

Allama Iqbal Open University AIOU AD B.com solved Assignment no 1 Autumn 2025 Code 1413 Financial Accounting

Q.1. Describe the purpose of accounting and explain its role in business and society. Also, identify the primary users of accounting information.

Introduction to Accounting

Accounting is widely regarded as the **language of business** because it provides a structured system for recording, organizing, summarizing, and interpreting financial transactions. In every stage of human civilization, from the barter trade systems of early societies to the advanced digital economies of the 21st century, people have needed ways to track resources, measure profits, and plan for the future. That function is fulfilled by accounting. In the modern world, accounting is not merely a tool for businesses to manage their finances but a

discipline that influences economic policies, guides investment decisions, ensures transparency, and promotes accountability across society. It is a bridge between financial activities and decision-making, serving individuals, businesses, governments, and international organizations.

The importance of accounting lies in its ability to provide **reliable financial information** that allows stakeholders to understand an entity's financial health. Whether it is a multinational corporation, a small shopkeeper, or a government agency, accurate accounting is indispensable. To fully appreciate its scope, we need to examine its **purpose, role in business, role in society, and the groups of people who depend on accounting information**.

Purpose of Accounting

The fundamental purpose of accounting can be broken into several key objectives:

1. Systematic Recording of Transactions

Every organization engages in multiple financial transactions daily—sales, purchases, salaries, rents, investments, and more. Accounting provides a systematic framework for recording these activities in books such as

the journal and ledger. This eliminates confusion and ensures accuracy in tracking financial movements. Without proper accounting, even a medium-sized business could quickly lose track of its inflows and outflows.

2. Classification and Organization

Transactions alone are meaningless without proper classification. Accounting sorts financial data into categories such as assets, liabilities, capital, revenues, and expenses. By organizing information into these categories, businesses can analyze where money is coming from and where it is being spent.

3. Summarization and Financial Statements

One of the most important purposes of accounting is to summarize large amounts of data into concise financial statements. Reports such as the **income statement**, **balance sheet**, and **cash flow statement** condense thousands of transactions into understandable formats. These summaries enable managers, investors, and regulators to quickly assess performance.

4. Interpretation and Analysis

Accounting is not just about recording numbers—it involves analyzing those numbers to derive insights. Profitability ratios, liquidity ratios, and solvency ratios are all accounting tools that help in interpreting data. For instance, knowing that a company earned a profit of \$1

million is useful, but analyzing whether that profit margin is sustainable provides deeper insights.

5. Decision-Making Support

Accounting provides a basis for strategic and operational decision-making. Whether it is expanding to a new market, cutting costs, or investing in technology, managers depend on financial reports to make evidence-based choices.

6. Accountability and Transparency

Accounting ensures that businesses and institutions are accountable for their use of resources. It fosters trust among stakeholders—employees trust that salaries will be paid on time, governments trust that taxes will be reported fairly, and investors trust that financial statements reflect reality.

Role of Accounting in Business

Businesses, regardless of size, cannot operate efficiently without accounting. Its role in business spans across management, operations, and future growth.

1. Measuring Profitability

The primary objective of any business is to earn profits. Accounting measures whether a business is profitable by comparing revenues with expenses. Without this

information, businesses would not know if they are progressing or moving toward failure.

2. Planning and Budgeting

Business planning depends heavily on accounting information. Budgets, which are future financial plans, are prepared using historical accounting data. For example, if a company notices rising electricity costs in its accounts, it may allocate more funds in the next budget to cover energy expenses or invest in energy-efficient systems.

3. Managing Costs and Resources

Accounting identifies areas where resources are being wasted. For instance, cost accounting helps in analyzing production costs and controlling unnecessary expenditures. This ensures efficient resource utilization.

4. Legal Compliance and Reporting

Businesses are bound by law to maintain financial records for tax purposes and to comply with corporate regulations. Accounting provides accurate records that help avoid legal penalties and maintain regulatory compliance.

5. Attracting Investors and Loans

Financial institutions and investors evaluate a company's worth by analyzing its accounting records. Reliable accounting builds trust and makes it easier for businesses to secure funding for expansion or innovation.

