

تمام کلاسز کی حل شدہ مشقیں MrPakistani.com ویب سائٹ سے فری ڈاؤن لوڈ کریں۔

Allama Iqbal Open University Solved Guess Paper (100% Work)	
Course Code:	1413/5418 Code
Course Name:	Financial Accounting
Class:	BA/ADC/B.Com/BS

گھر بیٹھے کتابیں اور خلاصے حاصل کرنے کے لیے رابطہ کریں واٹس ایپ نمبر: 03036940016

نوٹ: ہم طلبہ کے لیے جامع اور معیاری تعلیمی خدمات فراہم کرتے ہیں۔ ہماری خدمات میں علامہ اقبال اوپن یونیورسٹی کے حل شدہ اسائنمنٹس، گیس پیپرز، سابقہ پرچے، تازہ ملازمتوں کی معلومات، آن لائن سی وی تیار کرنا، ملازمت کے لیے درخواست دینا، یونیورسٹی داخلوں میں رہنمائی اور درخواست جمع کروانا شامل ہیں۔ اس کے علاوہ یونیورسٹی سے متعلق طلبہ کے ہر قسم کے تعلیمی اور رہنمائی کے کام میں مکمل تعاون فراہم کیا جاتا ہے تاکہ طلبہ کو ایک ہی جگہ پر تمام ضروری سہولیات میسر آسکیں۔



واٹس ایپ گروپ جوائن کرنے کے لیے سامنے دیے گئے لنک پر کلک کریں۔



واٹس ایپ چینل جوائن کرنے کے لیے سامنے دیے گئے لنک پر کلک کریں۔



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ان سوالوں کے علاوہ آپ کی موجودہ سمیسٹر کی اسائنمنٹس کے سوالات بھی اہم ہیں لہذا وہ بھی لازمی یاد کر لینا۔

Question 1: For each of the following separate cases, prepare adjusting entries required for the financial statements for the year ended on December 31, 2018. (Assume that prepaid expenses are initially recorded in asset accounts and that fees collected in advance of work are initially recorded as liabilities.)

(Note: The cases are taken from Practical Problem 2-1 on page 66 of the textbook "Financial Accounting (1413/5418)" by Muhammad Ashraf Bhutta.)

Answer:

The following adjusting journal entries are required on December 31, 2018, based on the data provided in Problem 2-1:

a) Interest on Bank Loan

The company borrowed Rs. 500,000 on November 1, 2018, at 18% per annum for 3 months.

Interest for November and December (2 months) has accrued.

Interest expense = Rs. 500,000 × 18% × 2/12 = Rs. 15,000.

Date	Particulars	Debit	Credit
2018 Dec 31	Interest Expense A/c	Rs. 15,000	
	Interest Payable A/c		Rs. 15,000
	(To accrue interest on bank loan)		

b) Prepaid Insurance

The company paid Rs. 136,000 for a two-year fire insurance policy starting October 1, 2018. The payment was recorded in Prepaid Insurance. At year-end, three months (October, November, December) have expired.

Insurance expense for 3 months = Rs. 136,000 × 3/24 = Rs. 17,000.

Date	Particulars	Debit	Credit
2018 Dec 31	Insurance Expense A/c	Rs. 17,000	
	Prepaid Insurance A/c		Rs. 17,000



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	(To record insurance expired)		
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c) Note Receivable

A note receivable of Rs. 600,000 dated September 1, 2018, is due in 6 months. No interest rate is mentioned; hence it is assumed to be non-interest bearing. No adjusting entry is required for interest. However, if the note were interest-bearing, an accrual would be necessary. In the absence of information, no entry is passed.

d) Unearned Rent Revenue

The company collected Rs. 27,000 on August 1, 2018, for rent of cafeteria space for six months. The amount was credited to Unearned Rent Revenue. By December 31, five months (August to December) have been earned.

Rent earned = Rs. 27,000 × 5/6 = Rs. 22,500.

Date	Particulars	Debit	Credit
2018 Dec 31	Unearned Rent Revenue A/c	Rs. 22,500	
	Rent Revenue A/c		Rs. 22,500
	(To record rent earned)		

These entries ensure that expenses and revenues are properly matched in accordance with the accrual basis of accounting as discussed in Unit 2 of the textbook.

Question 2: The following information is available for Sedona, Inc., as of May 31, 2018. Prepare a bank reconciliation for Sedona as of May 31, 2018, and pass the journal entries necessary to adjust the accounts.

(Note: The book "Financial Accounting (1413/5418)" does not contain a specific bank reconciliation problem. However, based on the principles of internal control and cash management discussed in Unit 3 (Accounting Information System), the following bank reconciliation format and adjusting entries are prepared using standard practice. The actual figures are assumed for illustration as they were not provided in the guess paper.)

Answer:

Bank Reconciliation Statement of Sedona, Inc. as of May 31, 2018

Particulars	Amount (Rs.)	Amount (Rs.)
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Balance per bank statement		XXX
Add: Deposits in transit	XXX	
Less: Outstanding checks	(XXX)	
Adjusted bank balance		XXX
Balance per books		XXX
Add: Bank collections (e.g., notes collected by bank)	XXX	
Interest earned	XXX	
Less: Bank service charges	(XXX)	
NSF checks	(XXX)	
Adjusted book balance		XXX

Journal Entries (based on adjustments):

1. To record bank collection of note receivable:

Date	Particulars	Debit	Credit
May 31	Cash A/c	XXX	
	Notes Receivable A/c		XXX
	Interest Revenue A/c		XXX

2. To record bank service charges:

Date	Particulars	Debit	Credit
May 31	Bank Service Charges Expense A/c	XXX	
	Cash A/c		XXX

3. To record NSF check returned:

Date	Particulars	Debit	Credit
May 31	Accounts Receivable A/c	XXX	
	Cash A/c		XXX



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(Note: The actual figures depend on the missing data. The above is a standard template based on accounting principles.)

Question 3: On April 1, 2018, Angel Corporation issued Rs. 8,000,000 12 percent, five-year bonds at 98. The semiannual interest payment dates are April 1 and October 1. Prepare journal entries to record the issue of the bonds by Angel on April 1, 2018, and the first two interest payments on October 1, 2018, and April 1, 2019. Use the straight-line method and ignore year-end accruals.

Answer:

Given:

- Par value of bonds = Rs. 8,000,000
- Issue price = 98% of par = Rs. 8,000,000 × 0.98 = Rs. 7,840,000
- Discount = Rs. 8,000,000 – Rs. 7,840,000 = Rs. 160,000
- Contract rate = 12% per annum, payable semiannually on April 1 and October 1.
- Life = 5 years, so number of semiannual periods = 5 × 2 = 10.
- Straight-line amortization of discount per period = Rs. 160,000 / 10 = Rs. 16,000.

Journal Entries:

1. Issuance of bonds on April 1, 2018:

Date	Particulars	Debit	Credit
2018 Apr 1	Cash A/c	Rs. 7,840,000	
	Discount on Bonds Payable A/c	Rs. 160,000	
	Bonds Payable A/c		Rs. 8,000,000
	(To record issuance of 12% bonds at 98)		

2. First interest payment on October 1, 2018:

Semiannual interest payment = Rs. 8,000,000 × 12% × 6/12 = Rs. 480,000.

Add amortization of discount: Rs. 16,000.

Total interest expense = Rs. 480,000 + Rs. 16,000 = Rs. 496,000.

Date	Particulars	Debit	Credit
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2018 Oct 1	Interest Expense A/c	Rs. 496,000	
	Discount on Bonds Payable A/c		Rs. 16,000
	Cash A/c		Rs. 480,000
	(To record semiannual interest and discount amortization)		

3. Second interest payment on April 1, 2019:

Same as above.

Date	Particulars	Debit	Credit
2019 Apr 1	Interest Expense A/c	Rs. 496,000	
	Discount on Bonds Payable A/c		Rs. 16,000
	Cash A/c		Rs. 480,000
	(To record semiannual interest and discount amortization)		

(Reference: This treatment follows the straight-line method for bond discount as illustrated in Demonstration Problem 7.02 of Unit 7, page 206.)

Question 4: Shah Garden Center is a retail garden supplier. Record the transactions needed to journalize, post to respective ledger accounts, and prepare a Trial Balance for October 2019:

Transactions:

- Oct. 2: Purchased inventory on credit terms of 1/10 net 30 FOB shipping point for Rs. 3,000. Freight charges were Rs. 150.
- Oct. 9: Sold garden supplies on credit terms 3/20 net 30 FOB shipping point for Rs. 4,000. The cost of supplies sold was Rs. 2,500.
- Oct. 10: Paid the amount owed on account for the Oct. 2 purchase.
- Oct. 15: Received defective merchandise returned (originally sold for Rs. 500 on Oct. 9). The original cost was Rs. 275.
- Oct. 25: Received payment for the Oct. 9 sale, less the sales discount.
- Oct. 28: Inventory lost by fire (cost: Rs. 350).

Answer:

Journal Entries (Perpetual Inventory System)

Date	Particulars	Debit (Rs.)	Credit (Rs.)
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Oct 2	Inventory A/c	3,000	
	Accounts Payable A/c		3,000
	(To record purchase on credit)		
Oct 2	Inventory A/c	150	
	Cash A/c		150
	(To record freight charges)		
Oct 9	Accounts Receivable A/c	4,000	
	Sales A/c		4,000
	(To record credit sale)		
Oct 9	Cost of Goods Sold A/c	2,500	
	Inventory A/c		2,500
	(To record cost of goods sold)		
Oct 10	Accounts Payable A/c	3,000	
	Cash A/c		2,970
	Inventory A/c		30
	(To record payment within discount period; discount 1% of 3,000 = 30)		
Oct 15	Sales Returns and Allowances A/c	500	
	Accounts Receivable A/c		500
	(To record return of defective goods)		
Oct 15	Inventory A/c	275	
	Cost of Goods Sold A/c		275
	(To restore cost of returned goods)		
Oct 25	Cash A/c	3,395	
	Sales Discounts A/c	105	
	Accounts Receivable A/c		3,500
	(To record collection within discount period: original sale 4,000 less return 500 = 3,500; discount 3% of 3,500 = 105; cash received = 3,395)		
Oct 28	Loss from Fire A/c	350	
	Inventory A/c		350



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(To record inventory lost in fire)		
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Ledger Accounts (T-accounts)

Cash Account

Debit	Credit
Oct 25: 3,395	Oct 2: 150
	Oct 10: 2,970
Balance c/d: 275	
Total: 3,395	Total: 3,395

Accounts Receivable

Debit	Credit
Oct 9: 4,000	Oct 15: 500
	Oct 25: 3,500
Balance: 0	
Total: 4,000	Total: 4,000

Inventory

Debit	Credit
Oct 2: 3,000	Oct 9: 2,500
Oct 2: 150	Oct 10: 30
Oct 15: 275	Oct 28: 350
Balance c/d: 545	
Total: 3,425	Total: 3,425

Accounts Payable

Debit	Credit
Oct 10: 3,000	Oct 2: 3,000
Balance: 0	
Total: 3,000	Total: 3,000

Sales



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Debit	Credit
	Oct 9: 4,000
Balance: 0	Total: 4,000

Cost of Goods Sold

Debit	Credit
Oct 9: 2,500	Oct 15: 275
Balance c/d: 2,225	
Total: 2,500	Total: 2,500

Sales Returns

Debit	Credit
Oct 15: 500	
Balance c/d: 500	
Total: 500	Total: 500

Sales Discounts

Debit	Credit
Oct 25: 105	
Balance c/d: 105	
Total: 105	Total: 105

Loss from Fire

Debit	Credit
Oct 28: 350	
Balance c/d: 350	
Total: 350	Total: 350



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Trial Balance of Shah Garden Center as at October 31, 2019

Account Title	Debit (Rs.)	Credit (Rs.)
Cash	275	
Inventory	545	
Accounts Receivable	0	
Accounts Payable		0
Sales		4,000
Cost of Goods Sold	2,225	
Sales Returns	500	
Sales Discounts	105	
Loss from Fire	350	
Total	4,000	4,000

The trial balance totals are equal.

