PROCESS AND BASES OF ACCOUNTING

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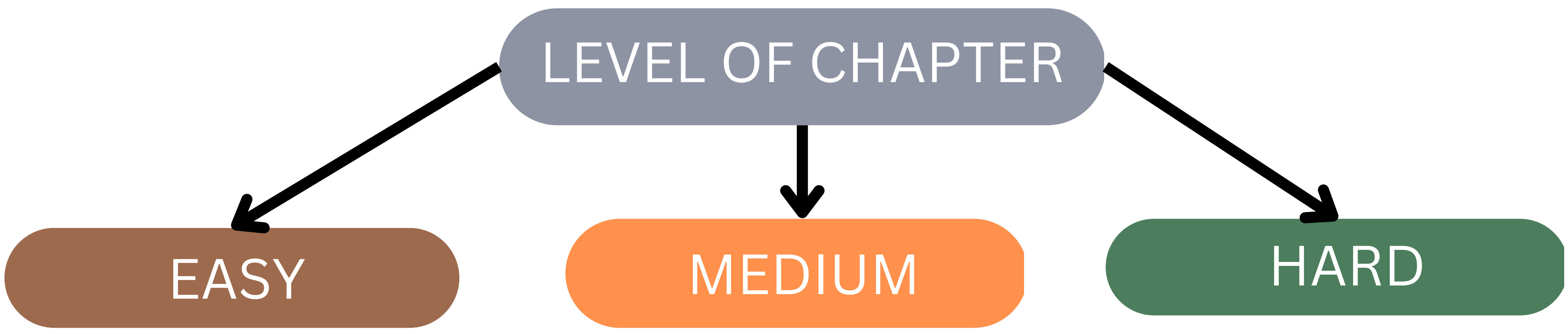

Accounting Cycle

The accounting cycle is the holistic process of recording and processing all financial transactions of a company, from when the transaction occurs, to its representation on the financial statements, to closing the accounts. One of the main duties of a bookkeeper is to keep track of the full accounting cycle from start to finish. The cycle repeats itself every fiscal year as long as a company remains in business.
The accounting cycle incorporates all the accounts, journal entries, T accounts, debits, and credits, adjusting entries over a full cycle.

Identifying and recording transactions.

The first step in the accounting cycle is to identify and record transactions through subsidiary ledgers (journals). When financial activities or business events occur, transactions are recorded in the books and included in the financial statements. Types of accounting periods for recording transactions include monthly and annually.
When accounting issues customer invoices, these invoices are issued in numerical sequences for internal control. If a company still issues paper checks, they're controlled and recorded in sequential numerical series. Any erroneous checks are voided and retained to control the numerical sequence.
Record accounting transactions in the accounting system using double-entry bookkeeping with balancing debits and credits. Generate subsidiary journals and a general journal. Types of subsidiary journals include aged accounts receivable, aged accounts payable, cash disbursements, and fixed assets & accumulated depreciation.

Preparing journal entries

To record non-routine accounting transactions, prepare journal entries for a required transaction not recorded through a subsidiary ledger like accounts receivable. You can also use journal entries to make corrections. Use automatic journal entries when possible.

Posting to the general ledger

in the next step, the transaction is posted in a summarised and classified manner to different accounts of the ledger

Generating unadjusted trial balance report

When you generate an unadjusted trial balance report from the financial records, you're checking for errors to ensure that all transactions are recorded in the general ledger. The trial balance format is that every general ledger account balance or total is listed without the details. With a double-entry bookkeeping system, total debits should equal total credits.

The unadjusted trial balance report is created by your accounting software. Use the report to make sure that total debits and total credit balance and analyze it for later making adjusting entries as corrections.

Preparing worksheets

Use worksheets to analyze, reconcile, and identify adjusting entries and consolidation entries. When possible, use the capabilities provided by your accounting system.
Each balance sheet account should be reconciled at least monthly to find and correct errors with adjusting journal entries. Compare each of the bank accounting statements to its general ledger cash account. A list of cash reconciling items will include outstanding payments and outstanding deposits that haven't yet cleared the bank and bank service fees.

Preparing adjusting entries

Make adjusting journal entries to correct errors and reflect any differences noted in reconciling balance sheet accounts. Journal entries require review and approval.

After entering adjusting entries and posting them to the general ledger, total debit balances should equal total credit balances as an accounting control process. You can check by running and reviewing an adjusted trial balance report.