6. Tracking Cash Flow

Even profitable companies can collapse due to poor cash flow management. Accounting monitors inflows and outflows of cash, ensuring liquidity for meeting day-to-day obligations.

7. Internal and External Auditing

Accounting serves as the foundation for audits. Internal audits ensure that company policies are followed, while external audits assure stakeholders that financial reports are accurate and comply with accounting standards.

Role of Accounting in Society

Accounting extends far beyond the business world and plays an integral role in society and governance.

1. Promoting Transparency

Accounting ensures that organizations are transparent in their operations. When companies publish financial statements, society can hold them accountable for their actions. This builds public trust in corporations and institutions.

2. Supporting Economic Development

Governments use accounting information to plan national budgets, manage debt, and design economic policies. For example, accurate tax collection relies on the accounting

records of businesses and individuals. National development projects, like building infrastructure or launching welfare programs, are financed and tracked through accounting systems.

3. Preventing Fraud and Corruption

Proper accounting systems reduce opportunities for fraud. Transparent financial reporting ensures that public funds are not misused, which is especially critical in government organizations and NGOs.

4. Encouraging International Trade

Global accounting standards such as **IFRS (International Financial Reporting Standards)** create uniformity in reporting, making it easier for businesses across borders to understand each other's financial health. This encourages foreign direct investment and international trade.

5. Promoting Corporate Social Responsibility

Modern society expects companies to contribute positively to communities. Through accounting, organizations can measure and report on sustainability efforts, environmental protection, and social welfare initiatives, thereby reinforcing ethical practices.

Primary Users of Accounting Information

Accounting information serves a diverse range of users, both internal and external.

Internal Users

1. **Managers** – Use accounting data to make operational and strategic decisions. For example, they may use cost reports to decide whether to outsource production.
2. **Owners** – Assess profitability and long-term sustainability of their investment.
3. **Employees** – Analyze financial reports to gauge job security, growth prospects, and potential bonuses.

External Users

1. **Investors/Shareholders** – Use accounting reports to evaluate returns on investment and future growth potential.
2. **Creditors and Banks** – Check a company's ability to repay loans before lending money.
3. **Suppliers** – Assess whether a company is financially stable enough to pay for goods on credit.
4. **Government Agencies** – Use accounting information for tax assessment, regulation, and economic

planning.

5. **Customers** – Especially in long-term contracts, customers may evaluate a company's stability to ensure reliability.

6. **General Public** – Gains insights into how businesses are contributing to the economy and whether they operate responsibly.

Case Examples to Illustrate the Role of Accounting

Example 1: Small Business

A local grocery store uses accounting to track daily sales, expenses, and profits. Without these records, the store owner cannot identify which products are most profitable or whether costs are too high. By analyzing accounting data, the owner can adjust inventory and pricing strategies.

Example 2: Large Corporation

Multinational corporations like **Unilever** or **Nestlé** rely on advanced accounting systems to consolidate financial information from different countries. This allows them to present global financial reports, comply with multiple

regulatory environments, and attract international investors.

Example 3: Government Sector

In Pakistan, accounting is vital for tax collection and public spending. The Federal Board of Revenue (FBR) depends on accurate accounting records to assess taxes from businesses and individuals. Similarly, government projects like the construction of dams or highways are monitored through accounting systems to prevent corruption and ensure funds are properly utilized.

Conclusion

Accounting is much more than bookkeeping—it is a vital system that fuels decision-making, accountability, and growth in business and society. Its purpose extends from recording transactions to ensuring transparency, guiding investments, and supporting government policies. In the business world, it helps organizations measure profitability, control costs, comply with laws, and secure investments. In society, it fosters transparency, supports development, reduces fraud, and promotes international trade. The users of accounting information are diverse, ranging from managers, owners, and employees to investors, creditors, governments, and the general public. Without accounting, modern economies would lack transparency, businesses

would fail to manage resources, and society would lose a critical tool for accountability and trust.

Q.2 (a) 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.