(Note: The above solution uses the perpetual inventory system as implied by the transactions. The book covers both periodic and perpetual; the choice is consistent with modern practice.)

Question 5: Define cash and cash equivalents and explain how to report them. Also, describe the use of documentation and verification to control cash disbursements.

Answer:

Definition of Cash and Cash Equivalents:

According to the textbook "Financial Accounting (1413/5418)" (Unit 8, page 218 and Unit 4, page 111), cash includes currency, coins, and amounts on deposit in bank accounts, cheques, and money orders. Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value. Examples include treasury bills, commercial paper, and money market funds. Typically, investments with original maturities of three months or less are considered cash equivalents.

Reporting of Cash and Cash Equivalents:

In the balance sheet, cash and cash equivalents are reported as the first item under current assets. They are presented at their face value. Any restrictions on cash (e.g., compensating balances)



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should be disclosed in the notes. The statement of cash flows (Unit 8) provides a detailed reconciliation of cash balances from operating, investing, and financing activities.

Control of Cash Disbursements:

The textbook in Unit 3 (Accounting Information System) emphasizes internal control principles, including the control of cash disbursements. Key procedures include:

1. **Use of Documentation:** All cash disbursements should be supported by proper documents such as purchase orders, receiving reports, supplier invoices, and approved payment vouchers. These documents provide evidence that the transaction is legitimate and authorized.
2. **Verification:** Before payment, the documents should be verified for accuracy, including mathematical checks, matching quantities, and ensuring that goods or services were received. This verification is typically done by a responsible person independent of the purchasing and receiving functions.
3. **Authorization:** Payments should be authorized by a designated official after verification. Cheques should be signed by authorized signatories, and supporting documents should be cancelled (e.g., stamped "paid") to prevent reuse.
4. **Segregation of Duties:** The duties of approving payments, signing cheques, and recording transactions should be separated among different employees to reduce the risk of fraud.
5. **Use of Cheques:** Payments should be made by pre-numbered cheques to create a permanent record. Bank reconciliations (as discussed in Unit 3) are performed regularly to verify the accuracy of cash records.

Question 6: On July 1, 2018, Ali Corporation, a new corporation, issued 50,000 shares of its common stock to finance a corporate headquarters building. The building has a fair market value of Rs. 1.5 million and a book value of Rs. 1 million. Because Ali is a new corporation, it is not possible to establish a market value for its common stock. Prepare journal entries to record the issuance of stock for the building.

Answer:

According to the textbook (Unit 5, page 149, section 5.3.6 "Issuing Stock for Non-cash Assets"), when common stocks are issued by a joint stock company in exchange for assets other than cash, such as land, building, and equipment, the assets so received should be recorded at their fair market value. Determination of the fair market value of the assets acquired is the responsibility of the Board of Directors of the Company. If shares are also being issued for cash at about the same time, the cash price of the shares may provide an indication of the proper valuation of the assets acquired. However, in this case, since Ali is a new corporation and no market value for its stock is



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available, the fair market value of the building (Rs. 1.5 million) is used as the basis for recording the transaction.

1. When the par value of the stock is Rs. 10 per share:

Number of shares issued = 50,000

Par value per share = Rs. 10

Total par value = 50,000 × Rs. 10 = Rs. 500,000

Fair market value of building = Rs. 1,500,000

Premium on common stock = Rs. 1,500,000 – Rs. 500,000 = Rs. 1,000,000

Date	Particulars	Debit	Credit
2018 July 1	Building A/c	Rs. 1,500,000	
	Common Stock Capital A/c		Rs. 500,000
	Premium on Common Stock A/c		Rs. 1,000,000
	(To record issuance of 50,000 shares of Rs. 10 par value for building)		

2. When the stock is no-par stock:

For no-par stock, the entire proceeds received on sale are credited to the common stock capital without recognition of any discount or premium (Unit 5, page 148, section 5.3.4).

Date	Particulars	Debit	Credit
2018 July 1	Building A/c	Rs. 1,500,000	
	Common Stock (No-Par Value) A/c		Rs. 1,500,000
	(To record issuance of 50,000 no-par shares for building)		

3. When the stock has a stated value of Rs. 5 per share:

For stated value stock, the stated value becomes legal capital which is credited to the stated value Stock Account. Any excess over stated value is credited to Paid-in Capital in Excess of Stated Value (Unit 5, page 148, section 5.3.5).

Stated value per share = Rs. 5

Total stated value = 50,000 × Rs. 5 = Rs. 250,000

Excess over stated value = Rs. 1,500,000 – Rs. 250,000 = Rs. 1,250,000



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Date	Particulars	Debit	Credit
2018 July 1	Building A/c	Rs. 1,500,000	
	Common Stock (Rs. 5 Stated Value) A/c		Rs. 250,000
	Paid-in Capital in Excess of Stated Value A/c		Rs. 1,250,000
	(To record issuance of 50,000 stated value shares for building)		

Question 7: Times Printing owned a piece of equipment that cost Rs. 36,400 and had accumulated depreciation of Rs. 18,000. The company disposed of the equipment on January 2 (the first day of the current year).

- a. Calculate the carrying value of the equipment.**
b. Calculate the gain or loss on disposal under these assumptions:
i. The equipment was discarded as having no value.
ii. The equipment was sold for Rs. 6,000 cash.
iii. The equipment was sold for Rs. 20,000 cash.

Answer:

a. Calculation of Carrying Value:

Carrying value (also called book value) is the cost of the asset less accumulated depreciation.

Particulars	Amount (Rs.)
Original cost of equipment	Rs. 36,400
Less: Accumulated depreciation	Rs. 18,000
Carrying value (book value)	Rs. 18,400

b. Calculation of Gain or Loss on Disposal:

i. When the equipment was discarded as having no value:

When an asset is discarded, if it has no market value, the loss is equal to the carrying value.

Particulars	Amount (Rs.)
Carrying value of equipment	Rs. 18,400



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Less: Sale proceeds (nil)	Rs. 0
Loss on disposal	Rs. 18,400

Journal Entry:

Date	Particulars	Debit	Credit
Jan 2	Accumulated Depreciation A/c	Rs. 18,000	
	Loss on Disposal of Equipment A/c	Rs. 18,400	
	Equipment A/c		Rs. 36,400
	(To record discarding of equipment with no value)		

ii. When the equipment was sold for Rs. 6,000 cash:

Particulars	Amount (Rs.)
Carrying value of equipment	Rs. 18,400
Less: Sale proceeds	Rs. 6,000
Loss on disposal	Rs. 12,400

Journal Entry:

Date	Particulars	Debit	Credit
Jan 2	Cash A/c	Rs. 6,000	
	Accumulated Depreciation A/c	Rs. 18,000	
	Loss on Disposal of Equipment A/c	Rs. 12,400	
	Equipment A/c		Rs. 36,400
	(To record sale of equipment at a loss)		

iii. When the equipment was sold for Rs. 20,000 cash:



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Particulars	Amount (Rs.)
Sale proceeds	Rs. 20,000
Less: Carrying value of equipment	Rs. 18,400
Gain on disposal	Rs. 1,600

Journal Entry:

Date	Particulars	Debit	Credit
Jan 2	Cash A/c	Rs. 20,000	
	Accumulated Depreciation A/c	Rs. 18,000	
	Equipment A/c		Rs. 36,400
	Gain on Disposal of Equipment A/c		Rs. 1,600
	(To record sale of equipment at a gain)		

(Note: The concept of depreciation and disposal of fixed assets is covered in Unit 2 under adjusting entries and in Unit 7 under long-term liabilities. The above treatment follows the standard accounting principles discussed throughout the book.)

Question 8: Define and describe revenue, expenses, assets, liabilities, and equity in detail.

Answer:

According to Unit 1 of the textbook "Financial Accounting (1413/5418)" (pages 16-17), accounts are classified broadly into five major categories. These five elements are the building blocks of financial accounting.

1. Assets:

Assets are the economic resources held by the organization which facilitate the conduct of business activities (Glossary, page 39). They represent tangible and intangible items used for the conduct of business. Assets are expected to provide future economic benefits to the enterprise.

Examples include cash, accounts receivable, inventories, building, plant and machinery, furniture, vehicles, and goodwill.



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Assets are recorded at cost and are presented on the left side of the accounting equation: $Assets = Liabilities + Equity$.

2. Liabilities:

Liabilities represent obligations of the enterprise and claims of the creditors against assets of the organization (Unit 1, page 16). They are amounts owed to outsiders—debts that must be paid in the future.

Examples include accounts payable, notes payable, salaries payable, unearned revenues, bonds payable, and debentures payable.

Liabilities are presented on the right side of the accounting equation and are classified as current (due within one year) or long-term.

3. Equity:

Equity accounts denote claims of the owners for investments made by them and the accumulated profits retained by the organization (Unit 1, page 16). It is the residual interest in the assets of the entity after deducting all liabilities.

Equity is increased by owner investments and revenues and decreased by expenses and owner withdrawals (drawings). In corporations, equity includes common stock, preferred stock, premium on stock, reserves, and retained earnings.

The accounting equation expresses this relationship as: $Assets - Liabilities = Equity$.

4. Revenues:

Revenue accounts represent the inflow of resources generated by the organization through sale of merchandise, professional fee earned, rental income, interest income, and commission income (Unit 1, page 16). Revenues increase owner's equity.

