ACCOUNTING CYCLE

- Bookkeeping should not be confused with accounting or accountancy.
- Persons with little knowledge of accounting may fail to understand the difference between these terms and often used to mean the same thing.
- Therefore, it is useful to make a distinction.

6.1 Bookkeeping

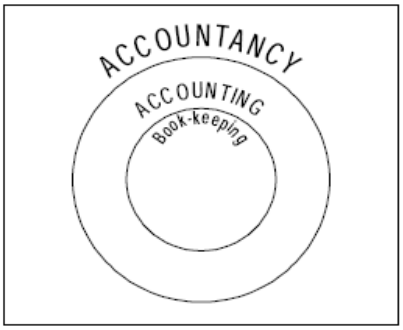
- Bookkeeping is a small part of the field of accounting and the simplest part, just like arithmetic is a small part of the broad discipline of mathematics
- Its work is clerical nature and can be performed by office workers, machine and computers. The functions of Bookkeeping is to properly record the financial transactions in the books of account
- Bookkeeping is recording or first phase of an accounting system

6.2 Accounting

- The process of accounting begins where the bookkeeping process ends
- Accounting is broad subject and final phase
- The function of accounting is to classify the recorded transactions, summarize them, interpret them, and collect and communicate necessary information to the management and other interested parties
- Accounting includes not only maintenance of accounting records, but also the preparation and interpretation of Financial Statements

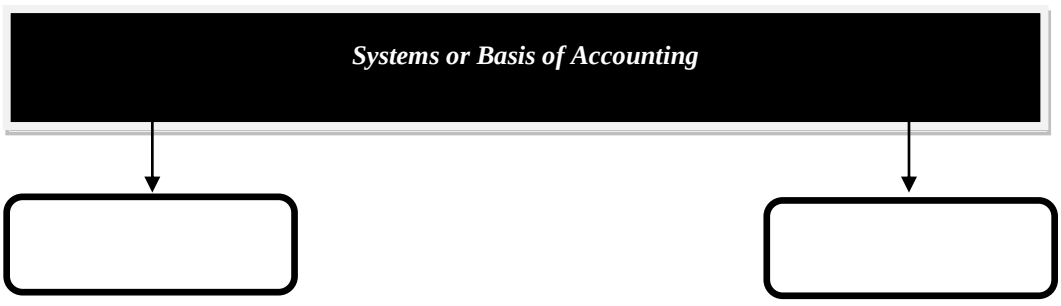
6.3 Accountancy

- The two words accounting and accountancy are often used to mean the same thing. But it is not correct
- Accountancy is the main subject while, accounting is one of its branches
- The word "accountancy" is far extensive; i.e. the scope of accountancy is far a wide and extensive compared to accounting
- It covers the entire body of theory and practice, e.g. bookkeeping, accounting, costing, auditing, taxation etc.



6.4 Systems or Basis of Accounting

There are two systems or basis of accounting, Cash and accrual. The difference between the two systems of accounting is when revenues and expenses are recorded



6.4.1 Cash Accounting

- With cash basis accounting, revenue is recognized (recorded) when cash is received. Expenses are recognized only when cash is paid
- It is the accounting system in which revenue and expenses are recorded when actual cash / cheque is received or paid
- The same principle applies for income and other transactions as well i.e. income is recorded when cash is actually received
- No Account Payable or Account Receivables
- Let's take the example of utility bills like electricity, telephone etc. The bill of January is received on 5th February and paid on 15th February. If the organization is following cash accounting practice it will record the expense of electricity on 15th February
- Cash-based accounting refers to keeping a record of cash inflows and cash outflows

