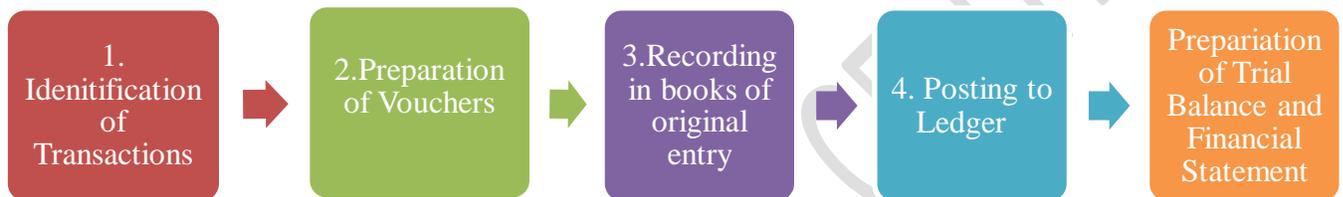


## CHAPTER-4

# PROCESS AND BASES OF ACCOUNTING

Process of accounting process begins with the origin and identification of business transaction and is followed by recording, classification and summarization of business transactions culminating in preparation of trial balance and financial statements, i.e., Profit & Loss Account and Balance Sheet. Following steps are followed in accounting process:



These steps are explained as below:

- 1. Identification of Transactions:** Accounting deals with business transactions which are monetary in nature. In other words, the transactions which cannot be measured and expressed in terms of money cannot be recorded in accounting. For recording business transactions, it is necessary that these transactions are evidenced by an appropriate document such as cash memo, purchase invoice, sales invoice, pay-in-slip, cheque book, pass book etc. A document which provides evidence of the transaction is called the Source Document.
- 2. Preparation of Vouchers:** On the basis of source documents entries are, first of all recorded on vouchers and then on the basis of vouchers recording is made in the Journal or books of original entry. Vouchers are printed separately by all the firms in their own names. A separate voucher is prepared for each transaction and it specifies the accounts to be debited and credited. Source document is generally attached to the voucher. Sometimes, voucher also serves as source document such as in the case of petty expenses. Vouchers, which are usually arranged in chronological order and serially numbered, are kept in a separate file.
- 3. Recording in Books of Original Entry:** The books in which transactions are recorded for the first time from a voucher or a source document are called 'Books of Original Entry'. Journal is one of the books of original entry in which transactions are recorded in

a chronological (day-to-day) order according to the principles of double entry system. When the size of the business is a small one, it may be possible to record all transactions in the journal but when the size of the business grows and the number of transactions is very large journal is sub-divided into a number of books called sub-journals or special journals.

4. **Posting to Ledger:** The next step in the accounting process is to transfer all entries recorded in journal or subsidiary books to respective accounts in ledger. A ledger is the principal book of accounts in which all the transactions ultimately find their place under their respective accounts in a duly classified form. For recording in ledger, all transactions are classified and transactions of similar nature are recorded at one place in an account opened in their name which will provide a complete picture of all the transactions relating to them at a glance. Thus, in ledger separate accounts are opened in the name of each person, whether customer or supplier. Likewise, separate accounts are opened for assets, liabilities, purchases, sales etc. Similarly, all incomes and expenses, which are already recorded in Journal are again classified under separate heads in ledger, such as Salary Account, Rent Account, and Discount Account etc.
5. **Preparation of Trial Balance and Financial Statements:** Last step in the accounting process is the balancing of ledger accounts and the preparation of Trial Balance with the help of such balances. A Trial Balance is a statement, prepared with the debit and credit balances of ledger accounts to check the arithmetical accuracy of posting and balancing of ledger accounts. If a trial balance does not tally, it indicates that some errors in posting or balancing of accounts have occurred and steps are taken to locate and rectify such errors. As the trial balance contains the balances of all ledger accounts, it provides a basis for preparation of financial statements namely Trading and Profit & Loss Account and a Balance Sheet.

### **Bases of Accounting**

One of the main objectives of accounting is to ascertain the profit or loss of a business enterprise at the end of an accounting period. There are two bases of ascertaining profit or loss, namely

- (1) Cash Basis, and
  - (2) Accrual Basis.
1. **Cash Basis of Accounting:** Under this basis, incomes are not recorded unless they are received in cash. Similarly, expenses are recorded only when they are paid in cash. In other words, credit transactions are not recorded at all and are ignored till cash is actually received or paid for them. Thus profit is merely the excess of actual cash receipts in respect of sale of goods and other income over actual payments in respect of purchase of goods, expenses on wages. salary, rent etc. Income or profit is calculated with the help of

a Receipts and Payments Account. This basis is useful for professional people like lawyers, doctors, chartered accountants etc.

**Advantages :**

- (i) This basis is simple, realistic and satisfies the conservative instinct of many people.
- (ii) It does not require the use of estimates and personal judgements.
- (iii) It is suitable for those enterprises where most of the transactions are on cash basis.

