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Name:

Registration No.:

Course Code: 1339

Program: FA/ICom

Semester: Autumn 2026

ALLAMA IQBAL OPEN UNIVERSITY, ISLAMABAD

(Department of Commerce)

Course: Basics of Accounting (1339)

Level: FA/ICom

Semester: Autumn 2026

Assignment No. 1 (Units: 1–4)

Total Marks: 100

Pass Marks: 40

SOLVED ASSIGNMENT GUIDE — For Study & Reference

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Question 1

Q.1 Define "Accounting" and describe its cycle. (20)

Introduction

Every business, whether it is a small shop in a bazaar or a large manufacturing company, deals in money every day. Goods are bought and sold, wages are paid, rent is settled, loans are taken and repaid, and cash keeps moving in and out. If none of these dealings were written down, the owner would very soon lose track of what he owns, what he owes, whom he has to pay and who has to pay him. Accounting is the discipline that answers this need. It is often called the "language of business" because, just as a language allows people to communicate ideas, accounting allows a business to record, summarise and communicate its financial story to

everyone who is interested in it. In this answer the term accounting is first defined and explained, and then the accounting cycle — the ordered sequence of steps through which every transaction passes from the day it happens to the day the final statements are prepared — is described step by step.

Meaning and Definition of Accounting

In simple words, accounting is the art and science of identifying, measuring, recording, classifying, summarising, analysing and communicating the financial transactions of a business in a systematic manner, so that interested users can make sound economic decisions. The American Institute of Certified Public Accountants has described accounting, in substance, as the art of recording, classifying and summarising in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the results thereof. The American Accounting Association has similarly emphasised that accounting is the process of identifying, measuring and communicating economic information to permit informed judgements and decisions by the users of that information. Three ideas run through every serious definition. First, accounting deals only with transactions that can be measured in money; a manager's honesty or a worker's skill, however valuable, cannot be recorded because they cannot be expressed in rupees. Second, accounting is not mere writing down: recording is only the first stage, and the recorded data must be classified, summarised and interpreted before it becomes useful. Third, accounting exists for its users — the owner, managers, creditors, banks, investors and government agencies — and its final product is information on which decisions can be based.

Main Features and Functions of Accounting

Accounting has several distinguishing features. It is historical in nature because it records transactions after they have taken place. It is systematic because entries follow fixed rules and a fixed order. It follows the double entry principle, under which every transaction affects at least two accounts. It is governed by generally accepted accounting principles and concepts such as the business entity concept, the money measurement concept, the going concern concept, the accrual concept and the consistency concept, so that the results of one business can be compared with another and with its own past. Its functions are equally clear: it keeps a permanent and systematic record of business dealings; it communicates financial results to interested parties; it helps in ascertaining profit or loss for a period and the financial position on a date; it provides information for planning, control and decision-making; it creates legal and documentary evidence of transactions, which is useful in disputes and for tax assessment; and it helps in the valuation of the business when it is sold or when a new partner is admitted. Accounting therefore serves both as a record-keeping system and as an information system, and it is this second role that separates it from simple book-keeping.

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The Accounting Cycle — Meaning

The accounting cycle is the complete sequence of steps that is repeated in every accounting period, beginning with the identification of a business transaction and ending with the preparation of the financial statements and the closing of the books. It is called a cycle because, as soon as one period's books are closed, the very same steps begin again for the next period. The cycle guarantees that no transaction is missed, that every entry is supported by evidence, and that the final accounts rest on a balanced and verified trial balance. The steps of the cycle are described below in their proper order.

Step 1: Identifying and Analysing Transactions

The cycle begins when a financial event takes place — for example, goods are purchased, cash is received from a customer, or salary is paid. The accountant first identifies whether the event is a business transaction at all: it must involve the business, it must be measurable in money, and it must change the financial position of the business. Each transaction is supported by a source document such as a cash memo, invoice, receipt, cheque counterfoil or debit and credit note. The document is analysed to decide which accounts are affected, whether each account is personal, real or nominal, and which account is to be debited and which credited. Without this analysis, correct recording is impossible, so this step, though invisible in the books, is the foundation of the whole cycle.