Revenues are recorded in accordance with the realization concept, which states that revenues should be recognized at the time when goods are sold or services are rendered, regardless of when cash is received.

5. Expenses:

Expense accounts are the outflow of resources of the organization in order to generate revenues (Unit 1, page 16). Expenses comprise cost of merchandise sold, salaries, utilities, rent, advertising, office supplies used, insurance, and depreciation expenses of assets.



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The matching concept requires that expenses be offset against revenues in the period in which they are incurred to help generate those revenues.

Relationship among the Five Elements:

These five elements are interconnected through the accounting equation and the double-entry system:

- Assets = Liabilities + Equity
- Revenues increase equity; expenses decrease equity.
- Every transaction affects at least two accounts, maintaining the equality of the accounting equation.

Question 9: Zahid started a computer programming business, Zahid's Programming Service. Pass entries in the General Journal, post them into the ledger, and prepare a Trial Balance for the following May transactions:

May 2: Zahid invested Rs. 15,000.

May 5: Purchased a computer for Rs. 6,000 cash.

May 7: Purchased supplies on credit for Rs. 1,600.

May 19: Received cash for programming services performed, Rs. 2,000.

May 22: Received cash for programming services to be performed, Rs. 1,800.

May 25: Paid rent for May, Rs. 1,200.

May 31: Billed a customer for services performed, Rs. 600.

Answer:

General Journal of Zahid's Programming Service

Date	Particulars	L/F	Debit (Rs.)	Credit (Rs.)
May 2	Cash A/c		15,000	
	Zahid's Capital A/c			15,000
	(To record investment by owner)			
May 5	Computer Equipment A/c		6,000	
	Cash A/c			6,000
	(To record purchase of computer for cash)			
May 7	Supplies A/c		1,600	
	Accounts Payable A/c			1,600
	(To record purchase of supplies on credit)			



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May 19	Cash A/c		2,000	
	Programming Service Revenue A/c			2,000
	(To record cash received for services performed)			
May 22	Cash A/c		1,800	
	Unearned Programming Revenue A/c			1,800
	(To record cash received for services to be performed in future)			
May 25	Rent Expense A/c		1,200	
	Cash A/c			1,200
	(To record payment of May rent)			
May 31	Accounts Receivable A/c		600	
	Programming Service Revenue A/c			600
	(To record services performed on credit)			

Ledger Accounts (T-format)

Cash Account

Date	Particulars	Amount	Date	Particulars	Amount
May 2	Capital A/c	15,000	May 5	Computer A/c	6,000
May 19	Revenue A/c	2,000	May 25	Rent A/c	1,200
May 22	Unearned Revenue A/c	1,800	May 31	Balance c/d	11,600
Total		18,800	Total		18,800

Zahid's Capital Account

Date	Particulars	Amount	Date	Particulars	Amount
May 31	Balance c/d	15,000	May 2	Cash A/c	15,000



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Total		15,000	Total		15,000
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Computer Equipment Account

Date	Particulars	Amount	Date	Particulars	Amount
May 5	Cash A/c	6,000	May 31	Balance c/d	6,000
Total		6,000	Total		6,000

Supplies Account

Date	Particulars	Amount	Date	Particulars	Amount
May 7	Accounts Payable A/c	1,600	May 31	Balance c/d	1,600
Total		1,600	Total		1,600

Accounts Payable Account

Date	Particulars	Amount	Date	Particulars	Amount
May 31	Balance c/d	1,600	May 7	Supplies A/c	1,600
Total		1,600	Total		1,600

Programming Service Revenue Account

Date	Particulars	Amount	Date	Particulars	Amount
May 31	Balance c/d	2,600	May 19	Cash A/c	2,000
			May 31	Accounts Receivable A/c	600
Total		2,600	Total		2,600

Unearned Programming Revenue Account



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Date	Particulars	Amount	Date	Particulars	Amount
May 31	Balance c/d	1,800	May 22	Cash A/c	1,800
Total		1,800	Total		1,800

Rent Expense Account

Date	Particulars	Amount	Date	Particulars	Amount
May 25	Cash A/c	1,200	May 31	Balance c/d	1,200
Total		1,200	Total		1,200

Accounts Receivable Account

Date	Particulars	Amount	Date	Particulars	Amount
May 31	Revenue A/c	600	May 31	Balance c/d	600
Total		600	Total		600

Trial Balance of Zahid's Programming Service as at May 31, 2019

Account Title	Debit (Rs.)	Credit (Rs.)
Cash	11,600	
Accounts Receivable	600	
Supplies	1,600	
Computer Equipment	6,000	
Accounts Payable		1,600
Unearned Programming Revenue		1,800
Zahid's Capital		15,000
Programming Service Revenue		2,600
Rent Expense	1,200	
Total	21,000	21,000



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Question 10: Prepare year-end adjusting entries for the following and show the impact on financial statements:

a. Accrued interest income on corporate bonds is Rs. 16,700.

b. Office Supplies had a balance of Rs. 15,000 on January 1. Purchases during the year were Rs. 12,830. A year-end inventory shows supplies of Rs. 15,700 on hand.

c. Depreciation of office equipment is estimated at Rs. 15,260 for the year.

d. Unearned Revenue has a balance of Rs. 12,800. Services worth Rs. 7,600 received in advance have now been performed.

e. Property taxes for six months (estimated at Rs. 12,750) have accrued but not been recorded.

Answer:

According to Unit 2 of the textbook (pages 36-40), adjusting entries are necessary for prepaid expenses, accrued expenses, unearned revenues, and accrued revenues. The following adjusting entries are prepared:

a. Accrued Interest Income

This is an accrued revenue—revenue that has been earned but neither received in cash nor recorded in the accounts (Unit 2, page 40).

Date	Particulars	Debit	Credit
Dec 31	Interest Receivable A/c	Rs. 16,700	
	Interest Income A/c		Rs. 16,700
	(To record accrued interest income on bonds)		

Impact on Financial Statements:

- Income Statement: Interest Income increases by Rs. 16,700, which increases net income.
- Balance Sheet: Interest Receivable (an asset) increases by Rs. 16,700, and Retained Earnings (through net income) increases.

b. Office Supplies

This involves adjusting for supplies used during the period (Unit 2, page 38, Prepaid Expenses).

Particulars	Amount (Rs.)
Beginning supplies (Jan 1)	Rs. 15,000



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Add: Purchases during the year			Rs. 12,830
Total supplies available			Rs. 27,830
Less: Ending supplies on hand			Rs. 15,700
Supplies used (expense)			Rs. 12,130
Date	Particulars	Debit	Credit
Dec 31	Supplies Expense A/c	Rs. 12,130	
	Office Supplies A/c		Rs. 12,130
	(To record supplies used during the year)		

Impact on Financial Statements:

- Income Statement: Supplies Expense increases by Rs. 12,130, which decreases net income.
- Balance Sheet: Office Supplies (asset) decreases by Rs. 12,130 to its correct ending balance of Rs. 15,700.

c. Depreciation of Office Equipment

Depreciation is the allocation of the cost of a fixed asset over its useful life (Unit 2, page 38).

Date	Particulars	Debit	Credit
Dec 31	Depreciation Expense A/c	Rs. 15,260	
	Accumulated Depreciation—Office Equipment A/c		Rs. 15,260
	(To record annual depreciation)		

Impact on Financial Statements:

- Income Statement: Depreciation Expense increases by Rs. 15,260, which decreases net income.
- Balance Sheet: Accumulated Depreciation (a contra-asset) increases by Rs. 15,260, which reduces the carrying value (book value) of office equipment.

d. Unearned Revenue

Unearned revenue refers to cash received in advance with an obligation to provide services later (Unit 2, page 39). Services worth Rs. 7,600 have now been performed.

Date	Particulars	Debit	Credit
Dec 31	Unearned Revenue A/c	Rs. 7,600	
	Service Revenue A/c		Rs. 7,600
	(To record revenue earned from amounts received in advance)		



Impact on Financial Statements:

- Income Statement: Service Revenue increases by Rs. 7,600, which increases net income.
- Balance Sheet: Unearned Revenue (a liability) decreases by Rs. 7,600 to its correct ending balance of Rs. 5,200 (Rs. 12,800 – Rs. 7,600).

e. Accrued Property Taxes

This is an accrued expense—expenses that have been incurred but not yet paid or recorded (Unit 2, page 38).

Date	Particulars	Debit	Credit
Dec 31	Property Tax Expense A/c	Rs. 12,750	
	Property Taxes Payable A/c		Rs. 12,750
	(To record accrued property taxes)		

Impact on Financial Statements:

- Income Statement: Property Tax Expense increases by Rs. 12,750, which decreases net income.
- Balance Sheet: Property Taxes Payable (a liability) increases by Rs. 12,750.

Question 11: What do you know about a Cash Flow Statement? Describe its objectives, significance, and major sections.

Answer:

According to Unit 8 of the textbook "Financial Accounting (1413/5418)" (pages 217-222), the Cash Flow Statement is an essential and integral part of the composition of the financial statements of all business enterprises constituted under Companies Act, 2017.

Definition:

A Cash Flow Statement is a statement which presents the flow of cash in a business enterprise. It shows the sources of cash inflows and cash outflows during an accounting period. According to International Accounting Standard-7 (IAS-7), the cash flow statement is mandatory for all business organizations and provides a reconciliation between the net income reported under the accrual basis of accounting and the actual cash balance.

Objectives of Cash Flow Statement:



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The textbook outlines the following objectives (page 218):

1. To provide information about the cash receipts (inflows) and cash disbursements (outflows) during an accounting period.
2. To explain why the net income as reported in the income statement (prepared under accrual basis) differs from the cash balance as reported in the balance sheet.
3. To show how much cash was collected from different sources during the period.
4. To indicate how much cash was disbursed on different heads of accounts during the period.
5. To disclose the amount of tax and dividends paid during the period.
6. To identify the non-cash items which were adjusted in the net income.

Significance and Importance of Cash Flow Statement:

The textbook emphasizes that cash is the life blood of a business (page 218). Understanding the flow of cash is specifically important to having a handle on the pulse of the enterprise. The significance includes:

1. **For Management:** The management may use the statement of cash flows to determine dividend policy, cash generated from operations, and investing and financing activities to develop different business policies.
2. **For Creditors and Investors:** Outsiders such as creditors and investors may use it to determine the company's ability to increase dividends, its capacity to pay debt with cash flow from operations, and the percentage of cash flow from operations in relation to cash from financing sources.
3. **For Decision Making:** The information about cash flows can influence decision making in important ways. It is usually considered better to finance expansion from funds generated from business operations rather than taking loans.
4. **For Reconciliation:** The cash flow statement reconciles the closing cash balance with the reported profit, satisfying management and external users that the profit amount is correct and cash has not been embezzled.

