

# 4

## Final accounts – the extended trial balance

### this chapter covers . . .

*So far we have looked at the techniques of recording different types of financial transactions in the books of account. The financial accountant will use the information from the accounting system, summarised in the two-column trial balance, to produce the final accounts of the business: profit and loss account and balance sheet.*

*These final accounts can be produced from a more elaborate form of trial balance known as the extended trial balance (ETB). This sets out debit and credit columns for:*

- *the ledger balances*
- *adjustments to the figures*
- *the final accounts where the figures are used: profit and loss account and balance sheet*

*Later in the chapter we study the link between double-entry book-keeping and the final accounts.*

### **NVQ PERFORMANCE CRITERIA COVERED**

#### **unit 5: MAINTAINING FINANCIAL RECORDS AND PREPARING ACCOUNTS**

##### **element 5.2**

##### **collecting and collating information for the preparation of final accounts**

*H ensure that the organisation's policies, regulations, procedures and timescales relating to preparing final accounts are observed*

### **KNOWLEDGE AND UNDERSTANDING – ACCOUNTING PRINCIPLES AND THEORY**

24 *the principles of double-entry accounting*

27 *the function and form of a trial balance and an extended trial balance*

## FINAL ACCOUNTS

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At regular intervals the owner of a business and other interested parties need to know how the business is progressing. To meet this need, final accounts are prepared which comprise the accounting statements of:

- *profit and loss account* – showing the profitability and performance of the business during the accounting period
- *balance sheet* – showing what the business is worth (in terms of assets, liabilities, and capital) at the end of the accounting period

Note that, for businesses that buy and sell goods, profit and loss account usually incorporates a trading account (see Chapter 5, page 66). The whole account may then be entitled *trading and profit and loss account*; however it often continues to be referred to as *profit and loss account*.

In this chapter we will see how the figures for the final accounts are prepared by means of the *extended trial balance* which takes the figures from the two-column trial balance explained in the last chapter and sets them out in columns ready for the preparation of the profit and loss account and balance sheet. To illustrate this process we will look at the accounts of a sole trader boutique owner, Tara Smith.

In the next chapter we will take the extended trial balance and will use it to produce final accounts in the conventional format used by accountants. This is a very important aspect of NVQ Unit 5 *Maintaining Financial Records and Preparing Accounts*, and one that we shall be continuing to develop throughout most of the rest of the book.

## ACCOUNTING PERIODS

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There is a link between the final accounts: a profit and loss account covers a specific time period, and a balance sheet shows the state of the business on the last day of that time period. For example:

- profit and loss account **for the year ended** 31 December 2004
- balance sheet **as at** 31 December 2004

The time period covered by the profit and loss account is known as an *accounting period*. Generally, for each business, an accounting period covers the same length of time, for example the year ended 31 December 2004, year ended 31 December 2005, and so on. The last day of one accounting period is immediately followed by the first day of the next accounting period. While accounting periods can cover any length of time, the most common are:

- *monthly or quarterly* – used within a business to monitor activity and profitability in the accounting period, and the state of the business, in terms of assets and liabilities, at the end of the period
- *half-yearly* – often produced by public limited companies as information for their shareholders
- *annually* – the most common accounting period, used by virtually every business from sole traders and partnerships, through to the largest public limited companies

## FINAL ACCOUNTS AND THE TRIAL BALANCE

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As we have seen in earlier chapters, the book-keeping system records day-to-day financial transactions. At regular intervals a trial balance is extracted to prove the arithmetical accuracy of the book-keeping. It is the trial balance that provides the starting point in the preparation of final accounts. There are two trial balance formats:

- the two-column trial balance (shown opposite)
- the trial balance *extended* into a number of columns (see page 55)

Note that the profit and loss account is an 'account' in terms of double-entry book-keeping. This means that an amount recorded in this account must be recorded elsewhere in the book-keeping system, eg a debit to profit and loss is recorded as a credit to another account, in order to complete double-entry. By contrast, the balance sheet is not an account, but is a statement of account balances remaining after the profit and loss account has been prepared.

To understand the preparation of the extended trial balance you should now read the Tara Smith Case Study which follows.