Step 2: Recording in the Journal

The analysed transactions are first recorded, in chronological order, in the journal, which is called the book of original entry. Each entry shows the date, the account to be debited, the account to be credited, the amount, and a brief explanation called the narration. Because the journal preserves the complete story of every transaction at one place and at the time it happens, it serves as legal evidence and makes errors easy to trace. In large businesses the journal is sub-divided into special journals such as the purchases journal, the sales journal, the cash book and the journal proper, but the principle of original recording remains the same.

Step 3: Posting to the Ledger

Recording alone does not show how much a particular customer owes or how much has been spent on rent in total, so the next step is classification. Every journal entry is posted to the ledger, the principal book of accounts, in which a separate account is opened for each person, asset, expense and income. All debits relating to one account are collected on its debit side and all credits on its credit side. Posting converts a day-by-day diary into an account-wise summary, and

it is from the ledger that the financial position regarding any single item can be known at a glance.

Step 4: Balancing the Accounts

At the end of the period, each ledger account is balanced: the two sides are totalled and the difference, if any, is written on the shorter side as "balance carried down", so that both sides become equal. The balance is then brought down at the start of the next period. Asset and liability accounts normally show debit and credit balances respectively, while the balances of personal accounts reveal whether a person is a debtor or a creditor of the business. Balancing is the stage at which the raw postings are converted into meaningful figures ready for verification.

Step 5: Preparing the Trial Balance

All ledger balances are then listed in a statement called the trial balance, with debit balances in one column and credit balances in another. If the two columns agree, it is strong (though not conclusive) evidence that the books are arithmetically accurate and that every debit has received its corresponding credit. If they disagree, errors are searched for and rectified before proceeding. The trial balance is the bridge between the ledger and the final accounts, and it also saves time because the accountant works from one summarised list instead of the whole ledger.

Step 6: Adjustment Entries

Before the final accounts are drawn up, certain adjustments are recorded through journal entries so that the accounts show a true and fair picture. Typical adjustments include closing stock, outstanding expenses, prepaid expenses, accrued income, income received in advance, depreciation on fixed assets, and provisions for doubtful debts. These adjustments arise mainly from the accrual concept: revenue and expenses must be matched with the period to which they

belong, regardless of when cash moves. After adjustment entries are posted, an adjusted trial balance may be prepared.

Steps 7 and 8: Final Accounts and Closing Entries

The adjusted balances are now used to prepare the financial statements: first the Trading Account, which finds the gross profit; then the Profit and Loss Account, which finds the net profit or net loss; and finally the Balance Sheet, which shows assets, liabilities and capital on the last day of the period. After the statements are ready, closing entries transfer the balances of all nominal accounts (revenues and expenses) to the Trading and Profit and Loss Accounts, so that these accounts start the next period at zero, while real and personal accounts are carried forward. In modern computerised systems the same cycle is followed, only the posting, balancing and totalling are done by software, which reduces arithmetic errors but not the need for correct analysis at the first step.

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Step	Name of Step	Main Work Done
1	Identifying & analysing	Source documents examined; accounts and debit/credit decided
2	Journalising	Transactions recorded chronologically in the journal
3	Posting	Entries classified into ledger accounts
4	Balancing	Ledger accounts balanced; balances carried down
5	Trial balance	Balances listed; arithmetical accuracy checked
6	Adjustments	Outstanding, prepaid, depreciation etc. recorded
7	Final accounts	Trading & P&L Account and Balance Sheet prepared
8	Closing entries	Nominal accounts closed; cycle restarts next period

Conclusion

To conclude, accounting is the systematic process of recording, classifying, summarising, analysing and communicating financial information so that its users can take informed decisions,

while the accounting cycle is the disciplined path — identification, journal, ledger, balancing, trial balance, adjustments, final accounts and closing entries — through which every transaction travels. A student who understands the cycle understands the whole subject, because each later topic of this course, from the cash book to the final accounts of Noor & Co. in Assignment No. 2, is simply one step of this same cycle studied in detail.