6.4.2 Accrual Accounting

- ✓ Accrual basis accounting requires accountants to follow the revenue recognition principle and the expense recognition principle
- ✓ It is the accounting system in which events are recorded as and when they occur
- ✓ This means that revenue is recorded when it is earned
- ✓ Expense is recorded when incurred i.e. the organization has obtained the benefit from it
- ✓ Consider the same example the electricity is utilized in the month of January so the expense should be recorded in the month of January 31st
- ✓ Similarly the case of revenue
- ✓ Account Payable and Account Receivable available
- ✓ Cash basis accounting does not satisfy the requirements of Generally Accepted Accounting Principles (GAAP), whereas accrual basis accounting does.
- ✓ Accrual basis accounting provides an objective measurement of net income

6.5 Methods of Recordings

There are two methods of recording for transactions

6.5.1 Single Entry Book-Keeping

- This is the conventional style of keeping records
- In single entry book keeping system, as it is clear from the name, only one aspect of the transaction is recorded
- This actually is not a system but is a procedure by which small business concerns, like retailers and small shopkeepers, keep record of their sale / income. In this system, there are usually two to three registers
- "Naqad Khata" is one register cash received from customers is recorded
- Whereas the other one is a person-wise record of goods sold on credit *"*Udhar Khata*"*
- That means only one aspect of transaction i.e. either cash receipt/payment or credit is maintained
- Single entry is faulty, incomplete, inaccurate, unscientific and unsystematic style of account keeping

