LESSON 5

Summarizing Changes in Financial Position

OBJECTIVES

The purpose of this lesson is to show how to summarize the transactions which were recorded during the last session. The General Ledger and ledger accounts are explained leading to account balances and finally a Trial Balance. From the Trial Balance, adjustments are made resulting in final account balances which are transferred to the corresponding accounts on the financial statements.

You will develop a good understanding of how transactions move from individual records to the creation of the Balance Sheet and Income Statement. Topics include:

- the General Ledger
- Ledger Accounts
- Account Balances
- Trial Balance
- Adjustments

In the last lesson, we covered journal entries and how they are recorded in the General Journal. From the General Journal, the information is consolidated and entered into ledger accounts which make up the General Ledger. This is the next step in the process of creating financial statements.

This lesson covers the steps from the General Journal to the General Ledger, the trial balance, adjustments, and finally the creation of the Balance Sheet and the Income Statement.

The General Ledger

A credit organization typically has many accounting transactions each day, such as the disbursement of loans, the payment of employee salaries and the receipt of loan payments. It would not be practical to prepare financial statements after each transaction. Instead, as we discussed in the last session, individual transactions are recorded in the General Journal, and at the end of the month (or other designated accounting periods), Financial Statements are prepared from these records.

Accounting systems include a separate record for each item listed on the financial statements. For example, a separate record is kept for the asset “Cash”, showing each increase and decrease in cash that occurred during the period as a result of transactions involving cash. Similar records are kept for all other Asset, Liability, Equity, Revenue and Expense accounts.
The format used to record increases and decreases in the Balance Sheet or Income Statement items is called a Ledger Account. Examples of ledger accounts are: Cash, Loans Outstanding, Equipment, Accounts Payable, Rent, Interest Expense, Interest Revenue, etc. The entire group of accounts is called the General Ledger.

[Note: A General Ledger summarizes the transactions of an organization in order of account number whereas the General Journal lists the transactions in chronological order.]

Ledger Accounts

A ledger account represents the accumulation of all information about changes in an asset, liability, equity, revenue or expense item in one place. For example, a ledger account for the asset cash would record each cash disbursement the organization made in a period as well as all cash which was received by the organization. By recording all cash that goes into and out of the organization, the ledger account provides a record of how much cash the organization has at any given time.

Each ledger account is identified by its account name and its account number. The accounts are numbered based on whether they are an Asset, Liability, Equity, Revenue or Expense account. This listing is called the “Chart of Accounts”.

You can see a Sample Chart of Accounts on the following page.
## SAMPLE CHART OF ACCOUNTS

### ASSETS
- 101 Cash
- 102 Deposits
- 103 Current Loans
- 104 Past-due Loans
- 105 Restructured Loans
- 106 Loan Loss Reserve
- 107 Other Current Assets
- 114 Long-Term Investments
- 115 Property
- 116 Equipment
- 117 Accumulated Depreciation
- 118 Other Assets

### LIABILITIES
- 201 Short-term Borrowing
- 202 Client Savings
- 203 Long-term Debt (commercial)
- 204 Long-term Debt (concessional)
- 205 Restricted / Deferred Revenue

### EQUITY
- 301 Loan Fund Capital
- 302 Retained Net Surplus (Deficit)

### REVENUE
- 401 Interest on Current & Past Due Loans
- 402 Interest Restructured Loans
- 403 Interest on Investments
- 404 Loan Fees/Service Charges
- 405 Late Fees on Loans
- 410 Donations - Unrestricted

### EXPENSES
- 501 Interest Paid on Short-term Borrowings
- 502 Interest Paid on Client Savings
- 503 Interest Paid on Long-term Debt
- 505 Provision for Loan Losses
- 510 Salaries and Benefits
- 512 Communications
- 513 Courier/Postage
- 514 Rent
- 515 Utilities
- 516 Equipment
- 517 Equipment Leasing
- 518 Depreciation
- 519 Bank Charges
- 520 Advertising and Promotion
- 521 Insurance
- 522 Supplies
- 523 Maintenance
- 524 Travel & Accommodation
- 525 Legal Fees
- 526 Professional Development
- 527 Computer Software
- 528 Printing
- 529 Fees/Dues
- 530 Miscellaneous
- 531 Volunteer Expense
Account Balances

Once journal entries have been made and the General Journal completed, the Account Balances for each ledger account must be determined. This is done by listing all of the debits and credits by ledger account into the General Ledger. The process of copying journal entry information from the General Journal to the General Ledger is called posting. In the posting process, journal debits become ledger account debits, and likewise, journal credits become ledger account credits. An Account Balance can be determined at any point in this process by adding or subtracting the debits and credits listed in the ledger account.

