CHAPTER 5

Bases of Accounting

MEANING OF KEY TERMS USED IN THE CHAPTER

1. Cash Basis of Accounting	It is a system of accounting according to which transactions are recorded in the books of account when cash is transacted, whether received or paid.
2. Accrual Basis of Accounting	It is a system of accounting according to which transactions are recorded in the books of account when a transaction is entered into irrespective of cash having been received or not.
3. Outstanding Expenses	These are expenses which have been incurred during the accounting period but have not yet been paid. In the Balance Sheet, they are shown as liability.
4. Prepaid Expenses	These are expenses which have been paid in advance. In the Balance Sheet, they are shown as an asset.
5. Accrued Income	It is an income which has been earned during the accounting period but has not yet become due for payment and, therefore, has not been received. In the Balance Sheet, it is shown as an asset.
6. Income Received in Advance	It is an income which has been received before it has been earned, *i.e.*, goods have been sold or services have been rendered. In the Balance Sheet, it is shown as a liability.

Note: *Terms at serial numbers 3, 4, 5 and 6 will appear when accrual basis of accounting is followed.*

CHAPTER SUMMARY

- **Bases of Accounting.** For recording financial transactions, there can be three broad approaches to accounting. These are:

  1. Cash Basis, 2. Accrual Basis, and 3. Hybrid Basis.

- **Cash Basis of Accounting.** A system in which accounting entries are made only when cash is transacted, whether received or paid.

- **Accrual Basis of Accounting.** A system in which accounting entries are made on the basis of amounts having become due for payment or receipt.

  Outstanding expenses, prepaid expenses, accrued income and unearned income are adjusted while preparing the Financial Statements.

Bases of accounting mean the basis of recording transactions in the books of account. There are three bases of accounting:

- Cash Basis of Accounting,
- Accrual Basis of Accounting, and
- Hybrid Basis of Accounting.

Cash Basis of Accounting

Cash Basis of Accounting is the basis of accounting whereby transactions are recorded in the books of account when amount is paid or received against the transaction and not when transaction is entered into. It means that credit transactions are not recorded in the books of account.

Its effect on revenue is that it is recognised when amount is received whether earned or not and not prior to it. It means accrued income and income received in advance is not determined and accounted.

Its effect on expenses is also that they are recognised only when they have been paid and not before. It means that outstanding expenses and prepaid expenses are not determined and accounted.

Cash System of Accounting is recognised by the Income Tax Act, 1961. However, it can be adopted by entities other than Companies as the Companies Act, 2013 requires Companies to maintain its accounts only on accrual basis.

Accrual Basis of Accounting

Accrual Basis of Accounting is based on the concept of realisation and expiration and follows two basic accounting principles, *viz.*, Revenue Recognition Principle and Matching Principle.

Its effect on income is that it is recognised when it is earned whether amount is received against it or not. For example, sale is recognised as sale when the title in the goods is transferred irrespective of the fact whether amount has been received against it or not. It means that recognition of revenue and receiving amount against it are two separate aspects, *i.e.*, transactions.

Its effect on expenses is that they are recognised as expenses when incurred irrespective of the fact whether amount has been paid against it or not. For example, rent for the month of March, 2020 has not been paid. It will be recognised as expense in the financial year ended 31st March, 2020 because it has become due and has not been paid. In this example, Rent Account will be debited and Rent Payable Account will be credited. When the payment is made, Rent Payable Account will be debited and Cash Account or Bank Account will be credited.

The Companies Act, 2013 requires Companies to maintain its books of account on accrual basis.

Hybrid Basis of Accounting

It is a combination of Cash Basis of Accounting and Accrual Basis of Accounting. Under the Hybrid Basis of Accounting (also called **Mixed System of Accounting**), revenues are accounted on Cash Basis and the expenses are accounted on Accrual Basis. In actual practice, this basis of accounting is not used since it fails to measure the income accurately.**Also Hybrid Basis of Accounting is not accepted by any authority including tax authorities.**

Note: *Hybrid Basis of Accounting is not the part of the Syllabus.*

Example. From the following information, determine the profit earned or loss incurred when (i) Cash Basis of Accounting and (ii) Accrual Basis of Accounting are followed:

	₹
Cash Sales	5,00,000
Credit Sales	2,00,000
Outstanding Salary and Wages	4,000
Insurance Paid in Advance	2,500
Outstanding Electricity Expenses	1,000
Income Received (excluding income received in advance)	5,000
Income Received in Advance	1,000
Income Earned but not Received	3,000
Cash Purchases	2,75,000
Credit Purchases	1,25,000
Salary and Wages Paid	44,000
Electricity Expenses Paid	11,000
Insurance Expenses Paid (including prepaid)	10,000

Solution:

(i) *When Cash Basis of Accounting is followed:*

			₹
Cash Sales			5,00,000
Add:	Income Received	5,000	
	Income Received in Advance	1,000	6,000
			5,06,000
Less:	Cash Purchases	2,75,000	
	Salary and Wages Paid	44,000	
	Electricity Expenses Paid	11,000	
	Insurance Expenses Paid	10,000	3,40,000
Profit			**1,66,000**

(ii) *When Accrual Basis of Accounting is followed:*

			₹
Sales (Cash + Credit)			7,00,000
Add:	Income Earned (Income Received + Income Earned but not Received (₹ 5,000 + ₹ 3,000))		8,000
			7,08,000
Less:	Purchases (Cash + Credit) (₹ 2,75,000 + ₹ 1,25,000)	4,00,000	
	Salary and Wages (Paid + Outstanding) (₹ 44,000 + ₹ 4,000)	48,000	
	Electricity Expenses (₹ 11,000 + ₹ 1,000)	12,000	
	Insurance Expenses (Paid *less* prepaid) (₹ 10,000 – ₹ 2,500)	7,500	4,67,500
Profit			**2,40,500**