Question 2

Q.2 Differentiate between Accounting and Book-Keeping. Also, describe their importance. (20)

Introduction

The words accounting and book-keeping are often used as if they meant the same thing, and in small shops one person may indeed do both jobs. Yet in the theory of the subject they are two distinct stages of the same process. Book-keeping is concerned with the routine recording of transactions, while accounting begins where book-keeping ends and is concerned with summarising, analysing and interpreting what has been recorded. Confusing the two leads to the common but wrong idea that the accountant merely writes up books. This answer first defines each term, then sets out the points of difference between them in detail, and finally describes the importance of each for a business.

Meaning of Book-Keeping and Accounting

Book-keeping is the art of recording business transactions in a systematic and chronological manner in the books of account. It covers identifying the transactions, measuring them in money, recording them in the journal and subsidiary books, and posting and balancing them in the ledger. Its work is largely clerical and routine, follows fixed rules, and can be performed by a person with a basic knowledge of the rules of debit and credit; today it is largely done by

accounting software. Accounting is a much wider term. It includes book-keeping but goes far beyond it: it covers summarising the recorded data through the trial balance and final accounts, analysing and interpreting the results through ratios and comparisons, and communicating the conclusions to owners, managers, creditors, investors and the government. Accounting also involves designing the accounting system itself, preparing budgets, handling tax matters and advising management. It therefore requires professional knowledge, judgement and analytical ability, and is performed by qualified accountants.

Points of Difference

The difference between the two can be understood clearly from the following comparison. In each row the book-keeping position is stated first and the accounting position second, so that the contrast is visible at a glance.

Basis	Book-Keeping	Accounting
Scope	Narrow: recording and posting transactions only	Wide: recording, summarising, analysing, interpreting and communicating
Stage	First / primary stage of the process	Second / higher stage; begins where book-keeping ends
Main books	Journal, subsidiary books and ledger	Trial balance, Trading & P&L Account, Balance Sheet and reports
Objective	To keep a complete, systematic record of transactions	To ascertain profit/loss and financial position and to aid decisions
Nature of work	Routine, repetitive and clerical	Analytical, interpretive and advisory
Skill required	Basic knowledge of debit/credit rules suffices	Professional knowledge, training and judgement required

Analysis	No analysis or interpretation is done	Results are analysed and interpreted (ratios, trends, comparisons)
Adjustments & closing	Not concerned with adjustments or closing entries	Passes adjustment and closing entries and finalises accounts
Users served	Serves mainly the accountant who uses its output	Serves owners, managers, creditors, banks, investors and government
Legal role	Provides the raw record used as evidence	Prepares statements required by company and tax law
Period result	Cannot tell profit or loss by itself	Determines net profit/loss and financial position for the period

Two popular statements summarise this table. First, "book-keeping is a part of accounting, but accounting is not a part of book-keeping." Second, "where the work of the book-keeper ends, the work of the accountant begins." Both statements are broadly true and are also used in Question 5(B) of this assignment. It should, however, be noted that the boundary is one of function, not necessarily of persons: in a sole proprietorship the owner may keep the books and also prepare the final accounts, performing both functions himself, while in a large company the functions are divided among many employees of the accounts department.

Importance of Book-Keeping

Book-keeping is important because everything else in accounting stands upon it. A complete and permanent record protects the business against the fallibility of human memory: after a year no trader can remember hundreds of credit sales, but his sales journal remembers all of them. Systematic records reveal at any time how much each debtor owes and how much is payable to each creditor, which prevents both bad debts and disputes. Books kept under the double entry system allow an arithmetical check through the trial balance, so errors are detected early instead

of at the end of the year. Proper books are accepted as evidence in courts and before tax authorities, and they are the raw material from which the trial balance and final accounts are prepared; if the recording stage is careless, no amount of later skill can produce reliable statements. Finally, regular book-keeping discourages fraud and negligence by employees, because every rupee received or paid must appear somewhere in the books.