It should be noted here that Balance Sheet accounts are a summary of the organization’s Assets, Liabilities and Equity since inception. Therefore, these accounts will have on-going balances which are carried forward from period to period. These are referred to as Opening Balances. For example, if a Balance Sheet dated December 31, 1994 showed a Cash balance of $28,500, this balance would be carried over as the opening balance on January 1, 1995. In contrast, Income Statement accounts reflect revenue and expenses over a specified period of time and therefore are not carried over from accounting period to accounting period. For example, an Income Statement for the 12 month period ending December 31, 1994 showed that the organization earned $5,000 Interest Revenue that period. When the next accounting period begins on January 1, 1995, the Interest Revenue account will begin with a zero balance since it will be measuring the Interest Revenue earned from January 1, 1995 to December 31, 1995.

The following example includes a number of journal entries which affected the Cash account. In this example, the account balance is recorded after each journal entry and the opening account balance of $28,500 has been carried over from the previous period.

[Note: this example shows only one side (asset - Cash) of the accounting entry for each transaction. In double-entry accounting, an equal entry must be made in another account(s).]

<table>
<thead>
<tr>
<th>Date</th>
<th>Explanation</th>
<th>Debit</th>
<th>Credit</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan. 1</td>
<td></td>
<td></td>
<td>5,000</td>
<td>23,500</td>
</tr>
<tr>
<td>12</td>
<td></td>
<td>200</td>
<td></td>
<td>23,700</td>
</tr>
<tr>
<td>15</td>
<td></td>
<td></td>
<td>1,000</td>
<td>22,700</td>
</tr>
<tr>
<td>Feb. 1</td>
<td></td>
<td>15,000</td>
<td></td>
<td>7,700</td>
</tr>
<tr>
<td>1</td>
<td></td>
<td>5,000</td>
<td></td>
<td>2,700</td>
</tr>
<tr>
<td>28</td>
<td></td>
<td>2,000</td>
<td></td>
<td>700</td>
</tr>
<tr>
<td>28</td>
<td></td>
<td>100</td>
<td></td>
<td>800</td>
</tr>
</tbody>
</table>

Each debit and credit entry in the Cash account represents a cash receipt or a cash payment (identified by journal entries). The amount of cash owned by the organization at a given point in time (e.g. Feb. 28th) is the account balance for that date. The account balance is equal to the difference between the total debits and the total credits in the account. If total debits exceed total credits then the account is said to have a debit balance; whereas if total credits exceed total debits then the account has a credit balance.
Therefore, in the above example, the account balance in the Cash account (or the ‘cash balance’) is $800. Since debits were greater than credits the Cash account in our example has a debit balance.

In the Cash account example, increases were recorded on the left or debit side of the account while decreases in cash were recorded on the right or credit side. The increases were greater than the decreases and the result was a debit balance in the account.

*All Asset accounts normally have debit balances.* In fact, the ownership of cash, land or any other asset indicates that the increases (debits) to that asset have been greater than the decreases (credits). This follows common sense as it is difficult to imagine an account for an asset such as land having a credit balance because this would mean that the organization had disposed of more land than it had acquired and had reached the impossible position of having a negative amount of land. *Likewise, all Expense accounts normally have debit balances. Liability, Equity and Revenue accounts normally have credit balances.*

### Trial Balance

At the end of an accounting period (usually monthly), once all journal entries have been made and posted, it is necessary to verify that the debits and credits are in balance. This procedure is referred to as preparing the **Trial Balance**.

The Trial Balance is prepared by taking the Account Balances from the General Ledger and listing the accounts having debit balances in one column and those having credit balances in the other column. Next, the debit balances are totaled and the credit balances are totaled. Finally, the sum of the debit balances is compared with the sum of the credit balances. The sums should be equal in order for the ledger accounts to be in balance.