**Disadvantages**

- (i) It does not give a true and fair view of profit or loss and financial position of the enterprise because it ignores outstanding expenses, prepaid expenses, accrued incomes and received in advance.
- (ii) It does not follow matching principle of accounting. For example, acquisition of goods will have to be treated as expenses of the period in which payment is made instead of the periods in which benefits are derived from them.
- (iii) There is a great possibility of manipulation of profits in cash basis of accounting because payments may either be delayed or made early and similarly incomes may be postponed or collected early.
- (iv) Companies Act, 2013 does not recognize it.

**2. Accrual Basis of Accounting :** Under this basis, incomes are recorded when they are earned or accrued, irrespective of the fact whether cash is received or not, e.g., sales made on credit will be included in the total sales of the period. Similarly, expenses are recorded when they are incurred or become due and not when the cash is paid for them, e.g., rent due to the landlord but not paid will be treated as expense for the period when it is due and not in the period when it is paid. Hence, in accrual basis, profit or loss of a particular period is the result of matching of the revenue earned and expenses incurred during the period. This makes it necessary to consider outstanding expenses, prepaid expenses, accrued incomes, incomes received in advance etc. for the preparation of financial statements. Under the Companies Act, 2013, all companies are required to maintain their accounts according to accrual basis of accounting.

**Advantages:**

- 1. It discloses true profit or loss for a particular period and also depicts true financial position of the business at the end of a particular period because it takes into account all transactions relating to a particular period and takes into account all adjustments like outstanding expenses, prepaid expenses, accrued income and income received in advance.
- 2. It follows the matching principle of accounting.
- 3. There is consistency in the computation of profits of different years in accrual basis because it makes a distinction between capital and revenue expenditure.
- 4. It is recognised by Companies Act, 2013.

**Disadvantages:**

1. It is not as simple as cash basis of accounting.
2. It requires the use of estimates and personal judgements.

**Distinction between Cash Basis of Accounting and Accrual Basis of Accounting:**

S.No.	Basis of Distinction	Cash Basis of Accounting	Accrual Basis of Accounting
1.	<b>Recording of cash and credit transactions</b>	This basis records only the cash transactions.	This basis makes a complete records of all cash as well as credit transactions.
2.	<b>Timing of recording of incomes</b>	As per this basis, only those incomes are recorded which have been received in cash.	As per this basis, all incomes are recorded whether cash is received for them or not.
3.	<b>Timing of recording of expenses</b>	As per this basis, only those expenses are recorded which have been paid in cash.	As per this basis, all expenses are recorded whether cash is paid for them or not.
4.	<b>Outstanding expenses, prepaid expenses, accrued incomes and incomes received in advance</b>	This basis does not take into consideration outstanding expense, prepaid expenses, accrued incomes and incomes received in advance.	This basis takes into consideration all such item.
5.	<b>Legal Position</b>	This basis is not recognised under the Companies Act, 2013	This basis is recognised under the Companies Act, 2013
6.	<b>Ascertainment of correct profits or loss</b>	This basis does not ascertain correct profit or loss because it does not make a complete record of all cash and credit transactions.	This basis ascertain correct profit or loss because it makes a complete record of all cash and credit transactions
7.	<b>Suitability</b>	This basis is suitable for professional people like doctors, lawyer etc.	This basis is adopted by business enterprises with profit motive.

**Hybrid or Mixed Basis of Accounting:**

This basis of accounting is the mixture of cash basis and accrual basis. Under hybrid basis of accounting, revenues and assets are recorded on cash basis whereas expenses and liabilities are recorded on accrual basis. Usually professional people such as doctors, lawyers etc. adopt this method and prepare Receipts and Expenditure Account to ascertain their net income during a period.

**VERY SHORT ANSWER QUESTION**

**1. What is cash basis of accounting ?**

**Ans :** Under this basis of , incomes are not recorded unless they are received in cash . Similarly , expenses are recorded only when they are paid in cash .

**2. What is Accrual basis of accounting ?**

**Ans:** Under this basis , incomes are recorded when they are earned or accrued , irrespective of the fact whether cash is received or not , e.g ., sales made on credit will be included in the total sales of the period , Similarly , expenses are recorded when they are incurred or become due and not when the cash is paid for them .

**3. In which basis of accounting Outstanding expenses are not recorded ?**

**Ans :** Cash basis of accounting .

**4. Write two advantages of accrual basis of accounting**

**Ans :**

- (i) It discloses true advantages of accrual basis of accounting
- (ii) It follows the matching principle of accounting

**5. Which basis of accounting is recognised under the Company Act 2013.**

**Ans:** Accrual basis of Accounting .

**6. Does cash basis of accounting violates GAAP? If yes , how?**

**Ans :** Yes , It does not follow matching principle and accrual concept .