Importance of Accounting

Accounting is important because it converts recorded facts into decisions. By preparing the Trading and Profit and Loss Account it tells the owner whether the business earned a profit or suffered a loss, and by the Balance Sheet what the business owns and owes — information without which prices, credit policy and expansion plans would be guesswork. Managers use accounting information for planning and control: budgets are prepared from past accounts, and actual performance is compared with targets. Creditors and banks examine the accounts before granting loans or trade credit, investors before buying shares, and government departments for assessing income tax and sales tax; companies are in fact legally required to prepare and present proper accounts. Accounting information also helps in comparing performance with previous years and with competitors, in valuing the business on sale or amalgamation, in settling the accounts of partners on admission, retirement or death, and in proving claims in case of insolvency or dispute. In short, book-keeping answers the question “what happened?” while accounting answers “what does it mean, and what should be done next?” — and a modern business needs both answers.

Conclusion

It may be concluded that book-keeping and accounting are two stages of one continuous process and not rivals. Book-keeping is the narrower, routine, recording stage performed at the primary

level; accounting is the wider, analytical stage that summarises, interprets and communicates. Neither can replace the other: without book-keeping there is nothing to analyse, and without accounting the records remain a lifeless store of figures. Their combined importance — reliable records, known profit, known financial position, legal compliance and informed decisions — makes them indispensable to every business, small or large.

Question 3

Q.3 Describe in detail the rules, merits, and demerits of the Double Entry System of bookkeeping. (20)

Introduction

The double entry system is the scientific and universally accepted system of book-keeping, first described in a systematic form by the Italian monk Luca Pacioli in 1494. Under this system every business transaction is recorded in two accounts — one account is debited and another account is credited with the same amount — so that the total of all debits always equals the total of all credits. The system rests on the simple truth that every transaction has two aspects: nothing is received without something being given in exchange. If a trader buys furniture for cash, he receives furniture and gives cash; if he sells goods on credit, he gives goods and receives a claim against the customer. This answer explains the rules that govern debit and credit, and then examines the merits and demerits of the system in detail.

The Basic Principle and the Accounting Equation

The foundation of double entry is the dual aspect concept, expressed in the accounting equation: Assets = Capital + Liabilities. Every transaction disturbs this equation in appearance but restores it in fact, because it either changes two items on opposite sides or increases one item and decreases another on the same side. Buying machinery for cash, for example, increases the asset

machinery and decreases the asset cash by the same amount, so the total of assets is unchanged. Buying goods on credit increases stock and increases the liability to the creditor. Because both aspects are always recorded, the equation always balances, and this permanent balancing is the system's built-in check on completeness: a transaction recorded on only one side is immediately incomplete.

Rules of Debit and Credit — Traditional Approach

Under the traditional (English) approach all accounts are divided into three classes, and each class has its own golden rule. Personal accounts relate to persons and firms — customers, suppliers, the proprietor, banks — and the rule is: debit the receiver, credit the giver. When goods are sold to Mr. Majid on credit, Majid receives goods, so his account is debited; when cash is received from him, he is the giver, so his account is credited. Real accounts relate to assets and properties such as cash, goods, furniture, machinery and building, and the rule is: debit what comes in, credit what goes out. When furniture is purchased, furniture comes into the business and is debited; when it is sold, it goes out and is credited. Nominal accounts relate to expenses, losses, incomes and gains such as rent, salary, commission and discount, and the rule is: debit all expenses and losses, credit all incomes and gains. Rent paid is therefore debited, and commission received is credited. These three rules, correctly applied, decide the debit and credit of any transaction a student will meet at this level.

Rules of Debit and Credit — Modern Approach

The modern (American) approach classifies accounts into five groups and states the rule in terms of increase and decrease. Assets: an increase is debited and a decrease is credited. Liabilities: an increase is credited and a decrease is debited. Capital: an increase is credited and a decrease (including drawings) is debited. Revenues and incomes: an increase is credited and a decrease is

debited. Expenses and losses: an increase is debited and a decrease is credited. Both approaches give identical entries; the traditional rules are easier for beginners at FA/ICom level, while the modern classification is convenient for understanding the structure of the Balance Sheet. A small illustration fixes the rules in mind: the proprietor starts business with cash of Rs. 100,000. The business receives the asset cash (real account — debit what comes in) and the proprietor is the giver (personal account — credit the giver); hence Cash Account is debited and Capital Account is credited with Rs. 100,000, exactly as is done on a far larger scale in Question 4 below.