<table>
<thead>
<tr>
<th>Ledger Accounts</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>7,300</td>
<td></td>
</tr>
<tr>
<td>Loans Outstanding</td>
<td></td>
<td>19,000</td>
</tr>
<tr>
<td>Loans Payable</td>
<td></td>
<td>17,000</td>
</tr>
<tr>
<td>Interest Income</td>
<td></td>
<td>15,800</td>
</tr>
<tr>
<td>Salaries</td>
<td>5,500</td>
<td></td>
</tr>
<tr>
<td>Rent Expense</td>
<td>1,000</td>
<td></td>
</tr>
<tr>
<td>Totals</td>
<td>32,800</td>
<td>32,800</td>
</tr>
</tbody>
</table>

If the trial balance does not balance, the General Ledger should be checked to ensure that every Account Balance is correct and has been transferred properly.
Adjustments

Once the Trial Balance is completed (and balanced), adjustments are made to record transactions that have not previously been recorded, such as bank charges, depreciation, loan loss provision, etc. For example, after an adequate loan loss reserve has been determined (discussed in FINANCE module) an entry must be made to record a loan loss provision. This is done periodically, either monthly, bi-monthly or annually. The same occurs with a depreciation charge. When a capital asset is purchased, the entire cost does not immediately go on the Income Statement as an expense. It is depreciated over time so that each year, an amount equal to the portion of its useful life is expensed. This entry must be made at the end of each year (or accounting period) and is referred to as an adjustment.

For example:

Purchase automobile for $10,000 in cash. Depreciate on a straight-line basis over five years:

<table>
<thead>
<tr>
<th>ANALYSIS</th>
<th>RULE</th>
<th>ENTRY</th>
</tr>
</thead>
<tbody>
<tr>
<td>* the asset equipment was increased</td>
<td>* increases in assets are recorded by debits</td>
<td>Debit: Equipment $10,000</td>
</tr>
<tr>
<td>* the asset cash was decreased</td>
<td>* decreases in assets are recorded by a credit</td>
<td>Credit: Cash $10,000</td>
</tr>
</tbody>
</table>

Equipment

10,000

Cash

10,000

At end of year, record depreciation for one year:

<table>
<thead>
<tr>
<th>ANALYSIS</th>
<th>RULE</th>
<th>ENTRY</th>
</tr>
</thead>
<tbody>
<tr>
<td>* the expense depreciation was increased</td>
<td>* increases in expenses are recorded by debits</td>
<td>Debit: Depreciation $2,000</td>
</tr>
<tr>
<td>* the asset equipment was decreased by recording accumulated depreciation</td>
<td>* decreases in assets are recorded by a credit</td>
<td>Credit: Accumulated Depreciation $2,000</td>
</tr>
</tbody>
</table>

Depreciation

2,000

Accumulated Depreciation

2,000
Once it has been determined what adjustments are required, journal entries must be prepared and transferred to the ledger accounts. After all the adjustments have been made, and final account balances have been calculated, the financial statements can be prepared.

The final step in summarizing an organization’s change in financial position over a period is recording closing entries. Closing entries are prepared after the Trial Balance, adjusting entries and financial statements are completed. Closing entries clear and close revenue and expense accounts at the end of each accounting period by transferring their balances to the Net Retained Surplus/(Deficit) account. This leaves them with a zero balance. These entries are necessary in order to transfer the net effect of increases and decreases out of the revenue and expense accounts and into the Net Retained Surplus/(Deficit) account. In addition, closing entries cause the revenue and expense accounts to begin each new accounting period with zero balances.

To clear revenue accounts, which have normal credit balances, an entry debiting the account and crediting the Net Retained Surplus/(Deficit) account is required. Similarly, to clear expense accounts, which have normal debit balances, an entry crediting the account and debiting the Net Retained Surplus/(Deficit) account is required. The net effect on the Net Retained Surplus/(Deficit) account is equal to the Net Income for the period.