Introduction to GAAPs

Generally Accepted Accounting Principles (GAAPs) form the foundation of modern financial accounting. They are a set of well-established rules, conventions, and guidelines that accountants must follow when recording, summarizing, and presenting financial data. These principles are not random; rather, they are carefully developed over time to ensure that accounting practices remain transparent, reliable, and useful for stakeholders. GAAPs work as a “common language” in the business world, so that all companies, regardless of size or industry, report their financial activities in a consistent and comparable way.

The idea behind GAAPs is to eliminate confusion and promote clarity. Without such principles, every organization might design its own method of reporting, which could result in financial chaos, manipulation, and a lack of trust among investors and other stakeholders. For example, if one company records assets at market value

while another records them at cost, it becomes nearly impossible for investors to compare them. Therefore, GAAPs act as the backbone of financial reporting.

Historical Background of GAAP

The concept of standardized accounting principles developed gradually. In the early 20th century, businesses in different regions used inconsistent methods of accounting, creating problems for investors, governments, and auditors. To resolve these inconsistencies, accounting bodies began to formulate standardized principles. In the United States, the Financial Accounting Standards Board (FASB) became responsible for developing GAAP. Similarly, in other countries, accounting bodies such as the Institute of Chartered Accountants developed their own versions of GAAP.

Although GAAPs vary slightly from country to country, the underlying concepts are largely similar because they are all based on fairness, clarity, and reliability. Globally, the International Financial Reporting Standards (IFRS) have gained prominence, but GAAP is still widely used in countries like the United States.

The Need for GAAPs in Financial Reporting

The purpose of GAAPs is not only to maintain uniformity in financial reporting but also to safeguard the interests of society. The following points explain why GAAPs are essential:

1. Uniformity in Financial Statements

GAAPs ensure that all businesses follow the same rules when preparing financial statements. This makes it easier to compare the performance of different organizations, even across industries.

2. Transparency and Trust

Stakeholders, such as investors and creditors, need confidence in the financial reports they rely on. GAAPs provide this by reducing the possibility of manipulation and fraud.

3. Decision-Making

Managers, investors, and creditors use financial data for decision-making. GAAPs ensure that this data is accurate, consistent, and reliable, enabling rational decisions.

4. Legal and Regulatory Compliance

Governments and regulatory authorities require businesses to submit GAAP-based reports to ensure taxation accuracy and compliance with financial

regulations.

5. International Comparability

In today's globalized world, investors often invest across borders. GAAPs, along with IFRS, provide a framework that allows comparison of financial reports worldwide.

Fundamental GAAPs with Examples

1. Business Entity Concept

- **Explanation:**

This principle states that the business is separate from its owner(s). Personal transactions of owners must not be mixed with business accounts.

- **Example:**

If the owner uses company money to buy personal items, it is recorded as "Drawings" rather than an expense of the business.

- **Importance:**

It ensures clarity in financial records by separating personal and business activities.

2. Going Concern Concept

- **Explanation:**

The assumption here is that the business will continue its operations indefinitely, unless there is evidence of liquidation or closure.

- **Example:**

A factory is recorded at its purchase cost and depreciated over its useful life, not at its liquidation value.

- **Importance:**

It justifies spreading expenses (like depreciation) over several years.

3. Monetary Unit Concept

- **Explanation:**

Only transactions measurable in monetary terms are recorded in financial statements. Non-monetary items like goodwill of employees, brand reputation, or customer loyalty are not directly recorded.

- **Example:**

The value of employee dedication cannot be shown in the balance sheet, but their salaries (monetary) are recorded.

- **Importance:**

It brings objectivity by focusing only on measurable data.

4. Cost Principle

- **Explanation:**

Assets should be recorded at their original cost, not at current market value. This ensures objectivity and prevents manipulation.

- **Example:**

If a building was purchased for Rs. 5 million, it remains recorded at Rs. 5 million (minus depreciation), even if its market value rises to Rs. 10 million.

- **Importance:**

It maintains consistency and reliability in reporting.

5. Matching Principle

- **Explanation:**

Revenues and expenses should be recorded in the same accounting period. This principle ensures that income statements reflect the true profitability of operations.

- **Example:**

A company makes a sale in December but pays commission in January. The commission expense is recorded in December, matching it with the sale revenue.