Merits of the Double Entry System

The merits of the system explain why it has survived for more than five hundred years. (1) Complete record: both aspects of every transaction are recorded, so the history of any dealing can be fully reconstructed — what was received, what was given, and with whom. (2) Arithmetical accuracy: because total debits must equal total credits, a trial balance can be prepared and agreement of the two sides is strong evidence that the books are arithmetically correct. (3) Knowledge of results: the system makes it possible to prepare the Trading and Profit and Loss Account and thus to know the gross and net profit or loss of any period. (4) Knowledge of financial position: assets and liabilities are recorded systematically, so a Balance Sheet can be drawn up showing what the business owns and owes on a given date. (5) Detection and prevention of fraud: a fraudster must alter two accounts to hide a theft, which is difficult; the balancing of books and the independent trial balance expose irregularities far more easily than a one-sided record. (6) Comparison: results of different years, and of different firms using the same system, can be compared to judge progress and efficiency. (7) Decision-making and credit: reliable final accounts help owners decide policy and help banks and suppliers decide whether to grant loans and credit. (8) Legal recognition: books kept under this system are accepted as

evidence by courts and tax authorities, and companies are required to keep accounts on this basis. (9) Ready information: the amount recoverable from any debtor and payable to any creditor is available at any time. (10) Valuation: on the sale of a business or admission of a partner, properly kept double entry books make valuation fair and defensible.

Demerits of the Double Entry System

The system also has genuine limitations which a balanced answer must admit. (1) It is costly and time-consuming for very small businesses: a petty shopkeeper with a handful of daily transactions may find full double entry books — journal, ledger, trial balance and final accounts — an expensive burden requiring paid staff. (2) It requires trained knowledge: the rules of debit and credit, adjustments and final accounts cannot be handled correctly by an untrained person, and a wrongly applied rule produces wrong results with an appearance of accuracy. (3) It is not foolproof: the trial balance agrees even when certain errors exist — errors of omission (a transaction not recorded at all), errors of principle (capital expenditure treated as revenue), compensating errors, and complete reversal of entries — so agreement does not guarantee correctness. (4) It involves a large number of books and much clerical labour in a manual system, though computers have reduced this burden greatly. (5) It does not by itself prevent fraud: a determined and knowledgeable employee can still manipulate both sides of an entry, so internal checks and audits remain necessary. (6) It records only money transactions; important non-monetary facts such as staff skill, market reputation and managerial efficiency remain outside the books. These demerits are real, yet they are defects of cost and limits rather than of logic; for any business beyond the smallest scale, the merits overwhelmingly outweigh them, which is why double entry remains the standard system worldwide.

Conclusion

In conclusion, the double entry system records the dual aspect of every transaction by debiting one account and crediting another according to settled rules — debit the receiver and credit the giver for personal accounts, debit what comes in and credit what goes out for real accounts, and debit expenses and losses while crediting incomes and gains for nominal accounts. Its merits — completeness, arithmetical check, known profit, known financial position, fraud detection and legal acceptance — make it the scientific backbone of accounting, while its demerits — cost, need of trained staff and the survival of certain undetected errors — merely remind us that a system is only as honest and careful as the people who operate it.

Question 4

Q.4 Record the following transactions in the journal. (20) — Transactions of Mr. Muhammad Waqar, November 2025, as printed in the booklet.

Introduction

The journal is the book of original entry in which transactions are recorded in date order before they are posted to the ledger. Recording in the journal is called journalising, and each record is a journal entry consisting of the account debited, the account credited, the amount, and a short narration explaining the transaction. The entries below are prepared for the business of Mr. Muhammad Waqar for November 2025 exactly on the transactions printed in the booklet. Two working assumptions are stated openly so that the method can be followed: first, where the booklet says an asset or expense was “purchased” or “paid” without naming a person, the payment is treated as made in cash (this applies to the machinery purchased on 20th November and to the utility bills, rent and salaries); secondly, purchases from and sales to named persons (Miss Zara and Mr. Majid) are treated as credit transactions, because no cash is mentioned and

named personal accounts are involved. A student writing this answer by hand should state the same assumptions in a line under the journal.