For example, the Revenue and Expense accounts reflected in the Sample Income Statement, which you can find in the document containing Sample Accounts attached to this study guide, would have following closing entries:

**GENERAL JOURNAL**

<table>
<thead>
<tr>
<th>Date</th>
<th>Account Title and Explanation</th>
<th>Ref</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Dec 31</td>
<td>Interest on Current and Past Due Loans</td>
<td>401</td>
<td>15,400</td>
<td></td>
</tr>
<tr>
<td>2 Dec 31</td>
<td>Interest on Restructured Loans</td>
<td>402</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>3 Dec 31</td>
<td>Interest on Investments</td>
<td>403</td>
<td>500</td>
<td></td>
</tr>
<tr>
<td>4 Dec 31</td>
<td>Loan Fees/Service Charges</td>
<td>404</td>
<td>5,300</td>
<td></td>
</tr>
<tr>
<td>5 Dec 31</td>
<td>Late Fees on Loans</td>
<td>405</td>
<td>200</td>
<td></td>
</tr>
<tr>
<td>6 Dec 31</td>
<td>Interest Paid on Long-term Debt</td>
<td>503</td>
<td>3,700</td>
<td></td>
</tr>
<tr>
<td>7 Dec 31</td>
<td>Provision for Loan Losses</td>
<td>505</td>
<td>2,500</td>
<td></td>
</tr>
<tr>
<td>8 Dec 31</td>
<td>Salaries and Benefits</td>
<td>510</td>
<td>6,000</td>
<td></td>
</tr>
<tr>
<td>9 Dec 31</td>
<td>Supplies</td>
<td>522</td>
<td>2,600</td>
<td></td>
</tr>
<tr>
<td>10 Dec 31</td>
<td>Rent</td>
<td>514</td>
<td>2,500</td>
<td></td>
</tr>
<tr>
<td>11 Dec 31</td>
<td>Travel</td>
<td>524</td>
<td>2,500</td>
<td></td>
</tr>
<tr>
<td>12 Dec 31</td>
<td>Depreciation Expense</td>
<td>518</td>
<td>400</td>
<td></td>
</tr>
<tr>
<td>13 Dec 31</td>
<td>Miscellaneous</td>
<td>530</td>
<td>300</td>
<td></td>
</tr>
<tr>
<td>14 Dec 31</td>
<td>Retained Net Surplus/(Deficit)</td>
<td>302</td>
<td></td>
<td>1,000</td>
</tr>
<tr>
<td>15 Dec 31</td>
<td>(to close &amp; clear expense &amp; revenue accts)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The net effect on the Retained Net Surplus/(Deficit) account is a $1,000 credit, which is equal to the Excess of Income over Expenses (or Net Income) for the period.
Summarizing Changes in Financial Position

EXERCISES

1. What is a ledger account?

2. What is the difference between the General Journal and the General Ledger?

3. Which of the following have opening balances?
   a. Balance Sheet accounts
   b. Income Statement accounts
   c. Both

4. Give two examples of adjustments made at the end of the accounting period.

5. Why is a Trial Balance created?
6. A Microfinance Institution had the following transactions in the month of April 1996:

<table>
<thead>
<tr>
<th>Date</th>
<th>Transactions</th>
</tr>
</thead>
</table>
| 2nd April  | • $500 cash withdrawal from bank account  
                  • Purchase furniture for $1,000 cash  
                  • Disburse loan of $2,500  
                  • Collect $75 service fee |
| 3rd April  | • Receive loan payment of $4,000 ($3,480 principal & $520 interest)  
                  • Collect $400 in client savings |
| 10th April | • A current loan of $1,000 becomes Past Due  
                  • Cash paid as follows:  
                      - electricity bill $109  
                      - telephone bill $125 |
| 16th April | • Staff travel $5,000 on company credit card  
                  • Disburse loan of $5,000  
                  • Collect $150 loan fee |
| 27th April | • Salaries paid to Manager & Credit staff $5,500  
                  • Pay interest on Long-term Debt $36  
                  • Receive loan payment of $1,020 ($1,000 principal; $20 interest) |
| 29th April | • Office rent paid $1,000  
                  • Disburse loan of $1,000  
                  • Collect $30 service fee |
| 30th April | • Restructure past due loan $2,500  
                  • Write-off $2,000 of past due loans  
                  • Borrow $10,000 from bank at commercial interest rates (long-term) |

On the basis of this information, prepare the following for the month of April, 1996 (use the opening balances from the Sample Balance Sheet in the document containing Sample Accounts attached to this study guide):

i. General Journal
ii. General Ledger
iii. Trial Balance