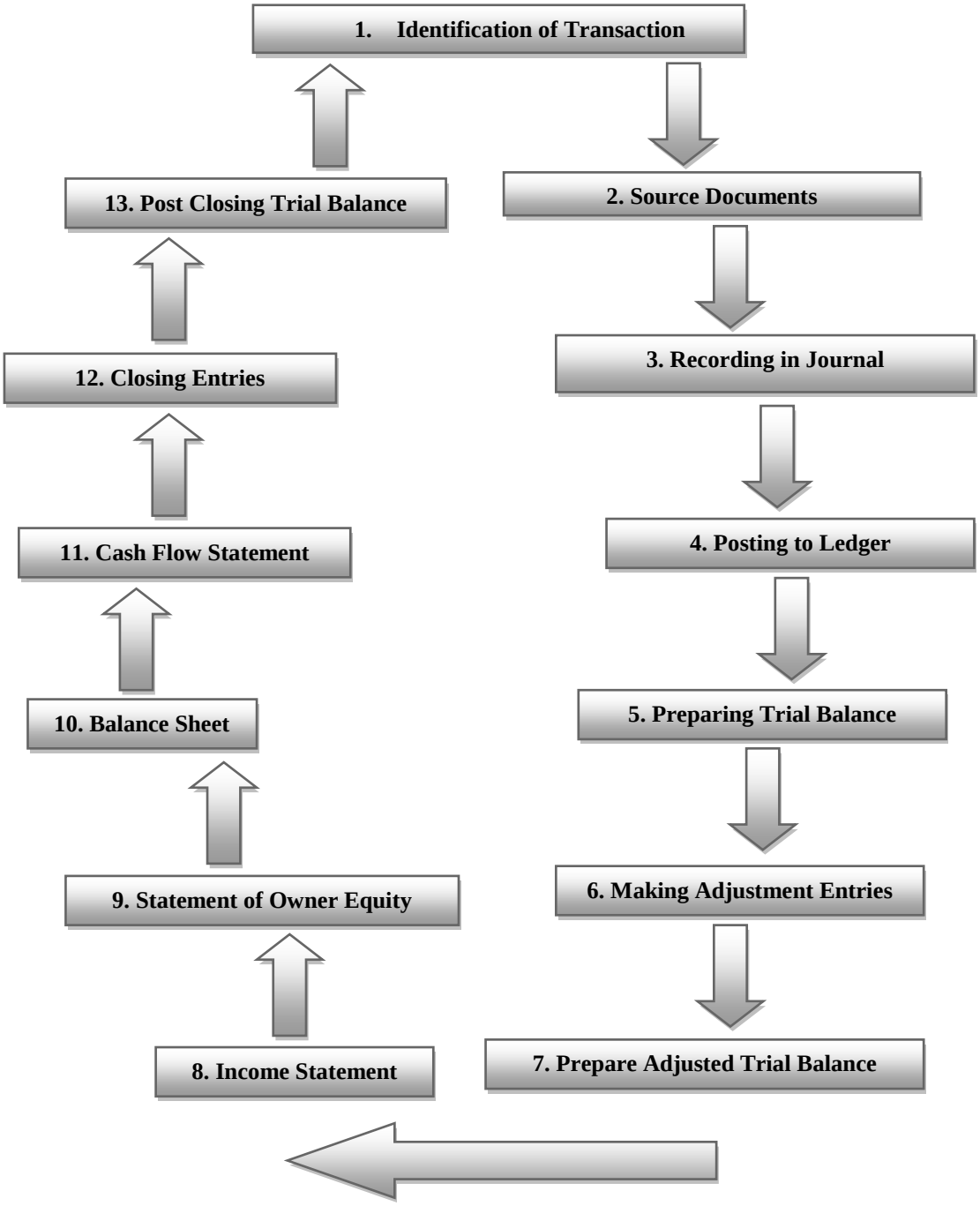
6.5.2 Double Entry Book-Keeping

- ❖ Locus Pacioli, an Italian wrote a first book on double entry system in 1494

- The concept of double entry is based on the fact that every transaction has two aspects i.e. receiving a benefit and giving a benefit
- The accounting system that records both the aspects of transaction in books of accounts is called double entry system
- 'Debit' (derived from Latin word *Debere* which means to owe) and 'Credit' (derived from Latin word *Credere* which means that which one believes in, including persons, like creditor) are denoted by 'Dr' and 'Cr' respectively. The ultimate result of the system is that for every Debit (Dr) there is an equal Credit (Cr)

6.6 Accounting Cycle

Accounting cycle refers to completed sequence of accounting steps and procedures which are required to be repeated in same order during each accounting period



6.6.1 Identification of Transactions

- In accounting, only business transaction or economic activities are recorded (except drawing in case of non-corporate form of business)
- A transaction is a particular type of event, which can be expressed in terms of money and brings changes in the financial position of a business unit
- A transaction involves transfer of something of value between two or more entities. A transaction may be an exchange in which each party receives as well as sacrifices values; in other words, in every transaction, there is a movement of value from one source to another
- A transaction can also be non-reciprocal transfer in which a business unit incurs a liability (penalty imposed by government) or transfer an asset to another entity (payment of income tax) or receives an asset (subsidy received from government)
- Transaction may be external (between business and second party) or internal (not involving second party like depreciation on machinery)

6.6.2 Source Documents

- Source documents are the evidences of business transactions (Audit requirements)
- Which provide information about the nature of the transaction, the date, the amount and the parties involved in it
- Since each transaction has an effect on the financial position of the business, there should be a documentary evidence to establish the monetary amount at which transactions are recorded
- According to the verifiable objective principle of Accounting, each transaction recorded in the books of accounts should have sufficient proof to support it
- That the transactions are properly authorized. The common documents that generally use are described below

6.6.2.1 Cash Memo:

- When a trader sells goods for cash, he gives a cash memo
- When a trader purchases goods for cash, he receives a cash memo
- Details regarding the items, quantity, rate and the price are mentioned in the cash memo

6.6.2.2 Invoice or Bill:

- When a trader sells goods on credit, he prepares a sale invoice
- It contains full details relating to the amount, the terms of payment and the name and address of the seller and buyer
- The original copy of the sale invoice is sent to the purchaser and its duplicate copy is kept for making records in the books of accounts
- Similarly, when a trader purchases goods on credit, he receives a credit bill from the supplier of goods

