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## Chapter 4

# **PROCESS AND BASES OF ACCOUNTING**

## **PROCESS OF ACCOUNTING**

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.

**(i) 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.

**(ii) 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.

**(iii) 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.

**(iv) 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. 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.

### **(v) 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. As the trial balance contains the balances of all ledger accounts, it provides a basis for preparation of financial statement.

## **SYSTEMS OF ACCOUNTING**

The systems of recording transactions in the book of accounts are generally classified into two types, viz. Double entry system and Single entry system. Double entry system is based on the principle of “Dual Aspect” which states that every transaction has two effects, viz. receiving of a benefit and giving of a benefit. Each transaction, therefore, involves two or more accounts and is recorded at different places in the ledger. The basic principle followed is that every debit must have a corresponding credit. Thus, one account is debited and the other is credited.

The system is accurate and more reliable as the possibilities of frauds and mis-appropriations are minimised. The arithmetic inaccuracies in records can mostly be checked by preparing the trial balance.

Single entry system is not a complete system of maintaining records of financial transactions. It does not record two-fold effect of each and every transaction. Instead of maintaining all the accounts, only personal accounts and cash book are maintained under this system. In fact, this is not a system but a lack of system as no uniformity is maintained in the recording of transactions. For some transactions, only one aspect is recorded, for others, both the aspects are recorded. The accounts maintained under this system are incomplete and unsystematic and therefore, not reliable.

## **CASH BASIS OF ACCOUNTING**

### **MEANING**

Under this basis, income 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. This basis are useful for professional people like lawyers, doctors, chartered accountants etc.

### **ADVANTAGES**

- ❖ This method is simple and realistic.
- ❖ It does not require the use of estimates and personal judgment.
- ❖ This method is suitable for those enterprises where most of the transactions are on cash basis.

### **DISADVANTAGES**

- ❖ It does not give true and fair view of profit or loss and financial position of the enterprise.
- ❖ It does not follow matching principle of accounting.

- ❖ Greater possibility of manipulation of profit.
- ❖ There is no consistency in profits of different years.
- ❖ Companies Act 1956 does not recognize it.

## **ACRRUAL BASIS OF ACCOUNTING**

### **DEFINITION**

Under this basis , income are recorded when they are earned or accrued, irrespective of the fact whether cash is received or not, Similarly, expenses are recorded when they are incurred or become due and not when the cash is paid for them.

### **ADVANTAGES**

- ❖ It discloses true profit or loss for a particular period.
- ❖ It depicts true financial position of the business at the end of particular period.
- ❖ It follow the matching principle of accounting.
- ❖ There is consistency in the computation of profits of different years in accrual basis
- ❖ It is recognised by Companies Act 1956.

### **DISADVANTAGES**

- ❖ **It is not as simple as cash basis of accounting.**
- ❖ **It requires use of estimates.**
- ❖ **It is affected by personal judgment.**

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