Major Sections of Cash Flow Statement:

According to the textbook (pages 220-222 and 224-226), the cash flow statement is divided into three major sections:

A. Cash Flow from Operating Activities:

This section includes cash inflows and outflows from the primary revenue-generating activities of the business.

Cash Inflows:



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- Cash sales or cash collected from rendering services
- Cash collection from accounts receivables/credit sales
- Cash received from disposal of marketable securities
- Cash received from royalties, fees, commission, and other revenues
- Cash collected from rentals
- Advances from customers and clients

Cash Outflows:

- Cash paid for purchase of merchandise
- Cash paid for operating expenses
- Payment of salaries and wages
- Cash paid for taxes and penalties
- Payment of interest on loans
- Cash paid against accounts payable

B. Cash Flow from Investing Activities:

This section includes cash inflows and outflows from the purchase and sale of long-term assets and investments.

Cash Inflows:

- From sale/disposal of property, plant, and equipment
- From sale of intangible assets
- From collection of long-term notes receivables
- From disposal of long-term investments

Cash Outflows:

- Cash paid for purchase of property, plant, and equipment
- Cash paid for purchase of intangible assets
- Cash paid for purchase of long-term investments
- Cash payment for future contracts and options

C. Cash Flow from Financing Activities:

This section includes cash inflows and outflows from transactions with owners and creditors.

Cash Inflows:

- From issuance of common and preferred stocks
- From issuance of short and long-term notes payables



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- From issuance of bonds and debentures
- From sale of treasury stocks

Cash Outflows:

- For purchase of treasury stocks
- For redemption of bonds and debentures
- For payment against short and long-term notes payables
- For payment of dividends

The net result of these three sections, when added to the opening cash balance, gives the closing cash balance which must match the cash balance shown in the balance sheet (page 227).

Question 12: Raja Industries Ltd was established with an authorized capital of 50,000 common shares of Rs. 100 each. The company issued 30,000 shares at Rs. 140 each. Later, it purchased 5,000 shares at Rs. 150 each from the market. Revenue reserves and retained earnings amounted to Rs. 800,000 and Rs. 1,000,000, respectively.

Required: A. Pass entries for the acquisition of treasury stock. B. Present the equity section of the balance sheet.

Answer:

A. Journal Entries for Acquisition of Treasury Stock:

According to Unit 6 of the textbook (page 169, section 6.2.1 Cost Method), when treasury stock is purchased, it reduces the equity balance and cash balance simultaneously. Under the cost method, the total cost paid for acquisition is charged to the Treasury Stock Account.

Number of shares purchased = 5,000

Purchase price per share = Rs. 150

Total cost = 5,000 × Rs. 150 = Rs. 750,000

Date	Particulars	Debit	Credit
	Treasury Stock A/c	Rs. 750,000	
	Bank A/c		Rs. 750,000
	(To record purchase of 5,000 own shares at Rs. 150 each from market)		



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B. Equity Section of the Balance Sheet:

First, we need to determine the components of equity before and after the treasury stock purchase.

Before Treasury Stock Purchase:

Particulars	Amount (Rs.)
Common Stock (30,000 shares × Rs. 100 par)	Rs. 3,000,000
Premium on Common Stock (30,000 shares × Rs. 40 premium)	Rs. 1,200,000
Revenue Reserves	Rs. 800,000
Retained Earnings	Rs. 1,000,000
Total Stockholders' Equity	Rs. 6,000,000

Note: Premium per share = Rs. 140 – Rs. 100 = Rs. 40

After Treasury Stock Purchase:

Following the cost method presentation as shown in the textbook (page 169), the treasury stock is shown as a deduction from total equity.

Raja Industries Ltd Balance Sheet (Partial) - Equity Section As at ...

Particulars	Amount (Rs.)
Stockholders' Equity	
Common Stock (50,000 shares of Rs. 100 each authorized, 30,000 shares issued and subscribed)	Rs. 3,000,000
Premium on Common Stock	Rs. 1,200,000
Revenue Reserves	Rs. 800,000
Retained Earnings	Rs. 1,000,000
Subtotal	Rs. 6,000,000
Less: Cost of Treasury Stock (5,000 shares)	(Rs. 750,000)



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Total Stockholders' Equity	Rs. 5,250,000
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Note: The textbook explains (page 170) that the purchase of treasury stock reduces the overall equity by the cost of treasury stock, and the cash balance is also simultaneously reduced by this amount. The presentation above follows the cost method illustrated in the book.

Question 13: Comparative income statements for two years of Decent Trading Company are provided.

Required: a. Perform horizontal analysis. b. Analyze and interpret the changes.

(Note: The income statement figures are taken from the problem statement in the guess paper, which appears to be P.9-1 from the textbook, page 270.)

Answer:

**Decent Trading Company
Comparative Income Statement
For the Years Ended ...
(Amounts in Rs.)**

Particulars	Year A	Year B	Change (Rs.)	Change (%)
Net Sales	780,000	955,000	175,000	22.44%
Less: Cost of Goods Sold	540,000	630,000	90,000	16.67%
Gross Income	220,000	325,000	105,000	47.73%
Less: Operating Expenses:				
Selling & Marketing	70,500	80,200	9,700	13.76%
Administration	40,300	45,000	4,700	11.66%
Operating Income	109,200	199,800	90,600	82.97%
Interest Expenses	200	300	100	50.00%
Net Income Before Tax	109,000	199,500	90,500	83.03%
Income Tax	33,000	58,000	25,000	75.76%
Net Income After Tax	76,000	141,500	65,500	86.18%



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Workings for Horizontal Analysis:

According to the textbook (Unit 9, page 246), horizontal analysis involves comparing figures of the current year with the base year. The change in amount is calculated by deducting the base year amount from the analysis year amount. The percentage change is computed by dividing the change amount by the base year amount multiplied by 100.

For example:

- Sales Change % = $(955,000 - 780,000) / 780,000 \times 100 = 175,000 / 780,000 \times 100 = 22.44\%$
- Cost of Goods Sold Change % = $(630,000 - 540,000) / 540,000 \times 100 = 90,000 / 540,000 \times 100 = 16.67\%$

Analysis and Interpretation:

Based on the horizontal analysis above, the following observations can be made:

1. **Sales Growth:** Net sales increased by 22.44% (Rs. 175,000) in Year B compared to Year A, indicating business expansion and successful marketing efforts.
2. **Cost Control:** The cost of goods sold increased by only 16.67%, which is less than the sales increase. This demonstrates effective cost control by management, resulting in a higher gross profit margin.
3. **Gross Profit Performance:** Gross income increased by 47.73% (Rs. 105,000), which is significantly higher than the sales increase. This indicates improved efficiency in purchasing and inventory management.
4. **Operating Expenses Control:** Selling and marketing expenses increased by only 13.76%, and administrative expenses by 11.66%, both lower than the sales increase percentage. This shows disciplined expense management.
5. **Operating Income Growth:** Operating income increased by an impressive 82.97% (Rs. 90,600), reflecting the combined effect of higher gross profit and controlled operating expenses.
6. **Net Income Performance:** Net income after tax increased by 86.18% (Rs. 65,500), which is the highest increase among all items. This indicates exceptional overall performance and profitability.
7. **Tax Impact:** Income tax increased by 75.76%, which is proportionate to the increase in pre-tax income, indicating consistent tax planning.

Conclusion: The company has demonstrated excellent performance in Year B compared to Year A. All profitability indicators show significant improvement, and management has successfully controlled costs relative to sales growth. This positive trend suggests strong operational efficiency and effective management decisions.

Question 14: How do accounts receivable differ from notes receivable? Explain. What are the sources for quickly collecting funds from accounts receivable?



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Answer:

According to Unit 4 of the textbook (pages 100-101 and 103-104), accounts receivable and notes receivable are both originated from credit sales but differ in several important aspects.

Differences between Accounts Receivable and Notes Receivable:

Basis of Difference	Accounts Receivable	Notes Receivable
Definition	Amounts due from customers on account of goods or services supplied on credit basis, usually without any formal written promise (Glossary, page 136).	Written evidence supported by the Negotiable Instruments Act, 1881, regarding due amount for goods or services, which is receivable within a specific period with or without interest (Glossary, page 136).
Legal Form	Open account with no formal written promise; based on the customer's proven track record of credit worthiness (page 100).	Formal instrument of credit called a promissory note which is secured by the Negotiable Instruments Act (page 101).
Evidence of Debt	No written acknowledgment of debt beyond the invoice.	The credit customer acknowledges the debt in writing and agrees to pay according to specified terms (page 101).
Legal Claim	Weaker legal claim in the event of court action.	Stronger legal claim in the event of court action because of the written promise (page 101).
Liquidity	Less liquid; cannot be easily transferred to others.	More liquid; the holder can transfer it to creditors in settlement of debt or to a bank for cash through discounting (page 101).
Interest	Usually non-interest bearing.	May be interest-bearing or non-interest bearing (page 102).
Accounting Treatment	Debited to Accounts Receivable account; individual customer accounts maintained in subsidiary ledger (page 100).	Debited to Notes Receivable account; separate record maintained for each note (page 101).

Sources for Quickly Collecting Funds from Accounts Receivable:



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The textbook (Unit 4, pages 103-104) describes the following sources when organizations need to generate funds quickly from accounts receivable:

1. Offering Cash Discounts:

Cash discounts are offered to credit customers as an incentive for early payment instead of waiting for the full credit period. Credit terms like "2/10, n/30" mean that a 2% discount is available if payment is made within 10 days of sale. This encourages customers to pay promptly, generating cash quickly and reducing accounts receivable balances (page 104).

2. Factoring Accounts Receivable:

Factoring involves selling accounts receivable outright to a third party (called a factor) on a without recourse basis (page 104). The factor purchases the receivables, assumes the burden of collection, and provides immediate cash to the business. The business receives cash (usually 80-94% of the receivable amount) minus a factoring fee (typically 6-8%). This provides immediate cash for business use, and the factor absorbs losses from irrecoverable accounts (page 104).

Journal entry for factoring:

Particulars	Debit	Credit
Bank Account	xxx	
Factoring Expenses	xxx	
Accounts Receivable		xxx

3. Pledging Accounts Receivable:

Pledging involves using accounts receivable as collateral security for borrowing money from banks or other financial institutions (page 104). The bank grants a loan (usually up to 70-80% of the pledged receivables) with interest charged on the loan amount. The accounts receivable remain on the balance sheet with a notation of pledging, and the loan is shown as a liability. When customers pay, the funds are deposited with the bank to reduce the loan (page 104).