Journal of Mr. Muhammad Waqar — November 2025

Date (2025)	Particulars	Debit (Rs.)	Credit (Rs.)
Nov. 1	Cash Account Dr. 25,000,000; Machinery Account Dr. 20,500,000 — To Capital Account 45,500,000 (Being business commenced by Mr. Muhammad Waqar with cash and machinery)	45,500,000	45,500,000
Nov. 3	Furniture Account Dr. — To Cash Account (Being furniture purchased for cash)	350,000	350,000
Nov. 5	Purchases Account Dr. — To Miss Zara Account (Being goods purchased on credit from Miss Zara)	175,000	175,000
Nov. 13	Mr. Majid Account Dr. — To Sales Account (Being goods sold on credit to Mr. Majid)	98,000	98,000
Nov. 15	Miss Zara Account Dr. — To Purchases Return Account (Being goods returned to Miss Zara)	5,000	5,000
Nov. 20	Machinery Account Dr. — To Cash Account (Being machinery purchased, paid in cash — see assumption note)	275,000	275,000
Nov. 22	Sales Return Account Dr. — To Mr. Majid Account (Being goods returned by Mr. Majid)	2,030	2,030
Nov. 25	Utility Bills (Expenses) Account Dr. — To Cash Account (Being utility bills paid in cash)	185,000	185,000
Nov. 26	Rent Account Dr. — To Cash Account (Being rent paid in cash)	80,000	80,000
Nov. 30	Salaries Account Dr. — To Cash Account (Being salaries paid in cash)	169,000	169,000

	TOTAL (both sides equal, as double entry requires)	46,839,030	46,839,030

Explanation of the Entries

The opening entry of 1st November is a compound entry: two assets come into the new business, so Cash Account (Rs. 25,000,000) and Machinery Account (Rs. 20,500,000) are both debited under the real account rule "debit what comes in", while the proprietor, being the giver, is credited through the Capital Account with the total investment of Rs. 45,500,000 under the personal account rule "credit the giver". On 3rd November furniture comes in and cash goes out, giving a simple exchange between two real accounts. The purchases of 5th November are on credit: Purchases Account is debited because goods (the stock-in-trade) come in, and Miss Zara, the giver, is credited. The sale of 13th November is the mirror image: Mr. Majid, the receiver, is debited and Sales Account is credited. Returns follow the original entries in reverse: goods returned to Miss Zara on 15th November debit her account (reducing what is owed to her) and credit Purchases Return Account; goods returned by Mr. Majid on 22nd November debit Sales Return Account and credit Majid, reducing his debt by Rs. 2,030, so that he finally owes Rs. 98,000 − Rs. 2,030 = Rs. 95,970, while the business finally owes Miss Zara Rs. 175,000 − Rs. 5,000 = Rs. 170,000. The additional machinery of 20th November is debited to Machinery Account as an asset coming in. The last three entries are payments of nominal accounts: utility bills, rent and salaries are all expenses, so each is debited under the rule "debit all expenses and losses", and Cash Account is credited as the asset going out.

Verification and What the Journal Shows

The journal verifies itself arithmetically: the debit column and the credit column both total Rs. 46,839,030, which must happen if every transaction has been recorded with equal debit and credit. Beyond arithmetic, the month's journal tells the financial story of the new business at a glance. Capital introduced was Rs. 45,500,000. Cash payments during the month were Rs.

350,000 (furniture) + Rs. 275,000 (machinery) + Rs. 185,000 (utility bills) + Rs. 80,000 (rent) + Rs. 169,000 (salaries) = Rs. 1,059,000, so the cash balance remaining at 30th November, after posting to the ledger, would be Rs. 25,000,000 − Rs. 1,059,000 = Rs. 23,941,000, assuming no other cash dealings. Fixed assets at cost stand at machinery Rs. 20,500,000 + Rs. 275,000 = Rs. 20,775,000 and furniture Rs. 350,000. Net purchases for the month are Rs. 175,000 − Rs. 5,000 = Rs. 170,000 and net sales are Rs. 98,000 − Rs. 2,030 = Rs. 95,970. These summaries are not part of the journal itself; they are shown here to demonstrate why the journal matters — once posted and balanced, its entries produce exactly these ledger balances, and from them the trial balance and final accounts of the cycle described in Question 1 are built. A common student error must be avoided: returns are never entered in the Purchases or Sales Accounts themselves but always in the separate Purchases Return and Sales Return Accounts, so that the proprietor can see the volume of returns distinctly.