- **Importance:**

It prevents distortion of profits and losses across accounting periods.

6. Accrual Principle (Bonus Principle)

- **Explanation:**

Income and expenses should be recognized when earned or incurred, not when cash is received or paid.

- **Example:**

Services worth Rs. 200,000 provided in March but payment received in April are recorded as revenue in March.

- **Importance:**

It ensures that financial statements show the true performance of a business, independent of cash flow timings.

Advantages of GAAP

1. Ensures uniformity and comparability of financial data.
2. Builds investor trust and confidence.
3. Provides accurate data for government tax authorities.
4. Assists in effective decision-making for management.
5. Reduces fraud and manipulation of accounts.

Criticisms of GAAP

Despite its advantages, GAAP is not free from criticism:

1. **Rigid Rules** – GAAP sometimes limits flexibility for unique industries.
2. **Historical Focus** – The cost principle ignores inflation and current market values.
3. **Complexity** – For small businesses, GAAP rules can be too detailed and expensive to follow.
4. **Non-monetary Values Ignored** – Skills, goodwill, and brand value are often not included, despite being important.

GAAP vs IFRS (International Comparison)

- **GAAP** is primarily rules-based, followed in the USA and some other countries.
- **IFRS** is principles-based, followed in over 120 countries.
- Example: Under GAAP, inventory can be valued using LIFO (Last In, First Out), but IFRS does not permit

LIFO.

This shows how GAAP provides strict structure while IFRS allows flexibility, but both aim at reliability and transparency.

Conclusion

GAAPs form the backbone of financial reporting. They ensure uniformity, transparency, and trust in accounting practices, enabling businesses and stakeholders to make informed decisions. Principles like **Business Entity, Going Concern, Monetary Unit, Cost, Matching, and Accrual** establish consistency and accuracy in reporting. Although GAAP has some limitations, it remains essential for ensuring accountability and comparability in the financial world. With globalization, the harmonization of GAAP and IFRS may further strengthen trust and transparency in financial reporting across borders.

Q.2(b)

The following transactions occurred in the books of Naeem Traders during the year ended 31st December 2023. For each item: (i) identify the GAAP/accounting concept applied (or violated) and (ii) justify your identification with reasoning. Also I add the **correct accounting treatment / sample journal entry** and the **impact if recorded incorrectly** to make the explanation clearer.

1. The business paid Rs. 60,000 as rent for the office premises. However, the owner included this in his financial records.

(i) Accounting concept: Business Entity Concept (Separate Entity Concept) — (principle violated)

(ii) Justification:

The Business Entity concept requires that the business's transactions be kept separate from the personal transactions of the owner(s). The rent for office premises is a business expense and must be recorded in the business books. By recording the rent in the owner's personal records instead of the business books, the separation is breached. This mis-recording understates business expenses and overstates the business's profit and assets (or may disguise the owner's drawings), leading to misleading financial statements.

Correct accounting treatment / sample journal entry:

If the business paid the rent from business bank/cash:

Dr Rent Expense (P&L)	Rs. 60,000
Cr Bank / Cash (B/S)	Rs. 60,000

If the business paid via owner (owner paid & business owes owner or owner contributed cash), the correct recordings would differ (capital contribution or owner's drawing), but the rent must still appear in business books as an expense.

Impact if recorded incorrectly:

- Overstates owner's personal expenses, understates business expenses → profit is overstated.
- Misleads investors/creditors; tax returns may be wrong; violates GAAP requirement for separateness.

2. The company purchased machinery worth Rs. 500,000 but recorded it at the purchase price, not at its current market value of Rs. 620,000.

(i) Accounting concept: Cost Principle / Historical Cost Concept — (principle correctly applied under GAAP)

(ii) Justification:

The Cost Principle (historical cost concept) states that assets should be recorded at their acquisition cost (the price paid) because historical cost is objective and verifiable. GAAP (U.S. GAAP) requires historical cost as the primary basis for initial recognition. Recording the machinery at Rs. 500,000 (purchase price) is therefore correct under GAAP; accounting does not revalue to current market value except in limited, prescribed circumstances (and IFRS permits revaluation in some cases but GAAP generally does not).