4. Credit Card Sales:

Although not explicitly mentioned in this section, selling through credit cards is another way to receive immediate cash (net of fees) instead of waiting for customer payment.

These methods help organizations avoid financial crunches and meet maturing liabilities when accounts receivable collections are delayed (page 103).



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Question 15: Zoobi Manufacturing Company requires Rs. 3 million to purchase plant and factory buildings. On April 1, 2023, it issued 3,000 bonds of Rs. 1,000 each at par with 10% interest payable semiannually over three years.

Required: a. Record the bond issuance. b. Record interest accruals and payments. c. Present bonds and accrued interest in financial statements.

Answer:

According to Unit 7 of the textbook (pages 196-200), when bonds are issued at par value, the contract rate of interest equals the market rate of interest. The accounting treatment follows the straight-line method for any premium or discount, but in this case, since bonds are issued at par, no amortization is required.

Given:

- Number of bonds = 3,000
- Par value per bond = Rs. 1,000
- Total par value = 3,000 × Rs. 1,000 = Rs. 3,000,000
- Issue price = At par (100%) = Rs. 3,000,000
- Interest rate = 10% per annum, payable semiannually
- Maturity = 3 years
- Issue date = April 1, 2023
- Semiannual interest payment dates = April 1 and October 1
- Financial year end = Assuming June 30 (as per standard practice in the book)

a. Journal Entry for Bond Issuance on April 1, 2023:

Date	Particulars	Debit	Credit
2023 Apr 1	Bank A/c	Rs. 3,000,000	
	Bonds Payable A/c		Rs. 3,000,000
	(To record issuance of 3,000, 10% bonds at par)		

b. Interest Accruals and Payments:

i. Interest Accrual on June 30, 2023 (Financial Year End):

Interest for 3 months (April 1 to June 30, 2023) has accrued but not yet paid.

Interest expense = Rs. 3,000,000 × 10% × 3/12 = Rs. 75,000

Date	Particulars	Debit	Credit
2023 Jun 30	Interest Expense A/c	Rs. 75,000	



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	Interest Payable A/c		Rs. 75,000
	(To record accrued interest for 3 months)		

ii. First Interest Payment on October 1, 2023:

Semiannual interest payment = Rs. 3,000,000 × 10% × 6/12 = Rs. 150,000

This payment covers interest for 6 months (April 1 to October 1, 2023). However, Rs. 75,000 was already accrued on June 30, so the remaining Rs. 75,000 relates to July-September.

Date	Particulars	Debit	Credit
2023 Oct 1	Interest Expense A/c (July-Sept)	Rs. 75,000	
	Interest Payable A/c (April-June)	Rs. 75,000	
	Bank A/c		Rs. 150,000
	(To record semiannual interest payment)		

iii. Interest Accrual on December 31, 2023 (if needed):

If the financial year ends on December 31, an additional accrual would be needed. Assuming the financial year ends on June 30, the next interest payment on April 1, 2024, would be recorded as follows:

iv. Interest Payment on April 1, 2024:

Interest for October 1, 2023 to April 1, 2024 (6 months) = Rs. 150,000

Date	Particulars	Debit	Credit
2024 Apr 1	Interest Expense A/c	Rs. 150,000	
	Bank A/c		Rs. 150,000
	(To record semiannual interest payment)		

v. Subsequent Interest Accruals and Payments:

Similar entries will be made for each semiannual period until maturity.

vi. Bond Redemption at Maturity on April 1, 2026:

Date	Particulars	Debit	Credit
2026 Apr 1	Bonds Payable A/c	Rs. 3,000,000	
	Bank A/c		Rs. 3,000,000
	(To record redemption of bonds at maturity)		



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c. Presentation in Financial Statements:

**Zoobi Manufacturing Company
Balance Sheet (Partial) as at June 30, 2023**

Particulars	Amount (Rs.)
Current Liabilities	
Interest Payable	Rs. 75,000
Long-term Liabilities	
Bonds Payable (10%, due April 1, 2026)	Rs. 3,000,000

**Zoobi Manufacturing Company
Income Statement (Partial)
For the year ended June 30, 2023**

Particulars	Amount (Rs.)
Other Expenses:	
Interest Expense on Bonds	Rs. 75,000

(Note: Only 3 months' interest (April-June) is expensed in the year ended June 30, 2023, as per the accrual basis of accounting.)

Question 16: Prepare journal entries for Channel One Company's issuance of 100,000 shares of Rs. 0.50 par value common stock assuming the shares sell for: (i) Rs. 0.50 cash per share. (ii) Rs. 2 cash per share. Also, prepare entries for Selectist Company's issuance of 104,000 no-par shares assuming: (i) Shares sell for Rs. 15 cash per share. (ii) Shares are exchanged for land valued at Rs. 1,560,000.

Answer:

According to Unit 5 of the textbook, shares can be issued at par, at premium, or for non-cash assets. The accounting treatment varies based on the type of stock (par value, no-par, stated value) and the issue price.

Part A: Channel One Company (Par Value Stock)

i. When shares are sold at par value (Rs. 0.50 per share):



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Number of shares = 100,000

Par value per share = Rs. 0.50

Total par value = 100,000 × Rs. 0.50 = Rs. 50,000

Issue price per share = Rs. 0.50 (at par)

Total cash received = 100,000 × Rs. 0.50 = Rs. 50,000

Date	Particulars	Debit	Credit
	Cash A/c	Rs. 50,000	
	Common Stock Capital A/c		Rs. 50,000
	(To record issuance of 100,000 shares of Rs. 0.50 par value at par)		

ii. When shares are sold at Rs. 2 cash per share (above par):

Issue price per share = Rs. 2

Total cash received = 100,000 × Rs. 2 = Rs. 200,000

Par value = 100,000 × Rs. 0.50 = Rs. 50,000

Premium on common stock = Rs. 200,000 – Rs. 50,000 = Rs. 150,000

Date	Particulars	Debit	Credit
	Cash A/c	Rs. 200,000	
	Common Stock Capital A/c		Rs. 50,000
	Premium on Common Stock A/c		Rs. 150,000
	(To record issuance of shares at premium)		

Part B: Selectist Company (No-Par Stock)

According to the textbook (Unit 5, page 148, section 5.3.4), when no-par shares are issued, the entire proceeds collected on sale are credited to the common stock capital without recognition of any discount or premium.

i. When shares sell for Rs. 15 cash per share:

Number of shares = 104,000

Issue price per share = Rs. 15

Total cash received = 104,000 × Rs. 15 = Rs. 1,560,000

Date	Particulars	Debit	Credit
	Cash A/c	Rs. 1,560,000	
	Common Stock (No-Par Value) A/c		Rs. 1,560,000
	(To record issuance of 104,000 no-par shares at Rs. 15 each)		



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ii. When shares are exchanged for land valued at Rs. 1,560,000:

According to the textbook (Unit 5, page 149, section 5.3.6), when common stocks are issued in exchange for assets other than cash, the assets so received are recorded at their fair market value.

Fair market value of land = Rs. 1,560,000

Date	Particulars	Debit	Credit
	Land A/c	Rs. 1,560,000	
	Common Stock (No-Par Value) A/c		Rs. 1,560,000
	(To record issuance of 104,000 no-par shares for land)		

Question 17: Describe the purpose of accounting and explain its role in business and society. Also, identify the primary users of accounting information.

Answer:

According to Unit 1 of the textbook (pages 4-5), accounting plays a vital role in business and society.

Purpose of Accounting:

The textbook defines accounting in the Encyclopedia Britannica as "the process of recording, classifying, summarizing and interpreting the business transactions which can be measured in financial terms with the objectives to promote financial and administrative discipline in the business organization" (page 4).

The major focus is on transactions that are measured in financial terms—those that can be related to monetary consideration. No business event can be considered a transaction until it is related to the prevailing currency, because the medium of recording business transactions is the currency amount which has been exchanged or promised to be collected or disbursed in future.

Role of Accounting in Business:

Accounting serves as the "language of business" (page 4). It provides a systematic way of recording business transactions and reporting results periodically to evaluate performance. The owners of business require this systematic approach to:

1. Record business transactions properly
2. Classify transactions according to their nature
3. Summarize information for decision-making



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4. Report results periodically to evaluate performance

Role of Accounting in Society:

Accounting provides economic information to society in a uniform manner and in selective format as is considered expedient (page 4). It promotes financial and administrative discipline in business organizations, which benefits the broader economy through:

1. Transparent financial reporting
2. Accountability in resource utilization
3. Informed investment decisions
4. Economic stability through reliable information

Primary Users of Accounting Information:

The textbook (pages 4-5) classifies users of accounting information into two main categories:

A. External Users:

External users are not usually directly involved in the affairs of an enterprise. They include:

1. **Shareholders** - Interested in profitability and dividend-paying ability
2. **Lenders** - Concerned about the company's ability to repay loans
3. **Creditors** - Want to know if amounts owed will be paid on time
4. **Analysts** - Evaluate performance for investment recommendations
5. **Suppliers** - Assess creditworthiness before extending credit
6. **Customers** - Evaluate long-term viability of the business
7. **Regulatory Agencies** - Such as:
 - o Securities and Exchange Commission of Pakistan
 - o Stock Exchanges
 - o Taxation authorities
 - o Other similar institutions

All such external users make their decisions about dealings with the enterprise based on accounting information provided to them on a uniform standard format of external reporting system.

B. Internal Users:

Internal users are those people who are directly related to the operating affairs of the organization (page 5). They include:

1. **Top Management** - Uses accounting information for strategic planning



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2. **Middle Management** - Uses information for tactical decisions
3. **Lower Management** - Uses information for operational control
4. **General Employees** - Interested in company stability and profitability
5. **Trade Unions** - Use information for wage negotiations
6. **Internal Auditors** - Use information for compliance verification

These internal users are provided accounting information in a tailored format according to their specific needs.

Question 18: What do you understand by Generally Accepted Accounting Principles (GAAPs)? Explain the need for GAAPs in financial reporting and discuss at least five fundamental GAAPs with appropriate examples.

Answer:

According to Unit 1 of the textbook (pages 5-7), Generally Accepted Accounting Principles (GAAP) are the guiding principles, conventions, and concepts implemented while recording business transactions and dealing with matters of concern.

Definition of GAAP:

The Financial Accounting Standard Board (FASB) has described certain guiding principles, conventions, and concepts for implementation while recording business transactions and dealing with matters of concern. These principles ensure that accounting records are maintained and reports are prepared based on professional ethics, enabling presentation of reliable accounting information to all external and internal users (page 5).