### Case Study

## TARA SMITH: THE EXTENDED TRIAL BALANCE

### **situation**

Tara Smith runs a designer fashion shop in town. Her book-keeper has just extracted the year end trial balance shown below. You will see that the trial balance includes the stock value at the *start* of the year, while the end-of-year stock valuation is noted *after* the trial balance. For the purposes of financial accounting, the stock of goods for resale is valued by the business (and may be verified by the auditor) at the end of each financial year, and the valuation is subsequently entered into the book-keeping system (see page 57).

We will go through the process of preparing the final accounts using an extended trial balance (ETB) – this is the next stage on from the trial balance shown below and is often presented in a spreadsheet format. We will go through this process before explaining adjustments for items such as accruals, prepayments, depreciation of fixed

assets, bad debts written off, and provision for doubtful debts (each of which will be dealt with in Chapters 6 to 8).

<b>TARA SMITH, TRADING AS "THE FASHION SHOP"</b>		
<b>Trial balance as at 31 December 2004</b>		
	<i>Dr</i>	<i>Cr</i>
	£	£
Opening stock	12,500	
Purchases	105,000	
Sales		155,000
Administration expenses	6,200	
Wages	23,500	
Rent paid	750	
Telephone	500	
Interest paid	4,500	
Travel expenses	550	
Premises	100,000	
Shop fittings	20,000	
Debtors	10,500	
Bank	5,450	
Cash	50	
Capital		75,000
Drawings	7,000	
Loan from bank		50,000
Creditors		14,500
Value Added Tax		2,000
	296,500	296,500

Note: closing stock was valued at £10,500

The layout on page 55 shows how an extended trial balance uses columns and rows to prepare the final accounts of Tara Smith. The steps to complete the extended trial balance are as follows:

**step 1**

Enter the trial balance details into the account name and ledger balances columns. Total the debit and credit columns of ledger balances to show that the trial balance proves the arithmetical accuracy of the book-keeping. Note that the blank lines after premises and shop fittings will be used for depreciation amounts – dealt with in Chapter 7.

**step 2**

- Transfer to the profit and loss columns the rows for
- opening stock at the start of the year
  - purchases made by the business
  - sales made by the business (together with any small amounts of income)

**step 3**

- overheads (revenue expenditure) of the business, such as administration expenses, wages, rent paid, interest paid, travel expenses

Ensure that debit balances from the trial balance rows are entered in the debit column of profit and loss account; credit balances are entered in the credit column.

Transfer to the balance sheet columns the remaining rows from the trial balance (keeping debit and credit figures in the correct columns). These figures represent:

- assets (amounts owned by the business) such as premises, shop fittings, debtors, bank, cash
- liabilities (amounts owed by the business) such as bank overdraft, creditors, loans, Value Added Tax due to HM Customs & Excise
- capital (the amount of the owner's finance in the business)
- drawings (the amount withdrawn from the business by the owner during the year)

**step 4**

Deal with adjustments – in this example, the only adjustment is for the valuation of closing stock (at 31 December 2004). In the adjustments columns the amount of closing stock is credited to the profit and loss account and debited to the balance sheet (see page 57 for the book-keeping entries for closing stock). Transfer the adjustment for closing stock to:

- profit and loss – credit column
- balance sheet – debit column

Now total the debit and credit adjustment columns; note that the totals are the same, ie they balance. We shall be using the other adjustment items (eg accruals and prepayments) in the next few chapters.

In the profit and loss columns, total the money amounts and then, just like balancing an account, enter the amount required to make both debit and credit sides equal: here it is £12,000. If the amount is entered on the debit side, it represents the net profit of the business for the accounting period; if on the credit side, it is a loss. For Tara Smith, it is a profit of £12,000 for the financial year.

**step 5**

Enter the net profit or loss in the balance sheet columns, but on the opposite side to that in profit and loss. For example, with Tara Smith's business, the amount of the net profit row is £12,000, which is *debited* in the profit and loss column and *credited* in the balance sheet column.

Now total the debit and credit balance sheet columns. They balance with the same total – here £153,500 – which proves that the balance sheet balances.

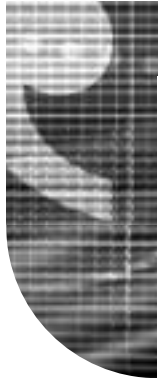
**points to note about the extended trial balance**

Each account balance from the trial balance is entered into the final accounts once only – either to profit and loss account (income and expenses), or to balance sheet (assets, liabilities, capital and drawings). The additional items of closing stock and net profit or loss are entered into both final accounts – this ensures that the double-entry book-keeping rules of one debit and one credit entry for each transaction are maintained.