A few points of journal technique visible in these entries should be noted by the student. The word “To” before the credited account and the abbreviation “Dr.” after the debited account are conventions of the journal format, and the narration in brackets is compulsory in good practice because an entry without its reason cannot be understood or verified later. The ledger folio column, omitted in this printed solution only because the ledger is written after the journal, must be filled in by hand once posting is done, so that every journal entry can be traced to its ledger account and every ledger entry back to its journal page. Finally, no entry has been made for any non-monetary event of the month, because the journal, like accounting itself, records only transactions measurable in money.

Conclusion

Thus all ten transactions printed in the booklet have been journalised for November 2025 using the rules of debit and credit explained in Question 3, with a narration for every entry and with the two sides agreeing at Rs. 46,839,030. The journal preserves the complete chronological record of the first month of Mr. Muhammad Waqar's business and provides the verified raw material for the ledger, the trial balance and the final accounts.

Question 5

Q.5 (A) Explain the following terms: (i) Profit and Loss Account; (ii) Direct & Indirect Expenses; (iii) Liabilities; (iv) Capital; (v) Income. (10) (B) Identify the correct and incorrect statements. (10)

Introduction

Part (A) of this question asks for the meaning of five terms that a student of accounting uses daily; each term is explained with its main features and a small example. Part (B) presents five statements and asks which are correct (Right) and which are incorrect (Wrong); each verdict is given with its reason, because in this subject a bare "R" or "W" without the reason earns little credit and teaches nothing.

Part A (i): Profit and Loss Account

The Profit and Loss Account is the financial statement prepared at the end of an accounting period to ascertain the net profit earned or the net loss suffered by a business during that period. It is the second part of the final accounts: it begins with the gross profit (or gross loss) brought down from the Trading Account, credits all indirect incomes and gains such as commission received, discount received and interest received, and debits all indirect expenses and losses such as rent, salaries, insurance, depreciation and interest paid. If the credit side is heavier, the excess is net profit, which is added to the proprietor's capital; if the debit side is heavier, the excess is

net loss, which is deducted from capital. For example, in Assignment No. 2 of this very booklet, Toor & Co. earns a gross profit of Rs. 295,560 and, after charging indirect expenses and adding commission income, a net profit of Rs. 44,060 is found through this account. The Profit and Loss Account is thus the period's performance report: it explains not merely whether the business gained or lost, but exactly which incomes and expenses produced that result.

Part A (ii): Direct and Indirect Expenses

Expenses are divided into direct and indirect according to their connection with the production or purchase of goods. Direct expenses are those incurred directly in bringing goods to a saleable condition and place: wages of factory workers, carriage inward, freight, octroi and customs duty on purchases, factory power and fuel, and royalty on production. They are debited to the Trading Account and form part of the cost of goods sold, so they directly affect the gross profit. Indirect expenses are those incurred in administering the business and selling and distributing the goods after production: office salaries, rent of office and shop, insurance, advertising, carriage outward, depreciation and interest. They are debited to the Profit and Loss Account and affect only the net profit. The distinction matters practically as well as for the accounts: a trader who confuses the two will misstate his gross profit and may fix a wrong selling price, because pricing decisions are normally based on direct cost, while control of overheads depends on watching the indirect expenses separately.

Part A (iii): Liabilities

Liabilities are the financial obligations of a business — the amounts it owes to outsiders and, in a wider presentation, the claims against its assets. Examples are creditors, bills payable, bank loans, bank overdraft, outstanding expenses and income received in advance. Liabilities are shown on the left-hand side of the Balance Sheet (in the traditional format) and are classified as

long-term liabilities, repayable after more than one year (for example a five-year loan), and current liabilities, repayable within one year (for example trade creditors and outstanding rent). In the accounting equation, Assets = Capital + Liabilities, the liabilities express the outsiders' claim, which ranks before the owner's claim: on the winding up of a business, outside liabilities must be paid first, and the proprietor receives only what remains. Recognising a liability does not require that cash has been received; outstanding insurance of Rs. 9,000 in the Toor & Co. question is a liability because the service has been taken and the amount is owed, even though it is unpaid at the balance sheet date.