Need for GAAP in Financial Reporting:

GAAP is necessary because:

1. It ensures presentation of reliable accounting information
2. It makes information compatible and dependable for users
3. It promotes uniformity in recording and reporting
4. It enables comparison between different organizations
5. It provides credibility to financial statements
6. It guides accountants in handling complex transactions

Five Fundamental GAAPs with Examples:

1. Business Entity Concept:



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According to this concept, the business unit has independent recognition from its owners (page 7). The business can purchase in its own name, own property, sue and be sued. Accounts are kept for the business entity as distinguished from the persons who are owners.

Example: If the owner invests Rs. 500,000 in the business, it is recorded as an increase in both assets (cash) and owner's equity (capital). The owner's personal expenses, like household grocery bills, are not recorded in the business books.

2. Going Concern Concept:

This concept assumes that an entity is a going concern—that it will continue to operate for an indefinite period and there is no intention to liquidate the business in the near future (page 7).

Example: When valuing assets, accountants do not take into account the sale value of assets. Depreciation on fixed assets is charged on expected useful life rather than market value. A machine purchased for Rs. 500,000 with a 10-year life is depreciated over 10 years, not written down to its immediate resale value.

3. Money Measurement Concept:

In financial accounting, a record is maintained only for transactions that can be expressed in monetary terms (page 7). No accounting is possible for an event or transaction that cannot be measured in money terms.

Example: The company hires an excellent manager, but this fact is not recorded in the books because it cannot be measured in monetary terms. However, the salary paid to the manager (Rs. 50,000 per month) is recorded because it involves monetary value.

4. Cost Principle:

The actual cost paid on acquisition of goods or assets is considered as the basis for recording in books of accounts (page 7). Generally, no subsequent market fluctuation is considered for assets held by the business.

Example: If a company purchases machinery for Rs. 200,000, it is recorded at Rs. 200,000 even if its market value increases to Rs. 250,000 or decreases to Rs. 180,000. The original cost remains the basis for accounting.

5. Matching Concept:

A significant relationship exists between revenue and expenses. Expenses are incurred for producing income, so expenses are offset against income (page 7). The concept of taking total periodical expenses for comparing with periodical income is called the matching concept.



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Example: If a company earns Rs. 100,000 in sales during December and pays Rs. 15,000 in salaries for the same month, both are recorded in December's income statement, even if the salaries are paid in January. This ensures that revenues and related expenses are matched in the same period.

Other Important GAAPs Mentioned in the Book:

6. **Accounting Period Concept** - The life of a business is divided into relatively short accounting periods of equal length (usually one year) for financial reporting.
7. **Realization Concept** - Revenues should be recognized when goods are sold or services are rendered, at the point when property passes to the buyer.
8. **Conservatism** - Accountants should anticipate no profit but provide for all possible losses—a policy of "playing safe."
9. **Full Disclosure** - Users must be informed about policies and procedures adopted while preparing financial statements.
10. **Consistency** - Once an entity has decided to use one method of treatment, the same method should be followed in subsequent periods.
11. **Materiality** - An item is material if it influences performance and may affect decision-makers; immaterial items can be treated differently.
12. **Dual Aspect Concept** - Every transaction has a dual impact on accounting records, forming the basis of the double-entry system and accounting equation.

Question 19: A company that records credit purchases in a purchases journal and records purchase returns in a general journal made the following errors. Indicate when each error should be discovered.

Answer:

According to Unit 3 of the textbook (pages 78-80 and 86-89), the purchases journal is used for recording all credit purchases of merchandise, and subsidiary ledger accounts are maintained for each supplier. Control accounts and subsidiary ledgers must be reconciled periodically to ensure accuracy. Based on these principles:

Error 1: Posted a purchase return to the Accounts Payable account and the creditor's subsidiary account, but did not post the purchase return to the Inventory account.

When discovered: This error will be discovered at the end of the accounting period when physical inventory is counted and compared with the inventory balance in the books. The inventory account will show a higher balance than the actual physical count because the return (which reduced inventory) was not recorded. During the year-end physical verification, the shortage will be revealed, leading to investigation and discovery of the error.



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Error 2: Posted a purchase return to the Inventory account and the Accounts Payable account, but did not post to the creditor's subsidiary account.

When discovered: This error will be discovered when the schedule of accounts payable is prepared at month-end (page 89). The total of all subsidiary ledger accounts (creditors' balances) will not match the balance in the Accounts Payable control account. Since the control account was credited (reduced) but the subsidiary account was not, the subsidiary total will be higher than the control account balance, revealing the error during reconciliation.

Error 3: Correctly recorded a Rs. 4,000 purchase in the purchases journal but posted it to the creditor's subsidiary account as a Rs. 400 purchase.

When discovered: This error will be discovered when the creditor sends a statement of account at month-end. The creditor's statement will show a receivable of Rs. 4,000, but the company's subsidiary account shows only Rs. 400. The difference of Rs. 3,600 will prompt investigation. Alternatively, when the schedule of accounts payable is prepared, the total may not reconcile with unusual differences, leading to detection.

Error 4: Made an addition error in determining the balance of a creditor's subsidiary account.

When discovered: This error will be discovered when the schedule of accounts payable is prepared and compared with the Accounts Payable control account (page 89). The total of all subsidiary accounts will not equal the control account balance. The discrepancy will prompt a review of individual creditor accounts, and the addition error will be found when the specific account is recalculated.

Error 5: Made an addition error in totaling the Office Supplies column of the purchases journal.

When discovered: This error will be discovered when posting the column total to the general ledger. The debit to the Office Supplies account will not equal the credits to Accounts Payable and other accounts, causing the trial balance to be out of balance (page 21). The trial balance will show unequal totals, leading to investigation and discovery of the addition error in the purchases journal.

Question 20: Prepare journal entries to record the following transactions involving both the short-term and long-term investments of Sophia Corp., all of which occurred during calendar year 2021. Use the account Short-Term Investments for any transactions that you determine are short-term.

Transactions:

a. On February 15, paid Rs. 150,000 cash to purchase American General's 120-day short-term



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notes at par, which are dated February 15 and pay 10% interest (classified as held-to-maturity).

b. On March 22, bought 700 shares of Frain Industries common stock at Rs. 25 cash per share plus a Rs. 250 brokerage fee (classified as long-term available-for-sale securities).

c. On June 15, received a check from American General in payment of the principal and 120 days' interest on the notes purchased in transaction a.

d. On July 30, paid Rs. 50,000 cash to purchase MP3 Electronics' 8% notes at par, dated July 30, 2021, and maturing on January 30, 2022 (classified as trading securities).

e. On September 1, received a Rs. 0.50 per share cash dividend on the Frain Industries common stock purchased in transaction b.

f. On October 8, sold 350 shares of Frain Industries common stock for Rs. 32 cash per share, less a Rs. 175 brokerage fee.

g. On October 30, received a check from MP3 Electronics for three months' interest on the notes purchased in transaction d.

Answer:

According to Unit 4 of the textbook (pages 111-117), investments are classified based on intent and type of security. Short-term investments (marketable securities) are those that can be encashed at any time, while long-term investments are held for longer periods. The accounting treatment follows specific rules for each classification.

a. February 15 - Purchase of American General Notes (Short-term, held-to-maturity)

These are 120-day short-term notes, so they qualify as short-term investments.

Date	Particulars	Debit	Credit
Feb 15	Short-Term Investments (American General Notes) A/c	Rs. 150,000	
	Cash A/c		Rs. 150,000
	(To record purchase of 120-day, 10% notes at par)		

b. March 22 - Purchase of Frain Industries Shares (Long-term, available-for-sale)

Cost per share = Rs. 25

Brokerage fee = Rs. 250

Total cost = (700 × Rs. 25) + Rs. 250 = Rs. 17,500 + Rs. 250 = Rs. 17,750

Date	Particulars	Debit	Credit
Mar 22	Long-Term Investments (Frain Industries) A/c	Rs. 17,750	
	Cash A/c		Rs. 17,750
	(To record purchase of 700 shares at Rs. 25 each plus brokerage)		



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c. June 15 - Collection of American General Notes with Interest

Principal amount = Rs. 150,000

Interest rate = 10% per annum

Period = 120 days = 120/360 year (using 360 days for interest calculation as per banking practice)

Interest = Rs. 150,000 × 10% × 120/360 = Rs. 150,000 × 0.10 × 1/3 = Rs. 5,000

Total received = Rs. 150,000 + Rs. 5,000 = Rs. 155,000

Date	Particulars	Debit	Credit
Jun 15	Cash A/c	Rs. 155,000	
	Short-Term Investments (American General Notes) A/c		Rs. 150,000
	Interest Income A/c		Rs. 5,000
	(To record collection of principal and interest on notes)		

d. July 30 - Purchase of MP3 Electronics Notes (Trading Securities)

These are 8% notes maturing on January 30, 2022 (6 months), classified as trading securities.

Date	Particulars	Debit	Credit
Jul 30	Short-Term Investments (MP3 Electronics Notes) A/c	Rs. 50,000	
	Cash A/c		Rs. 50,000
	(To record purchase of 8% notes at par, maturing Jan 30, 2022)		

e. September 1 - Dividend Received on Frain Industries Shares

Dividend per share = Rs. 0.50

Number of shares = 700

Total dividend = 700 × Rs. 0.50 = Rs. 350

Date	Particulars	Debit	Credit
Sep 1	Cash A/c	Rs. 350	
	Dividend Income A/c		Rs. 350
	(To record cash dividend on Frain Industries shares)		

f. October 8 - Sale of 350 Shares of Frain Industries

Selling price per share = Rs. 32

Gross proceeds = 350 × Rs. 32 = Rs. 11,200

Less brokerage fee = Rs. 175

Net cash received = Rs. 11,200 – Rs. 175 = Rs. 11,025



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Cost of shares sold (using average cost or specific identification):

Original cost for 700 shares = Rs. 17,750

Cost per share = Rs. 17,750 ÷ 700 = Rs. 25.357 per share (approximately)

Cost of 350 shares = 350 × Rs. 25.357 = Rs. 8,875 (rounded)

Gain on sale = Net proceeds – Cost = Rs. 11,025 – Rs. 8,875 = Rs. 2,150

Date	Particulars	Debit	Credit
Oct 8	Cash A/c	Rs. 11,025	
	Long-Term Investments (Frain Industries) A/c		Rs. 8,875
	Gain on Sale of Investments A/c		Rs. 2,150
	(To record sale of 350 shares at Rs. 32 each less brokerage)		

g. October 30 - Interest Received on MP3 Electronics Notes

Principal amount = Rs. 50,000

Interest rate = 8% per annum

Period = 3 months (July 30 to October 30) = 3/12 year

Interest = Rs. 50,000 × 8% × 3/12 = Rs. 50,000 × 0.08 × 0.25 = Rs. 1,000

Date	Particulars	Debit	Credit
Oct 30	Cash A/c	Rs. 1,000	
	Interest Income A/c		Rs. 1,000
	(To record 3 months' interest on MP3 Electronics notes)		

Question 21: What do you know about stockholder equity? Explain. Also, draw the specimen of stockholder equity section of the balance sheet. Prepare journal entries to record four separate issuances of stock.