Correct accounting treatment / sample journal entry (at purchase):

Dr Machinery (Asset)	Rs. 500,000
Cr Bank / Cash	Rs. 500,000

Then record depreciation over useful life.

Impact if recorded at market value instead (incorrect under GAAP):

- Overstates assets and equity; inflates return-on-assets and distorts comparability.

- Violates objectivity and verifiability; inconsistent with GAAP.

(Note: under IFRS a revaluation model is permitted for some asset classes, but under GAAP historical cost is the norm.)

3. Goods costing Rs. 80,000 were sold to a customer on credit. The company recorded the sale in the books even though payment had not been received yet.

(i) Accounting concept: Accrual Principle / Revenue Recognition Principle (Realization Concept) —
(principle correctly applied)

(ii) Justification:

Under the Accrual Basis of accounting and the Revenue Recognition principle, revenue is recognized when it is earned (when goods are delivered or services performed), not when cash is received. A sale on credit meets the criteria for recognizing revenue because the company has transferred control/ownership of goods to the customer and has a legal right to payment. Recording the sale on credit is therefore correct under GAAP.

Correct accounting treatment / sample journal entry:

Dr Accounts Receivable Rs. 80,000

Cr Sales Revenue Rs. 80,000

(plus record cost of goods sold)

Dr Cost of Goods Sold Rs. 80,000

Cr Inventory Rs. 80,000

Impact if not recorded until cash received (incorrect under accrual accounting):

- Revenues and receivables understated in the period earned → profit understatement and poor matching of revenues with associated COGS.
- Financial statements lose comparability and decision usefulness.

4. A sum of Rs. 200,000 was expected from a customer but was not recorded as revenue due to uncertainty regarding recovery.

(i) Accounting concept: Conservatism / Prudence Principle (and also Revenue Recognition / Realization under accrual accounting) — (principle applied: conservatism)

(ii) Justification:

Conservatism (prudence) requires accountants to exercise caution and not overstate assets or income when outcomes are uncertain. If collection of the Rs. 200,000 is doubtful, GAAP requires that revenue generally should only be recognized when it is realized or realizable and earned (revenue recognition). If there is significant uncertainty about collectibility at the time revenue would otherwise be recognized, prudence may lead to non-recognition of revenue until uncertainty is resolved, or recognition of revenue with a corresponding allowance for doubtful accounts if revenue is recognized but collectibility is uncertain. The company's decision not to record the revenue reflects conservative treatment to avoid overstating assets/income.

Correct accounting approaches:

- If revenue has been earned but collectibility is doubtful: recognize revenue and create an allowance for doubtful accounts (contra-asset) reflecting expected uncollectible amount. Example:

Dr Accounts Receivable Rs. 200,000

Cr Sales Revenue Rs. 200,000

Dr Bad Debt Expense / Allowance (if specific) Rs. X

Cr Allowance for Doubtful Accounts Rs. X

- If revenue criteria are not met (e.g., service not completed), do **not** record revenue until earned.

Impact of mis-treatment either way:

- Recognizing revenue without allowance when collectibility is doubtful overstates assets and income (risk of revision later).
- Completely withholding recognition even when revenue is earned may understate income and assets (too conservative). Correct application requires judgment and disclosure.

5. The company recorded the salary expense of Rs. 150,000 relating to December 2023 even though it was paid in January 2024.

(i) Accounting concept: Accrual Principle / Matching Principle — (principle correctly applied)

(ii) Justification:

The Accrual Basis requires that expenses be recognized in the period in which they are incurred, regardless of cash

payment timing. The Matching Principle complements this: expenses should be matched with the revenues they help generate in the same accounting period. Since the salary relates to December 2023 services, it must be recorded as an expense in December 2023 even if cash is paid in January 2024. This treatment presents an accurate measure of December's expenses and profit.