Generating financial statements

Choose your customized financial reports to generate financial statements for the accounting period, whether monthly or year-end. Your financial statements can be set up to show quarterly totals in many accounting systems. The SEC requires quarterly financial reporting for public companies. Financial statements have a management review and approval process before they are issued.
Types of financial statements of a company include:

- **Balance sheet**
- **Statement of owner's equity**
- **Income statement**
- **Statement of cash flows**

Closing the books

Perform step 8 only at fiscal or calendar year-end, but not for a normal month-end close.
Close income statement temporary accounts into a permanent account. Temporary accounts include the revenue and expense accounts. At year-end, net income or loss is closed into the permanent account, retained earnings. Revenue and expense ledger account balances are reduced to zero through a closing entry in the system.

Basis of Accounting

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Despite the fact that the accrual basis is the most fundamental accounting concept, the cash basis is also used, though in a restricted way. Professionals and non-trading organizations like clubs, schools, and hospitals, for example, employ the cash basis of accounting. The three methods to accounting, namely Cash Basis of Accounting, Accrual Basis of Accounting, and Hybrid Basis of Accounting, will be discussed in detail to show how and when income and expenses are recognized.

Cash Basis of Accounting

The cash basis of accounting is a method of accounting in which transactions are recorded in the books of account when cash is received and paid. Credit transactions, such as credit purchases and sales, are not recorded in the books of account under this method. When cash is paid or received, they are documented in the books of account. When cash is received, revenue is recognized using the Cash Basis of Accounting. Goods sold on credit, for example, will not be recorded until the sale proceeds are received. Accrued income and income received in advance are not calculated and recorded since revenue is recognized on a cash basis.

Expenses, on the other hand, are only recorded as incurred once they have been paid. If a salary is paid in April for the month of March, for example, it will be recorded in April. Outstanding and prepaid expenditures are not evaluated and recognised since the transaction is recorded when cash is exchanged. The profit or loss of an enterprise for a certain accounting period is the difference between cash revenues and cash payments. The Receipts and Payments Account, which is created for non-trading organizations such as charity institutions, clubs, and schools, is an example of cash-basis accounting.

Advantages of Cash Basis of Accounting

- It is easy since adjustment entries are not required.
- This method is more objective since it requires fewer estimations and judgments.
- This accounting method is appropriate for businesses when the majority of transactions are handled in cash.

Disadvantages of Cash Basis of Accounting

- It fails to provide an accurate and fair picture of an enterprise's profit or loss and financial condition because it overlooks a basic accounting assumption, namely, the Accrual Assumption. As a result, accruing earnings and incomes received in advance, as well as ongoing and prepaid costs, are not accounted for.
- It does not adhere to the Matching Principle of accounting.
- Since this approach does not differentiate between capital and revenue items, the profits of the two years are inconsistent.
- Actual cash inflows and outflows are taken into account under this accounting method. Profit manipulation is a possibility. Payments, for example, may be delayed or postponed, and income may be delayed or received early.

Accrual Basis of Accounting

According to the accrual basis of accounting revenue and costs are recorded in the period in which they become due, rather than when they are received or paid, Credit sales, for example, are included in total sales for the period, regardless as to whether money is received or not. Similarly, if a company uses a service but does not pay for it, the expenditure is recorded in the books in the year in which the service is used, not in the year in which the payment is made.

Advantages of Accrual Basis of Accounting

- This system discloses proper profit or loss for a given period as well as the actual financial situation of the firm, since it takes into account all transactions relevant to the period adjusted for outstanding costs, prepaid expenses, accrued earnings, and incomes received in advance.
- It accurately reflects profit or loss throughout the accounting period and, as a result, it is widely accepted. Almost every commercial institution follows this system.

Disadvantages of Accrual Basis of Accounting

- The accounting procedure is very lengthy and complex under this basis.
- A rapid assessment of profit/loss is impossible due to the numerous adjustments that are necessary to identify the real financial performance of the firm, such as outstanding costs, prepaid expenses, accumulated revenue, money received in advance, and so on.

Hybrid Basis of Accounting

It is a mix of the Cash Basis and the Accrual Basis of Accounting. Revenues are accounted for on a Cash Basis, while costs are accounted for on an Accrual Basis, under the Hybrid Basis of Accounting (also known as Mixed System of Accounting). In practice, this method of accounting is not employed since it fails to appropriately assess income. Furthermore, no authority, including tax authorities, accepts the hybrid basis of accounting.