Answer:

According to Unit 5 and Unit 6 of the textbook, stockholders' equity represents the owners' claim on the assets of a corporation after all liabilities have been deducted.

Definition of Stockholder Equity:

The textbook (Unit 6, page 177) defines stockholders' equity as "the owners' equity in a company commonly called as stock holders' equity, shareholders' equity, shareholders' investment or capital of owners." Generally, the stockholders' equity comprises the contributions in a corporate business



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enterprise by owners in the shape of cash resources and fixed assets. The company in turn issues common stock (ordinary shares) and preferred stocks.

Components of Stockholder Equity:

The equity section typically includes:

1. **Capital Stock** - The par or stated value of shares issued (common and preferred)
2. **Additional Paid-in Capital** - Amounts received in excess of par value (premium)
3. **Retained Earnings** - Accumulated profits not distributed as dividends
4. **Treasury Stock** - Company's own shares repurchased (shown as deduction)
5. **Accumulated Other Comprehensive Income** - Unrealized gains/losses on certain investments
6. **Reserves** - Revenue reserves and capital reserves created out of profits

Specimen of Stockholder Equity Section of Balance Sheet:

Based on the textbook examples (pages 150, 178), a typical stockholders' equity section appears as follows:

STOCKHOLDERS' EQUITY

Common Stock [Rs. 10 par value, 100,000 shares authorized, 60,000 shares issued and outstanding]	Rs. 600,000
Preferred Stock [10% cumulative, Rs. 100 par value, 20,000 shares authorized, 10,000 shares issued]	Rs. 1,000,000
Premium on Common Stock	Rs. 200,000
Premium on Preferred Stock	Rs. 50,000
Revenue Reserves	Rs. 150,000
Retained Earnings	Rs. 300,000
Total Stockholders' Equity before Treasury Stock	Rs. 2,300,000
Less: Cost of Treasury Stock (5,000 common shares)	(Rs. 100,000)
Total Stockholders' Equity	Rs. 2,200,000

Journal Entries for Four Separate Issuances of Stock:

1. Issuance of No-Par Common Stock to Promoters (No Stated Value)

When no-par stock is issued without a stated value, the entire amount received is credited to the common stock account (Unit 5, page 148).



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Particulars	Debit	Credit
Organization Expense A/c	Rs. 30,000	
Common Stock (No-Par Value) A/c		Rs. 30,000

(To record issuance of 2,000 no-par shares to promoters for services)

2. Issuance of No-Par Common Stock to Promoters (With Stated Value of Rs. 1 per share)

For stated value stock, the stated value becomes legal capital. Any excess is credited to paid-in capital in excess of stated value (Unit 5, page 148).

Stated value = 2,000 × Rs. 1 = Rs. 2,000

Excess over stated value = Rs. 30,000 – Rs. 2,000 = Rs. 28,000

Particulars	Debit	Credit
Organization Expense A/c	Rs. 30,000	
Common Stock (Rs. 1 Stated Value) A/c		Rs. 2,000
Paid-in Capital in Excess of Stated Value A/c		Rs. 28,000
(To record issuance of 2,000 stated value shares to promoters)		

3. Issuance of Par Value Common Stock for Cash

When par value stock is issued at a price above par, the excess is recorded as premium (Unit 5, pages 146-147).

Number of shares = 4,000

Par value per share = Rs. 10

Total par value = 4,000 × Rs. 10 = Rs. 40,000

Cash received = Rs. 70,000

Premium on common stock = Rs. 70,000 – Rs. 40,000 = Rs. 30,000

Particulars	Debit	Credit
Cash A/c	Rs. 70,000	
Common Stock Capital A/c		Rs. 40,000
Premium on Common Stock A/c		Rs. 30,000



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(To record issuance of 4,000 shares of Rs. 10 par value at Rs. 17.50 per share)

4. Issuance of Preferred Stock for Cash

Preferred stock issuance follows the same principles as common stock (Unit 5, pages 149-150).

Number of shares = 1,000

Par value per share = Rs. 100

Total par value = 1,000 × Rs. 100 = Rs. 100,000

Cash received = Rs. 120,000

Premium on preferred stock = Rs. 120,000 – Rs. 100,000 = Rs. 20,000

Particulars	Debit	Credit
Cash A/c	Rs. 120,000	
Preferred Stock Capital A/c		Rs. 100,000
Premium on Preferred Stock A/c		Rs. 20,000
(To record issuance of 1,000 shares of Rs. 100 par value preferred stock at Rs. 120)		

Question 22: The stockholders' equity of Whiz.com Company at the beginning of the day on February 5 follows. Prepare entries to record both the dividend declaration and its distribution. Compute the book value per share and total book value of this stockholder's shares immediately before and after the stock dividend. Compute the total market value of the investor's shares as of February 5 and February 28.

Given:

- Common stock—Rs. 25 par value, 150,000 shares authorized, 60,000 shares issued and outstanding Rs. 1,500,000
- Paid-in capital over par value, common stock 525,000
- Retained earnings 675,000



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- Total stockholders' equity Rs.
2,700,000

On February 5, the directors declare a 20% stock dividend distributable on February 28 to the February 15 stockholders of record. The stock's market value is Rs. 40 per share on February 5 before the stock dividend. The stock's market value is Rs. 34 per share on February 28.

Answer:

According to Unit 5 of the textbook (pages 151-152), a stock dividend is the distribution of additional shares to existing stockholders without receipt of payment. It transfers some portion from retained earnings to capital stock within the owners' equity section.

Part 1: Journal Entries for Stock Dividend Declaration and Distribution

Step 1: Calculate the stock dividend amount

Number of shares outstanding = 60,000
Stock dividend percentage = 20%
Additional shares to be issued = 60,000 × 20% = 12,000 shares
Par value per share = Rs. 25
Market value per share on declaration date = Rs. 40

According to the textbook (page 152), when stock dividend is declared, retained earnings is reduced by the market value of shares to be issued, common stock is increased by par value, and the excess is credited to paid-in capital.

Total market value of stock dividend = 12,000 × Rs. 40 = Rs. 480,000
Par value of additional shares = 12,000 × Rs. 25 = Rs. 300,000
Excess over par (credit to paid-in capital) = Rs. 480,000 – Rs. 300,000 = Rs. 180,000

Journal entry on February 5 (Declaration Date):

Date	Particulars	Debit	Credit
Feb 5	Retained Earnings A/c	Rs. 480,000	
	Common Stock Dividend Distributable A/c		Rs. 300,000
	Paid-in Capital in Excess of Par Value A/c		Rs. 180,000
	(To record declaration of 20% stock dividend)		

Journal entry on February 28 (Distribution Date):

Date	Particulars	Debit	Credit
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Feb 28	Common Stock Dividend Distributable A/c	Rs. 300,000	
	Common Stock Capital A/c		Rs. 300,000
	(To record distribution of stock dividend)		

Part 2: Book Value Per Share Before and After Stock Dividend

Before Stock Dividend:

Total stockholders' equity = Rs. 2,700,000

Number of shares outstanding = 60,000

Book value per share = Rs. 2,700,000 ÷ 60,000 = Rs. 45 per share

After Stock Dividend:

Total stockholders' equity remains the same = Rs. 2,700,000

Number of shares outstanding after dividend = 60,000 + 12,000 = 72,000 shares

Book value per share after dividend = Rs. 2,700,000 ÷ 72,000 = Rs. 37.50 per share

For the stockholder who owned 750 shares:

Before dividend:

Total book value = 750 shares × Rs. 45 = Rs. 33,750

After dividend:

Number of shares after 20% stock dividend = 750 + (750 × 20%) = 750 + 150 = 900 shares

Total book value = 900 shares × Rs. 37.50 = Rs. 33,750

The total book value remains the same (Rs. 33,750), confirming that stock dividend does not change the ownership value.

Part 3: Total Market Value of Investor's Shares

As of February 5:

Market value per share = Rs. 40

Number of shares owned = 750

Total market value = 750 × Rs. 40 = Rs. 30,000

As of February 28:

Market value per share = Rs. 34

Number of shares owned after dividend = 900

Total market value = 900 × Rs. 34 = Rs. 30,600



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The market value increased slightly from Rs. 30,000 to Rs. 30,600, representing a 2% increase despite the drop in per-share price.

Question 23: Koral Corporation engaged in the transactions listed below. Identify each transaction as (a) an operating activity, (b) an investing activity, (c) a financing activity, (d) a noncash transaction, or (e) not on the statement of cash flows. (Assume the indirect method is used.)

Answer:

According to Unit 8 of the textbook (pages 220-222 and 224-226), cash flows are classified into three categories: operating activities, investing activities, and financing activities. Some transactions are noncash transactions that are disclosed separately, and some items do not appear on the statement of cash flows.

No.	Transaction	Classification	Explanation (based on textbook, pages 220-222)
1	Declared and paid a cash dividend	(c) Financing Activity	Dividend payments to shareholders are cash outflows in financing activities (page 222, 226)
2	Purchased a long-term investment	(b) Investing Activity	Purchase of long-term investments is a cash outflow in investing activities (page 221)
3	Increased accounts receivable	(a) Operating Activity	Changes in accounts receivable affect operating activities under indirect method (page 225)
4	Paid interest	(a) Operating Activity	Interest paid is classified as operating activity (page 220)
5	Sold equipment at a loss	(b) Investing Activity	Sale of equipment is an investing activity; the loss is adjusted in operating activities under indirect method but the cash proceeds are in investing (page 221)
6	Issued long-term bonds for plant assets	(d) Noncash Transaction	Exchange of bonds for plant assets is a noncash investing and financing transaction (page 221)
7	Increased dividends receivable	(e) Not on statement of cash flows	Dividends receivable is a noncash item; only cash dividends received appear in operating activities
8	Issued common stock	(c) Financing Activity	Issuance of stock is a cash inflow from financing activities (page 221)



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9	Declared and issued a stock dividend	(e) Not on statement of cash flows	Stock dividend is a noncash transaction within equity; no cash flow occurs
10	Repaid notes payable	(c) Financing Activity	Repayment of debt is a cash outflow from financing activities (page 222)
11	Decreased wages payable	(a) Operating Activity	Changes in wages payable affect operating activities under indirect method (page 225)
12	Purchased a 60-day Treasury bill	(a) Operating Activity	Short-term Treasury bills (3 months or less) are considered cash equivalents; purchases are part of cash management, not separately reported (page 218)
13	Purchased land	(b) Investing Activity	Purchase of land is a cash outflow from investing activities (page 221)

Question 24: Moss issues bonds with a par value of Rs. 90,000 on January 1, 2021. The bonds' annual contract rate is 8%, and interest is paid semiannually on June 30 and December 31. The bonds mature in three years. The annual market rate at the date of issuance is 10%, and the bonds are sold for Rs. 85,431.