Correct accounting treatment / sample journal entry at year-end (accrual):

On December 31, 2023 (accrue salary):

Dr Salary Expense	Rs. 150,000
Cr Salaries Payable	Rs. 150,000

On payment in January 2024:

Dr Salaries Payable	Rs. 150,000
Cr Bank / Cash	Rs. 150,000

Impact if expense recorded only when paid (cash basis):

- December 2023 expenses understated and net income overstated for that year; January 2024 expenses overstated → misaligned periods and

misleading performance figures. Violates accrual/GAAP.

Summary Table (quick reference)

No.	Transaction summary	GAAP Concept	Correctness	Key effect if mishandled
1	Business paid rent but owner recorded it in his personal records	Business Entity (separate entity)	Violated	Overstates profit; mixes owner & business transactions
2	Machinery recorded at purchase price Rs.500,000 vs market Rs.620,000	Cost / Historical Cost Principle	Correct under GAAP	Recording at market inflates assets; violates objectivity

3	Credit sale Rs.80,000 recorded though cash not received	Accrual / Revenue Recognition	Correct	Not recording understates revenue & receivables
4	Expected Rs.200,000 not recorded due to doubt about recovery	Conservatism / Prudence (and Revenue Recognition)	Conservative treatment not applied	Recognizing without allowance overstates assets; ignoring earned revenue may understate income
5	Salary for Dec 2023 recorded although paid Jan 2024	Accrual / Matching Principle	Correct	Recording when paid distorts period results (violates accrual basis)

Q.3. Prepare adjusting journal entries at December 31, 2022, for each item.

1. Unearned rent received Aug 1, 2022 — Rs. 4,800 for 12 months beginning Aug 1

Rent per month = $4,800 \div 12 = \text{Rs. } 400$.

Months earned Aug–Dec = 5 months \Rightarrow Earned = $400 \times 5 = \text{Rs. } 2,000$

Adjusting entry — Dec 31, 2022

Dr Unearned Rent (Liability) 2,000

 Cr Rent Revenue 2,000

(To recognise rent earned from Aug 1 to Dec 31)

2. Prepaid insurance paid Mar 1, 2022 — Rs. 3,000 for 24 months

Insurance per month = $3,000 \div 24 = \text{Rs. } 125$.

Months expired Mar–Dec = 10 months \Rightarrow Expense = $125 \times 10 = \text{Rs. } 1,250$

Adjusting entry — Dec 31, 2022

Dr Insurance Expense 1,250

 Cr Prepaid Insurance 1,250

(To record insurance expense for March–December 2022)

3. Wages — monthly payroll Rs. 22,000; wages paid mid-month

Assume employees earn half the monthly payroll between Dec 16–31 that has not yet been paid. Half-month wages = $22,000 \div 2 = \text{Rs. 11,000}$

Adjusting entry — Dec 31, 2022

Dr Wages Expense 11,000
 Cr Wages Payable (or Accrued Wages) 11,000
(To accrue wages earned by employees for Dec 16–31, 2022)

4. Note receivable dated June 1, 2022 — Rs. 1,000 at 12% interest; due June 1, 2024

Interest rate 12% p.a. Interest from June 1 → Dec 31 = 7 months.

Interest = $1,000 \times 12\% \times 7/12 = \text{Rs. 70}$

Adjusting entry — Dec 31, 2022

Dr Interest Receivable 70
 Cr Interest Revenue 70
(To accrue interest earned on the note from June 1 to Dec 31, 2022)

5. Received Rs. 2,500 on Dec 20, 2022 for services — recorded as Unearned Revenue. By year-end 3/4 of services completed

Earned portion = $2,500 \times 3/4 = \text{Rs. } 1,875$ (remaining unearned = 625)

Adjusting entry — Dec 31, 2022

Dr Unearned Revenue 1,875

Cr Service Revenue 1,875

(To recognise 3/4 of the contracted services completed by year-end)

6. Supplies purchased Sept 1, 2022 — Rs. 500 recorded as asset. One-fourth used by Dec 31

Used supplies = $500 \times 1/4 = \text{Rs. } 125$ (ending supplies = 375)

Adjusting entry — Dec 31, 2022

Dr Supplies Expense 125

Cr Supplies (Asset) 125

(To record supplies used during the year)

Q.4 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. (20)

Introduction

Errors in accounting are a common occurrence, and the stage at which they are discovered depends on the type of error. Some errors affect the trial balance directly and are found when totals do not agree, while others are only detected through subsidiary ledger reconciliations, inventory checks, or when preparing financial statements. In this question, different posting and totaling errors are presented, and we need to identify at which stage each error would likely be discovered.