6.6.2.3 Receipt:

- When a trader receives cash from a credit customer, he issues a receipt containing the date, the amount and the name of the customer
- The original copy is handed over to the credit customer and the duplicate copy is kept for record
- In the same way, whenever we make payment, we obtain a receipt from the party to whom we make payment

6.6.2.4 Debit Note:

- A debit note is prepared by the buyer and it contains the date of the goods returned, name of the supplier, details of the goods returned and reasons for returning the goods
- A duplicate copy or counter foil of the debit note is retained by the buyer. On the basis of debit note, the suppliers account is debited in the books

6.6.2.5 Credit Note:

- A credit note is prepared by the seller and it contains the date on which goods are returned, name of the customer, details of the goods received back, amount of such goods and reasons for returning the goods
- A duplicate copy of the credit note is retained for the record purpose
- On the basis of credit note, the customer's account is credited in the books

6.6.2.6 Pay-in-Slip:

- Pay-in-slip is a form available in banks and is used to deposit money into a bank account
- Each pay-in-slip has a counterfoil which is returned to the depositor duly sealed and signed by the bank official
- This source document relates to bank transactions. It gives details regarding date, account number, amount deposited (in cash or cheque) and name of the account holder

6.6.2.7 Cheque

- ✓ A cheque is a document in writing drawn upon a specified banker to pay a specified sum to the bearer or the person named in it and payable on demand
- ✓ Each cheque book has a counterfoil in which the same details in the cheque are filled
- ✓ The counterfoil remains with the account holder for his future reference. The counterfoil forms the source document for entries to be made in the books of accounts

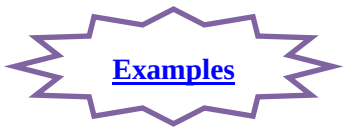
6.6.2.8 Vouchers

- ★ A voucher is a written document in support of a business transaction
- ★ Vouchers are prepared by an accountant and each voucher is counter signed by an authorized person of the organization
- ★ The vouchers are properly filed according to their serial numbers so that the auditors may easily vouch them and these may also serve as documentary evidence in future.
- ★ Voucher may be receipt, payment and general

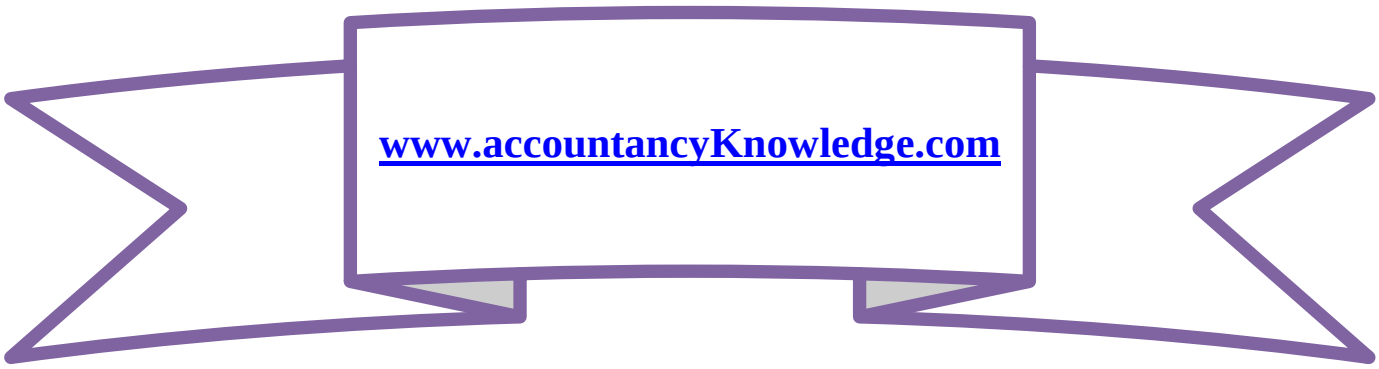
Practice MCQs

www.accountancyknowledge.com/accounting-cycle-mcqs/

Formats


Examples

Past Papers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