Part A (iv): Capital

Capital is the amount contributed by the proprietor (or the shareholders, in a company) to start and run the business, together with the profits retained in it. From the business's point of view, capital is its liability towards the owner, because the business entity is treated as separate from the proprietor; that is why capital appears on the liabilities side of the Balance Sheet and why the proprietor is credited when he introduces cash or assets, as Mr. Muhammad Waqar was credited with Rs. 45,500,000 in Question 4. Capital increases by additional investment and by net profit, and decreases by drawings (cash or goods withdrawn for personal use) and by net loss. It is the owner's residual claim: Capital = Assets − Outside Liabilities. Capital must be distinguished from a loan: a loan carries fixed interest, must be repaid on a fixed date and gives the lender no ownership, whereas capital earns no fixed return, is repaid only on closure after all outsiders are paid, and carries the whole risk and reward of ownership.

Part A (v): Income

Income is the inflow of economic benefits during a period arising from the ordinary activities of a business, which increases capital (other than contributions by the owner). Its main forms are

revenue from sales of goods, fees for services rendered, commission, interest, rent and discount received. Income must be distinguished from receipts: every income is usually accompanied by a receipt of cash or a claim, but not every receipt is income — a bank loan received, or capital introduced by the owner, is a receipt but not income, because it creates a liability or represents ownership rather than an earning. Income is recognised on the accrual basis when it is earned, not merely when cash arrives; interest earned but not yet received is still income of the year, shown as accrued income. In the final accounts, incomes appear on the credit side of the Trading Account (sales) and of the Profit and Loss Account (indirect incomes), and their excess over expenses is precisely the profit of the period.

Part B: Correct and Incorrect Statements

(i) "It is a legal requirement to maintain accounting records for all business units." — INCORRECT (Wrong). Keeping proper accounts is compulsory by law for companies and for businesses registered under tax laws beyond prescribed limits, but there is no general law compelling every small sole proprietor or partnership to maintain formal accounting records in a prescribed form. Such traders keep accounts because it is necessary and beneficial, not because a statute compels every business unit to do so. The word "all" makes the statement false.

(ii) "There is no difference between accounting and bookkeeping." — INCORRECT (Wrong). As shown in Question 2, book-keeping is only the recording stage, whereas accounting additionally covers summarising, analysis, interpretation and communication. Book-keeping is a part of accounting, and the two terms are therefore not interchangeable.

(iii) "When the work of a bookkeeper ends, the work of an accountant starts." — CORRECT (Right). The book-keeper records transactions in the journal and ledger and balances the accounts; from that point the accountant takes over, preparing the trial balance, passing

adjustments, drawing up the final accounts and interpreting the results. The statement correctly expresses the sequence of the two functions.

(iv) "The duty of the accountant is just to record all the business transactions." — INCORRECT (Wrong). Mere recording is the duty of the book-keeper. The accountant's duties are wider: to summarise and finalise the accounts, analyse and interpret results, advise management, assist in taxation and help in designing the accounting system. The word "just" reduces his role to its smallest part and makes the statement false.

(v) "The basic principle of the double-entry system of bookkeeping is to record the transactions twice in different books." — INCORRECT (Wrong). Double entry does not mean writing the same transaction twice in different books. Its principle is the dual aspect: every transaction has two effects, so one account is debited and another is credited with an equal amount in the same set of books. Recording twice in different books would be mere duplication and would prove nothing; recording the two aspects is what makes total debits equal total credits and permits the trial balance check explained in Question 3.

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Conclusion

To conclude Part (A), the Profit and Loss Account measures net performance, direct and indirect expenses divide period costs between the Trading and Profit and Loss Accounts, liabilities are outsiders' claims, capital is the owner's claim increased by profit and reduced by drawings and loss, and income is the earned inflow that creates profit. In Part (B), only statement (iii) is correct; statements (i), (ii), (iv) and (v) are incorrect for the reasons given — a pattern worth remembering, because each wrong statement fails through one exaggerated word: "all", "no difference", "just", and "twice in different books".