- 1. What is the amount of the discount on these bonds at issuance?**
- 2. How much total bond interest expense will be recognized over the life of these bonds?**

Answer:

According to Unit 7 of the textbook (pages 197-198), when bonds are issued at a price below par value (discount), the difference between the par value and the issue price is the discount. The discount is amortized over the life of the bonds, and total interest expense exceeds the cash interest paid.

Given:

- Par value of bonds = Rs. 90,000
- Issue price = Rs. 85,431
- Contract rate = 8% per annum (paid semiannually)
- Market rate = 10% per annum
- Life = 3 years
- Interest payment dates = June 30 and December 31



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- Issue date = January 1, 2021

1. Amount of Discount on Bonds at Issuance:

Particulars	Amount
Par value of bonds	Rs. 90,000
Less: Issue price	Rs. 85,431
Discount on bonds payable	Rs. 4,569

2. Total Bond Interest Expense Over the Life of the Bonds:

According to the textbook (page 198), the total bond interest expense equals the total cash interest payments plus the discount amortized over the life of the bonds.

Step 1: Calculate total cash interest payments

Number of periods = 3 years \times 2 = 6 semiannual periods
Semiannual interest payment = Par value \times Contract rate \times 6/12
= Rs. 90,000 \times 8% \times 6/12 = Rs. 90,000 \times 4% = Rs. 3,600 per period

Total cash interest payments over 3 years = Rs. 3,600 \times 6 = Rs. 21,600

Step 2: Calculate total discount amortization

Total discount = Rs. 4,569 (to be amortized over 6 periods)

Step 3: Calculate total interest expense

According to the textbook (page 198), the formula is:

Total bond interest expense = Total cash interest payments + Discount amortized

Particulars	Amount
Total cash interest payments (6 \times Rs. 3,600)	Rs. 21,600
Add: Discount amortized over life	Rs. 4,569
Total bond interest expense	Rs. 26,169

Verification using straight-line amortization (per period):

Semiannual discount amortization = Rs. 4,569 \div 6 = Rs. 761.50 per period

Semiannual interest expense = Cash interest + Discount amortization

= Rs. 3,600 + Rs. 761.50 = Rs. 4,361.50 per period



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Total interest expense over 6 periods = Rs. 4,361.50 × 6 = Rs. 26,169

Alternative Calculation:

Amount to be repaid at maturity = Rs. 90,000

Cash received at issuance = Rs. 85,431

Total cash paid to bondholders = Principal + Total interest payments
= Rs. 90,000 + Rs. 21,600 = Rs. 111,600

Total interest expense = Total cash paid – Cash received
= Rs. 111,600 – Rs. 85,431 = Rs. 26,169

This matches the calculation above.

Question 25: Define liquidity and efficiency ratios in the context of financial statement analysis. Explain the significance of these ratios in evaluating a company's short-term financial health. Using financial data extracted from Arshad Trading Corporation, compute the following ratios for the years 2022 and 2023 and comment on each to ascertain liquidity analysis: Working Capital, Current Ratio, Acid Test ratio, Days Sales in Receivables, Accounts Receivable Turnover ratio, Days' sales in inventories, Inventory turnover ratio, and Operating cycle.

Given Financial Data:

Particulars	2022	2023
Sales	Rs. 3,000,000	Rs. 3,200,000
Cost of Goods Sold	Rs. 2,300,000	Rs. 2,500,000
Current Assets	Rs. 1,500,000	Rs. 1,650,000
Current Liabilities	Rs. 1,100,000	Rs. 1,150,000
Inventories	Rs. 750,000	Rs. 800,000
Accounts Receivable	Rs. 400,000	Rs. 450,000
Prepaid Expenses	Rs. 50,000	Rs. 40,000

Answer:

According to Unit 9 of the textbook (pages 260-266), liquidity and efficiency ratios measure a company's ability to meet its short-term obligations and how efficiently it manages its assets.



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Definitions:

Liquidity Ratios: According to the textbook (page 260), liquidity ratios express the capability of an organization to discharge its maturing short-term liabilities. These ratios measure the company's ability to convert assets into cash to pay its current obligations. Key liquidity ratios include working capital, current ratio, acid test ratio, and cash ratio.

Efficiency Ratios: These ratios measure how efficiently a company manages its assets, particularly receivables and inventories. They indicate the speed with which assets are converted into cash. Key efficiency ratios include accounts receivable turnover, days sales in receivables, inventory turnover, days sales in inventory, and the operating cycle.

Significance in Evaluating Short-Term Financial Health:

The textbook emphasizes (pages 260-266) that these ratios are significant because:

1. They indicate the company's ability to pay its maturing obligations on time
2. They reveal how efficiently management uses company resources
3. They help predict potential cash flow problems
4. They provide insights into the company's operating cycle and working capital management
5. Creditors and suppliers use these ratios to assess creditworthiness

Computations for Arshad Trading Corporation:

a. Working Capital

Working Capital = Current Assets – Current Liabilities (page 260)

Year	Calculation	Result
2022	Rs. 1,500,000 – Rs. 1,100,000	Rs. 400,000
2023	Rs. 1,650,000 – Rs. 1,150,000	Rs. 500,000

Comment: Working capital increased from Rs. 400,000 to Rs. 500,000, indicating improved liquidity and a stronger cushion to meet short-term obligations.

b. Current Ratio

Current Ratio = (Current Assets / Current Liabilities) × 100 or expressed as a ratio (page 260)

Year	Calculation	Result
2022	Rs. 1,500,000 / Rs. 1,100,000	1.36:1 or 136%
2023	Rs. 1,650,000 / Rs. 1,150,000	1.43:1 or 143%



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Comment: The current ratio improved from 1.36 to 1.43. According to the textbook (page 261), a 2:1 or 200% ratio is generally considered adequate. Both years are below this benchmark, indicating potential liquidity concerns. The improvement in 2023 is positive but still below the ideal level.

c. Acid Test Ratio (Quick Ratio)

Acid Test Ratio = (Current Assets – Inventories – Prepaid Expenses) / Current Liabilities × 100 (page 261)

Year	Calculation	Result
2022	(Rs. 1,500,000 – Rs. 750,000 – Rs. 50,000) / Rs. 1,100,000	Rs. 700,000 / Rs. 1,100,000 = 0.64:1 or 64%
2023	(Rs. 1,650,000 – Rs. 800,000 – Rs. 40,000) / Rs. 1,150,000	Rs. 810,000 / Rs. 1,150,000 = 0.70:1 or 70%

Comment: The textbook (page 261) states that the general criteria for adequate acid test ratio is 150% or 1.5 times. Both years show ratios below this benchmark (64% and 70%), indicating that the company might face difficulty meeting short-term obligations if forced to pay all current liabilities immediately. However, the improvement in 2023 is positive.

d. Days Sales in Receivables

Days Sales in Receivables = (Average Gross Accounts Receivable / Net Credit Sales) × 365 days (page 262)

Assuming all sales are on credit:

Year	Calculation	Result
2022	(Rs. 400,000 / Rs. 3,000,000) × 365	0.1333 × 365 = 48.7 days
2023	(Rs. 450,000 / Rs. 3,200,000) × 365	0.1406 × 365 = 51.3 days

Comment: The collection period increased from 48.7 days to 51.3 days, indicating that customers are taking longer to pay. This ties up more funds in receivables and may signal collection problems. Management should investigate the causes and implement stricter collection policies.

e. Accounts Receivable Turnover Ratio

Accounts Receivable Turnover Ratio = Net Credit Sales / Average Gross Receivables (page 263)

Year	Calculation	Result
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2022	Rs. 3,000,000 / Rs. 400,000	7.5 times
2023	Rs. 3,200,000 / Rs. 450,000	7.1 times

Comment: The receivables turnover decreased from 7.5 to 7.1 times per year, meaning the company is collecting its receivables less frequently. This confirms the findings from days sales in receivables and indicates declining efficiency in collections.

f. Days Sales in Inventories

Days Sales in Inventories = (Ending Inventory / Cost of Goods Sold) × 365 days (page 264)

Year	Calculation	Result
2022	(Rs. 750,000 / Rs. 2,300,000) × 365	0.3261 × 365 = 119.0 days
2023	(Rs. 800,000 / Rs. 2,500,000) × 365	0.32 × 365 = 116.8 days

Comment: The inventory holding period decreased slightly from 119 days to 116.8 days, showing marginal improvement. However, holding inventory for nearly 4 months is quite long and may indicate slow-moving or obsolete stock. Management should review inventory levels and turnover.

g. Inventory Turnover Ratio

Inventory Turnover Ratio = Cost of Goods Sold / Average Inventory (page 264)

Year	Calculation	Result
2022	Rs. 2,300,000 / Rs. 750,000	3.07 times
2023	Rs. 2,500,000 / Rs. 800,000	3.13 times

Comment: Inventory turnover improved slightly from 3.07 to 3.13 times per year, meaning inventory is being sold and replaced about 3 times annually. This is relatively low, confirming that inventory moves slowly. Higher turnover would indicate better inventory management.

h. Operating Cycle

Operating Cycle = Days Sales in Receivables + Days Sales in Inventories (page 265)

Year	Calculation	Result
2022	48.7 days + 119.0 days	167.7 days
2023	51.3 days + 116.8 days	168.1 days

Comment: The operating cycle remained relatively stable at about 168 days (approximately 5.6 months). This means it takes about 168 days from purchasing inventory to collecting cash from



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sales. This is quite long and indicates that funds are tied up in operations for an extended period. Management should work to reduce both collection periods and inventory holding periods to shorten the operating cycle.

Overall Liquidity Assessment:

Based on the ratios computed:

1. The company's liquidity position is weak but improving slightly, as indicated by the current ratio (below 2:1) and acid test ratio (below 1.5:1).
2. Efficiency ratios show that the company takes too long to collect receivables (about 50 days) and holds inventory for too long (about 118 days), resulting in a lengthy operating cycle of 168 days.
3. Management should focus on:
 - Accelerating collections from customers
 - Reducing inventory levels
 - Improving inventory turnover
 - Shortening the operating cycle
 - Strengthening the current and acid test ratios



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