

Undergraduate Diploma in Business Administration

Module 03 Financial Analysis MQF Level 5 (8 ECTS)

Lecture 2

Phase 1: The Accounting Cycle & Building the Statements



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Recap



Assets (what we own) and Liabilities (what we owe).



The Rule

$$\text{ASSETS} = \text{CAPITAL} + \text{LIABILITIES}$$

The Ledger Purpose

BANK					
Debit (Dr) €			Credit (Cr) €		
Jul 1	Capital	20,000	Jul 25	B. Brown	1,924
Jul 6	Cash	200	Jul 29	Aberdeen Cars	9,100

Double Entry Logic:

When an Asset increases this is recorded on the Debit side and when a Liability increases this is recorded on the Credit side



Balancing Off

BANK					
Debit (Dr) €			Credit (Cr) €		
Jul 1	Capital	20,000	Jul 25	B. Brown	1,924
Jul 6	Cash	200	Jul 29	Aberdeen Cars	9,100
			Jul 31	Balance c/d	9,176
		20,200			20,200

BALANCE B/D: € 9,176

Class exercise:

*Business Accounting – Frank Woods – Balancing
off accounts – 6.2*





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Class quiz exercise

The Kahoot! logo is centered on a rectangular background divided into four quadrants by color: red (top-left), blue (top-right), yellow (bottom-left), and green (bottom-right). Each quadrant contains a faint, stylized map of a world region. The word "Kahoot!" is written in a large, white, bold, sans-serif font across the center of the background.

Kahoot!

Trial Balance



Think of the Trial Balance as a "pre-flight checklist" before generating the final financial statements.

Trial Balance



A trial balance is a critical internal financial report that lists the closing balances of all general ledger accounts. Its primary function is to verify that the total euro amount of all debit balances **equals** the total euro amount of all credit balances. This equality is a foundational requirement of the double-entry accounting system.

Trial Balance

- **Definition:** A schedule that lists the balances of all ledger accounts at a specific date.
- **The Golden Rule:** It is based on the Dual Aspect Concept. Every debit must have a corresponding credit. Therefore, the sum of all debit balances must equal the sum of all credit balances.
- **The Primary Objective:** To verify the arithmetical accuracy of the ledger. If it doesn't balance, you know for a fact there is an error in the double-entry or the addition.



Trail Balance – Extraction Technique

ATTENTION: The transition from T-accounts to the TB is where most errors happen.

- The Balance b/d Rule: The Trial Balance simply "**collects**" all the Balance b/ds.
 - If the Balance b/d is on the Left (Debit) side of the T-account, it goes in the Left (Debit) column of the TB.
 - If the Balance b/d is on the Right (Credit) side of the T-account, it goes in the Right (Credit) column of the TB.



EUROPEAN ENTERPRISES LTD.
TRIAL BALANCE
AS OF 31 DECEMBER 202X
IN EURO (€)

ACCOUNT NO.	ACCOUNT DESCRIPTION	DEBIT (€)	CREDIT (€)
101	Cash	150,000.00	0.00
102	Accounts Receivable	1,250,750.00	0.00
110	Inventory	29,000.00	26,950.00
120	Accounts Payable	26,150.00	138,200.00
201	Accounts Payable	330,000.00	0.00
301	Capital	3,400.00	0.00
301	Sales	25,300.00	0.00
401	Satsehord Receivants	15,100.00	0.00
402	Mentral Capital	3,200.00	0.00
401	Sales	0.00	230,750.00
407	Accounts Receivable	0.00	270,850.00
478	Accounts Receivable	29,000.00	0.00
479	Inventory	22,800.00	86,850.00
480	Credit Item.	139,750.00	36,700.00
501	Accounts Receivable	58,100.00	18,100.00
502	Accounts Payable	15,700.00	0.00
503	Other	6,320.00	19,750.00
504	TOTALS	112,450.00	19,750.00
		€1,250,750.00	€1,250,750.00

TOTAL DEBITS EQUALS
TOTAL CREDITS

Common Errors – **Error Of Omission**

Complete Transaction Omitted

- **Definition:** A whole business transaction is completely missed and not recorded in any journal or ledger account.
- **Example:** €2,500 Cash Sales (Account: Sales, Cash) are omitted entirely. No debit is made to Cash, and no credit is made to Sales.



Common Errors – **Error Of Omission**

- **Trial Balance Impact:** *Still Balance.* Neither total increases or decreases relative to the other.
- **Detection:** Might be detected by comparing bank statements (cash omission) or inventory counts (sales omission) with the records.



Common Errors - **Error of Commission**

Wrong Personal/Impersonal Account

- **Definition:** A transaction is recorded on the correct side (debit or credit) and for the correct amount, but in the *wrong personala/c*
- **Example:** A customer, A. Smith is mistakenly recorded as a payment from customer J. Brown Both Accounts Receivable (A/R) accounts are assets and would normally be debited. The correct amount is processed, but credited to the wrong *specific* A/R account.