There are blank rows below the items of premises and shop fittings. These are intentionally left blank and will eventually show depreciation amounts (see Chapter 7).

EXTENDED TRIAL BALANCE TARA SMITH TRADING AS "THE FASHION SHOP" 31 DECEMBER 2004

Account name	Ledger balances		Adjustments		Profit and loss		Balance sheet	
	Dr £	Cr £	Dr £	Cr £	Dr £	Cr £	Dr £	Cr £
Opening stock	12,500				12,500			
Purchases	105,000				105,000			
Sales		155,000				155,000		
Administration expenses	6,200				6,200			
Wages	23,500				23,500			
Rent paid	750				750			
Telephone	500				500			
Interest paid	4,500				4,500			
Travel expenses	550				550			
Premises	100,000						100,000	
Shop fittings	20,000						20,000	
Debtors	10,500						10,500	
Bank	5,450						5,450	
Cash	50						50	
Capital		75,000						75,000
Drawings	7,000						7,000	
Loan from bank		50,000						50,000
Creditors		14,500						14,500
Value Added Tax		2,000						2,000
Closing stock: Profit and loss				10,500		10,500		
Closing stock: Balance sheet			10,500				10,500	
Accruals								
Prepayments								
Depreciation								
Bad debts								
Provision for doubtful debts: adjustment								
Net profit/loss	296,500	296,500	10,500	10,500	12,000	165,500	153,500	153,500



*Revenue expenditure* (the payment of expenses and overheads) is shown in the profit and loss account, while *capital expenditure* (the cost of fixed assets, such as premises, vehicles and equipment) is shown in the balance sheet. Note that if, for example, the cost of buying a new vehicle was wrongly recorded as an overhead in profit and loss account, then

- net profit would be understated (or even a net loss sustained)
- the balance sheet would not show the value of a fixed asset owned by the business

This means that both accounting statements would fail to show the correct state of the business' finances. Thus it is important to show revenue expenditure in the profit and loss account, and capital expenditure in the balance sheet – we will look in more detail at these two types of expenditure in Chapter 9.

## EXTENDED TRIAL BALANCE – A 'PRO-FORMA'

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The extended trial balance gives an understanding of the principles of final accounts by showing

- the profit (or loss) made by the business during the accounting period
- the assets, liabilities and capital of the business at the end of the accounting period

The extended trial balance format is often used by accountancy firms as a first step towards preparing year-end accounts for their clients. When the adjustments have been completed and the accounts have been finalised, it provides a posting sheet for making transfers in the main ledger (see the book-keeping entries in the section which follows).

To help with your practice of extended trial balances, a set layout or pro-forma is included in the Appendix (page 341). This may be photocopied (it is advisable to enlarge it up to A4 size); alternatively, the layout can be downloaded from the website [www.osbornebooks.co.uk](http://www.osbornebooks.co.uk)

Note that the layout used for the extended trial balance includes space for a number of other adjustments (eg accruals and prepayments) – these will be covered in the later chapters.

## DOUBLE-ENTRY BOOK-KEEPING AND THE FINAL ACCOUNTS

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We have already noted that the profit and loss account (which often incorporates a trading account) forms part of the double-entry book-keeping system. Therefore, each amount recorded in this account must have an opposite entry in the main (or nominal) ledger. In preparing the profit and loss account we are, in effect, emptying each account that has been storing

up a record of transactions during the course of the financial year and transferring it to profit and loss account.

**purchases, sales and stock**

In the accounts of Tara Smith the balance of purchases account will be transferred to profit and loss account as follows (*debit* profit and loss account; *credit* purchases account):

Dr	<b>Purchases Account</b>		Cr
2004	£	2004	£
31 Dec Balance b/d (ie total for year)	105,000	31 Dec Profit and loss account	105,000

The account now has a nil balance and is ready to receive the transactions for next year.

The balances of sales account (and also, where used, sales returns and purchases returns accounts) will be cleared to nil in a similar way and the amounts transferred to profit and loss account, as debits or credits as appropriate.

