

Journal

Hair	PL 42	800	
Hair	SL 61		800

After this transfer, the ledgers would show:

Purchases ledger page 42

Dr	Hair		Cr
Transfer to sales ledger	800	Office equipment	800

Sales ledger page 61

Dr	Hair		Cr
Sales	1200	Transfer from purchases ledger	800

All entries in any personal ledger must also show in a control account. There are:

- a debit entry for £800 in Ash's purchases ledger control account
- a credit entry for £800 in Ash's sales ledger control account

Schedules of debtors and creditors

These are lists of balances extracted from the sales and purchases ledgers:

- **schedule of debtors** — a list of all the debit balances extracted from the sales ledger
- **schedule of creditors** — a list of all the credit balances extracted from the purchases ledger

Credit balances in the sales ledger must not be netted out with the debit balances. Debit balances in the purchases ledger must not be netted out with the credit balances.

The total of the schedule debtors should equal the debit balance shown in the sales ledger control account. The total of the schedule of creditors should equal the credit balances shown in the purchases ledger control account.

Preparing a control account

In a business that has a large number of credit customers and credit suppliers, there will be many entries made in the sales ledger and purchases ledger. This means that there is great potential for errors to be made. Control accounts are used to check the accuracy of the entries made in each of the sales ledgers and each of the purchases ledgers.

A control account is a summary of all the entries that have been made in each sales ledger and each purchases ledger in any particular month. Any entry in any sales ledger or purchases ledger is duplicated in the appropriate control account. Some businesses maintain control accounts as part of their double-entry system, while others maintain the control accounts as memorandum accounts. For the purposes of the examination, there is no difference in their preparation.

Practise preparing individual accounts as they would appear in the appropriate ledger. If you can do this then you should be able to prepare the control account for that ledger — they are similar and only the magnitude of the figures will be different.

Examples:

Sales ledger

Dr	B. Keaton		Cr
Balance b/d	123	Returns inward	57
Sales	217	Cash	200
		Discount all'd	22
		Balance c/d	61
	340		340
Balance b/d	61		

Sales ledger control account

Dr			Cr
Balance b/d	123 000	Returns inward	57 000
Sales	217 000	Cash	200 000
		Discount all'd	22 000
		Balance c/d	61 000
	340 000		340 000
Balance b/d	61 000		

Follow the same principles when preparing a purchases ledger control account.

Remember that if an entry in the double-entry system does not appear in a personal ledger then it will not appear in a control account.

You should know where each of the figures used in a control account comes from. They all come from a total extracted from a subsidiary book. In the example above of a sales ledger control account:

- sales £217 000 is the total of the credit sales recorded in the sales day book
- returns inward £57 000 is the total of the goods returned recorded in the sales returns day book.
- cash £200 000 is the total of cash received from customers recorded in the cash book
- discount allowed £22 000 is the total of the discount allowed columns in the cash book

Trading and profit and loss accounts and balance sheets

Trading and profit and loss accounts

You must be able to prepare trading accounts and profit and loss accounts quickly and above all accurately from a trial balance, taking into account any additional information given in the question. To speed up your preparations of these accounts, practise marking alongside each item given in a trial balance: 'T' for trading account, 'P' for profit and loss account, and 'B' for balance sheet. This can help when you start your answer. In most, if not all, examinations you will find a question that requires the preparation of:

- a trading account, or
- a profit and loss account, or
- a combined trading and profit and loss account

You must practise the layout used by your teacher and in textbooks. Good layouts could be rewarded with a quality of presentation mark (or two).

Some items in trading accounts that cause students problems include the following.

Headings

Always use a full heading. Do not abbreviate any part of the heading. The heading should include the business name. An example might be:

R. Rajan. Trading account for the year ended 31 March 2009

Note that there are no abbreviations (except for the first name) in the title or the date.

Returns

Inset returns and extend the net sales and net purchases into the main body of your answer. For example:

A. Smith. Trading account for the year ended 30 April 2009

	£	£	£
Sales		210 367	
Less returns inwards		1 248	209 119
Less cost of sales			
Stock 1 May 2008		15 762	
Purchases	96 499		
Less returns outwards	634	95 865	
		111 627	
Stock 30 April 2009		17 498	94 129
Gross profit			114 990

Note that 'gross profit' is written in full — abbreviating the words will cost you a mark — and that the cost of sales is identified.

Some people prefer to identify the cost of sales figure in the line above the gross profit.

A. Smith. Trading account for the year ended 30 April 2009

	£	£	£
Sales			210 367
Less returns inwards			1 248
			209 119
Stock 1 May 2008		15 762	
Purchases	96 499		
Less returns outwards	634	95 865	
		111 627	
Stock 30 April 2009		17 498	
Cost of sales			94 129
Gross profit			114 990

This is equally acceptable as a layout. Choose the one you feel most comfortable using and use it always.

Goods taken out of the business

Goods taken out of the business for the use of the proprietor should not be included in the final accounts of the business so they are deducted from purchases. They must also be included as part of the owner's drawings. Show your calculation as workings.

For example:

R. Roy. Trading account for the year ended 28 February 2009

		£	£
	Sales		72 488
	Less cost of sales		
	Stock 1 March 2008	748	
27 603 purchases less 1500 goods for own use	Purchases	26 103	
		26 851	
	Stock 28 February 2009	649	26 202
	Gross profit		46 286

Carriage

Carriage inwards is shown as an addition to purchases since carriage inwards makes the purchases more expensive. For example:

P. Lefevre. Trading account for the year ended 31 March 2009

	£	£	£
Sales			143 003
Less cost of sales			
Stock 1 April 2008		7 461	
Purchases	64 728		
Carriage inwards	643	65 371	
		72 832	
Stock 31 March 2009		8 112	64 720
Gross profit			78 283

Carriage outwards is an expense that is shown in the profit and loss account.

The profit and loss account must also have a full heading. An example is:

A. Lim. Profit and loss account for the year ended 31 January 2009

Note that there are no abbreviations in the title or the date.

Other items in a profit and loss account can cause problems to some students.

Accruals

The value of resources that are used to produce sales (and consequently profits) must be accounted for in the financial year of use, whether or not they have been paid for.

For example, wages amounting to £37 430 have been paid during the financial year (amount shown on trial balance). At the year end, wages amounting to £674 remain unpaid. £674 of workers' skills and expertise, although used during the financial year,