Common Errors - **Error of Commission**

- **Trial Balance Impact:** *Still Balance.* The credit goes to the *wrong specific impersonal account* (e.g., Rent Expense instead of Telephone Expense). Debit Cash €300 (correct), credit *Telephones* €300 instead of *Rent*. Both expenses.
- **Detection:** Reconciling individual customer/supplier accounts might reveal the error.



Common Errors - **Error of Principle**

Fundamental Accounting Rule Violated

- **Definition:** A transaction is recorded in the correct direction (debit/credit) and for the correct amount, but violates a fundamental accounting principle, such as confusing capital and revenue expenditure or mixing up assets and expenses.
- **Example:** A €5,000 repair to a delivery vehicle (Account: Repairs Expense, an expense) is mistakenly capitalised (added to the vehicle's asset value, Account: Motor Vehicles, an asset).



Common Errors - **Error of Principle**

- **Trial Balance Impact:** *Still Balance.* The asset total (Motor Vehicles) is €5,000 higher than it should be, and the expense total (Repairs) is €5,000 lower, but the overall debit entries (increases in asset and expense totals) balance the credit entries (decrease in cash or increase in A/P).
- **Detection:** Careful review by experienced accountants or auditors who understand which costs should be capitalised versus expensed.



Common Errors - **Error of Original Entry**

Wrong Amount Recorded Initially on Both Sides

- **Definition:** The initial transaction amount is incorrectly recorded in the journal entry itself, and this *incorrect amount* is then posted consistently as both the debit and the credit.
- **Example:** A €1,200 purchase of office supplies is recorded as €2,100 (digits transposed in *original entry*) in the journal. A debit of €2,100 is posted to Office Supplies Expense, and a credit of €2,100 is posted to Accounts Payable.



Common Errors - **Error of Original Entry**

- **Trial Balance Impact:** *Still Balance.* Both Office Supplies Expense and Accounts Payable are €900 (€2,100 - €1,200) higher than correct, but they increase equally.
- **Detection:** Careful checking of source documents (invoices) against journal entries.



Common Errors – **Compensating Errors**

Two Errors Cancel Each Other Out

- **Definition:** Two separate and unrelated errors occur in different accounts, but the total amount of error on one side is exactly equal to the total amount of error on the other side *relative to balance*. Essentially, one mistake compensates for another, leaving the trial balance *still in balance*.
- **Example (Simultaneous Omission):** A €1,000 purchase on credit is omitted (Accounts Payable undervalued by €1,000), *and* a €1,000 credit sale is also omitted (Accounts Receivable undervalued by €1,000).



Common Errors – **Compensating Errors**

- **Trial Balance Impact:** *Still Balance.* The undervalued debit and undervalued credit cancel each other out, making the trial balance appear balanced but with both totals €1000 lower than correct.
- **Detection:** Very difficult, usually requiring a thorough audit or unexpected results when analysing specific account balances.



Common Errors – **Complete reversal**

- **Definition:** The debit was put in the credit side, and the credit was put in the debit side.
- **Example:** Imagine a company buys €500 of office supplies with cash. Cash account is Debited with €500 as an (increased asset – incorrect) and Office Supplies €500 credited (decrease in expense – incorrect)



Common Errors – **Complete reversal**

- **Trial Balance Impact:** *Still Balance.* Even though the specific accounts have incorrect balances, the *overall structure* of the double-entry accounting system ensures that the numerical totals for both columns are equally affected (both increased or both decreased), maintaining the equilibrium of the trial balance summary.
- **Detection:** Very difficult, usually requiring a thorough audit or unexpected results when analysing specific account balances.



The Illusion of Balance

If the Trial Balance totals match, can I go home and tell the CEO the books are perfect?

- The Trail Balance proves that the math matches and not the logic.
- Accounting requires judgment (Error of Principle). The Trial Balance cannot detect if a manager incorrectly capitalised an expense to make the company look more profitable.
- If a receipt is lost in the back of a van and never entered, the Trail Balance will never 'know' its is missing (now this is a bit eliminated since technology with the use of the statements heavily reduced this.)
- The Trial Balance is a necessary but insufficient step. It is the foundation for the Financial Statements, but still requires a human eye to audit for principles and missions.



Name that Error - Quiz Questions





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SAMPLE COMPANY
Post-closing Trial Balance
March 31, 2023
(Amounts in Dollars)

ACCOUNT NUMBER	ACCOUNT TITLE	DEBIT	CREDIT
100	Cash	5,000	
101	Cash in bank	40,000	
120	Accounts receivable	3,500	
121	Allowance for doubtful accounts		200
130	Office supplies	500	
140	Equipment	28,000	
145	Accumulated depreciation – Equipment		5,980
150	Vehicles	34,000	
155	Accumulated depreciation – Vehicles		2,800
200	Accounts payable		6,000
210	Utilities payable		3,360
220	Accrued salaries		1,500
300	You, capital		91,160
Totals		111,000	111,000

Class exercise:

Business Accounting – Frank Woods – Trial Balance – 6.2





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