Stock account, however, is dealt with differently. Stock is valued for financial accounting purposes at the end of each year (it is also likely to be valued more regularly in order to provide management information). Only the annual stock valuation is recorded on stock account, and the account is not used at any other time. After the book-keeper has extracted the trial balance, but *before* preparation of the profit and loss account, the stock account appears as follows:

Dr	<b>Stock Account</b>		Cr
2004	£	2004	£
31 Dec Balance b/d	12,500		

This balance, which is the opening stock valuation for the year, is transferred to the profit and loss account to leave a nil balance, as follows (*debit* profit and loss account; *credit* stock account):

Dr	<b>Stock Account</b>		Cr
2004	£	2004	£
31 Dec Balance b/d	12,500	31 Dec Profit and loss account	12,500

The *closing* stock valuation for the year – for Tara Smith it is £10,500 – is now recorded on the account as an asset (*debit* stock account; *credit* profit and loss account):

Dr		Stock Account	Cr	
2004		£	2004	£
31 Dec	Balance b/d	<u>12,500</u>	31 Dec	Profit and loss account <u>12,500</u>
31 Dec	Profit & loss account	<u>10,500</u>	31 Dec	Balance c/d <u>10,500</u>
2005				
1 Jan	Balance b/d	10,500		

The closing stock figure is shown on the balance sheet as a current asset, and will be the opening stock in next year's profit and loss account. In the extended trial balance the closing stock figure is normally put through the adjustments columns; however, some trial balances in Skills Tests and Examinations may already incorporate the closing stock adjustments – see Student Activity 4.6 on page 63 for an example of this.

### overheads

The overheads or expenses of running the business are transferred from the double-entry accounts to the profit and loss account. For example, the wages account of Tara Smith has been storing up information during the year and, at the end of the year, the total is transferred to profit and loss account (*debit* profit and loss account; *credit* wages account):

Dr		Wages Account	Cr	
2004		£	2004	£
31 Dec	Balance b/d (ie total for year)	<u>23,500</u>	31 Dec	Profit and loss account <u>23,500</u>

The wages account now has a nil balance and is ready to receive transactions for 2005, the next financial year.

### net profit

After the profit and loss account has been completed, the amount of net profit (or net loss) is transferred to the owner's capital account. The book-keeping entries are:

- net profit
  - *debit* profit and loss account
  - *credit* capital account

- net loss
  - debit capital account
  - credit profit and loss account

A net profit increases the owner's stake in the business by adding to capital account, while a net loss decreases the owner's stake.

At the same time the account for drawings, which has been storing up the amount of drawings during the year is also transferred to capital account:

- debit capital account
- credit drawings account

Thus the total of drawings for the year is debited to capital account.

When these transactions are completed, the capital account for Tara Smith appears as:

Dr	<b>Capital Account</b>		Cr
2004	£	2004	£
31 Dec Drawings for year	7,000	31 Dec Balance b/d	75,000
31 Dec Balance c/d	80,000	31 Dec Profit and loss account (net profit for year)	12,000
	87,000		87,000
2005		2005	
		1 Jan Balance b/d	80,000

*Note:* Although the balance of capital account at the end of the year, £80,000, does not appear on the extended trial balance, the constituent figures are shown, ie capital £75,000, net profit £12,000, drawings £7,000.

**balance sheet**

Unlike profit and loss account, the balance sheet is not part of the double-entry accounts. The balance sheet is made up of those accounts which remain with balances at the end of the financial year, after the profit and loss account transfers have been made. Thus it consists of asset and liability accounts, not forgetting the asset of closing stock, together with the owner's capital and drawings.

## Chapter Summary

- The final accounts of a business comprise:
  - profit and loss account (which often incorporates a trading account)
  - balance sheet
- The extended trial balance method of preparing final accounts starts with the trial balance and then transfers each account balance to one of the final accounts.
- Each account balance from the trial balance is entered into the final accounts once only; the additional items of closing stock and net profit or loss are entered into both final accounts – this ensures that the double-entry rules of one debit and one credit entry for each transaction are maintained.
- The profit and loss account forms part of the double-entry system; amounts entered must have the opposite entry recorded in the appropriate general (or nominal) ledger account.
- The balance sheet is not part of the double-entry system; it lists the balances of accounts for assets, liabilities and capital at a particular date.
- The extended trial balance gives an understanding of the principles of final accounts. It is often used by accountancy firms as a first step towards preparing year-end accounts for their clients.

## Key Terms

<b>final accounts</b>	accounting statements, comprising the profit and loss account and balance sheet, produced at least once a year, which give information to the owner(s) and other interested parties on how the business is progressing
<b>profit and loss account</b>	shows the net profit (or net loss) of the business for the accounting period
<b>trading account</b>	used by businesses that buy and sell goods; a part of profit and loss account
<b>balance sheet</b>	shows the assets, liabilities and capital of the business at the end of the accounting period
<b>extended trial balance</b>	a spreadsheet format used to produce the final accounts



# Student Activities

**Extended trial balance format:** a blank photocopyable extended trial balance is included in the Appendix (page 341)– it is advisable to enlarge it up to full A4 size. Alternatively you can set up a computer spreadsheet – but remember to allow for all the rows shown on the pro-forma – they will be needed in later chapters.

**4.1** Which one of the following does not appear in the profit and loss account?

- (a) salaries
- (b) vehicles
- (c) fuel for vehicles
- (d) net profit

Answer (a) or (b) or (c) or (d)

**4.2** Net profit is:

- (a) assets minus liabilities
- (b) debtors minus creditors
- (c) closing bank balance minus opening bank balance
- (d) income minus expenses

Answer (a) or (b) or (c) or (d)

**4.3** You are to fill in the missing figures for the following businesses:

	Income	Expenses	Net profit or loss*	Assets	Liabilities	Capital
	£	£	£	£	£	£
Business A	100,000	60,000	.....	250,000	150,000	.....
Business B	80,000	.....	10,000	200,000	.....	100,000
Business C	.....	50,000	20,000	.....	40,000	50,000
Business D	60,000	.....	(15,000)	130,000	.....	70,000
Business E	90,000	100,000	.....	.....	60,000	40,000

\* Note: net loss is indicated by brackets

## 4.4 Complete the table below for each item (a) to (g) indicating with a tick:

- whether the item would normally appear in the debit or credit column of the trial balance
- in which final account the item would appear at the end of the accounting period and whether as a debit or credit in the extended trial balance

	TRIAL BALANCE		FINAL ACCOUNTS			
			PROFIT & LOSS		BALANCE SHEET	
	Debit	Credit	Debit	Credit	Debit	Credit
(a) Salaries						
(b) Purchases						
(c) Debtors						
(d) Sales returns						
(e) Discount received						
(f) Motor vehicle						
(g) Capital						

## 4.5 The following trial balance has been extracted by Nick Johnson on 31 December 2004:

	<i>Dr</i> £	<i>Cr</i> £
Opening stock	25,000	
Purchases	210,000	
Sales		310,000
Administration expenses	12,400	
Wages	41,000	
Rent paid	7,500	
Telephone	1,000	
Interest paid	9,000	
Travel expenses	1,100	
Premises	200,000	
Machinery	40,000	
Debtors	31,000	
Bank	900	
Cash	100	
Capital		150,000
Drawings	14,000	
Loan from bank		100,000
Creditors		29,000
Value Added Tax		4,000
	593,000	593,000

Note: closing stock was valued at £21,000

**You are to** prepare the final accounts of Nick Johnson for the year ended 31 December 2004, using the extended trial balance method.

*Note: please retain the extended trial balance as it will be used in the next chapter as the starting point for a further Student Activity.*

**4.6** The following trial balance has been extracted by the book-keeper of Alan Harris at 30 June 2004:

	<i>Dr</i>	<i>Cr</i>
	£	£
Opening stock	13,250	
Capital		70,000
Premises	65,000	
Motor vehicle	5,250	
Purchases	55,000	
Sales		85,500
Administration expenses	850	
Wages	9,220	
Rent paid	1,200	
Telephone	680	
Interest paid	120	
Travel expenses	330	
Debtors	1,350	
Creditors		6,400
Value Added Tax		1,150
Bank	2,100	
Cash	600	
Drawings	8,100	
Closing stock – trading and profit and loss account		18,100
Closing stock – balance sheet	18,100	
	181,150	181,150

Tutorial note: this trial balance already incorporates the closing stock adjustments

**You are to** prepare the final accounts of Alan Harris for the year ended 30 June 2004, using the extended trial balance method.

*Note: please retain the extended trial balance as it will be used in the next chapter as the starting point for a further Student Activity.*