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.

- **Explanation:** In this situation, the liability was reduced correctly because both the Accounts Payable control account and the creditor's subsidiary account were updated. However, the reduction in inventory

due to the return of goods was not recorded. This means the Inventory account will remain overstated.

- **When Discovered:** This error will not affect the agreement of the trial balance because the debit and credit entries are still balanced. It will be discovered later when comparing the balance in the Inventory account with the physical stock records or when preparing financial statements, where the cost of goods available for sale appears overstated.

Stage of discovery: At the time of inventory reconciliation or preparation of financial statements.

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.

- **Explanation:** Here, both Inventory and Accounts Payable control accounts are updated correctly. However, the individual creditor's subsidiary account was left unchanged. This creates a difference between the control account and the total of subsidiary accounts.
- **When Discovered:** Such an error will be identified when reconciling the Accounts Payable control

account with the creditors' subsidiary ledger. The control account will show the correct liability, but the subsidiary ledger will reflect an incorrect individual balance.

Stage of discovery: During reconciliation of creditors' subsidiary ledger with the control account.

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.

- **Explanation:** In this case, the purchase was correctly entered in the purchases journal, and the General Ledger accounts are correct. However, in the subsidiary ledger, the liability of the creditor was understated because only Rs. 400 was posted instead of Rs. 4,000.
- **When Discovered:** The mismatch will become visible during reconciliation of the Accounts Payable control account with the subsidiary ledger accounts. The control account will show Rs. 4,000 as payable, while the creditor's subsidiary account will reflect only Rs. 400. It could also be detected if the creditor sends a statement of account showing a higher balance than

the company's records.

Stage of discovery: During subsidiary ledger reconciliation or while verifying creditor statements.

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

- **Explanation:** This is a simple arithmetic error while totaling a subsidiary account. The balance of the creditor's account becomes inaccurate, although the control account remains correct.
- **When Discovered:** The error will be detected when reconciling the Accounts Payable control account with the creditors' subsidiary accounts. The mismatch between the two balances will highlight the miscalculation.

Stage of discovery: During reconciliation of subsidiary accounts with the control account.

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

- **Explanation:** This mistake occurs in summing the column of the purchases journal. Because of this, the total posted to the Office Supplies account in the General Ledger will be incorrect.
- **When Discovered:** The error will be detected during the preparation of the trial balance, because the total debits and credits will not agree, or the balance of Office Supplies will appear unusual when compared to expectations.

Stage of discovery: At the time of preparing the trial balance.

Summary Table

Error	Nature of Error	Stage of Discovery
1. Purchase return not posted to Inventory	Overstated Inventory	During inventory reconciliation or preparation of financial statements
2. Purchase return not posted to	Mismatch between subsidiary and	During reconciliation of subsidiary ledger with control account

creditor's subsidiary account	control accounts	
3. Rs. 4,000 purchase posted as Rs. 400	Understated liability in subsidiary ledger	During reconciliation of subsidiary accounts or when checking creditor statements
4. Addition error in creditor's subsidiary account	Incorrect individual creditor balance	During reconciliation of subsidiary accounts with control account
5. Addition error in purchases journal (Office Supplies)	Incorrect General Ledger total	During preparation of the trial balance

This detailed explanation shows that inventory-related errors are identified during stock checks or preparation of financial statements, errors in subsidiary ledgers are discovered during reconciliation with control accounts, and totaling mistakes in journals are normally identified while preparing the trial balance.

Q.5 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.

Assumptions & notes used in preparing the entries

- Interest calculations use an annual basis (annual rate \times fraction of year). Unless otherwise stated, short-term notes use a 360-day banking year when convenient; here 120 days = $120/360 = 1/3$ year.
- The transaction dates and maturities are treated as stated (the July 30 note matures six months later on Jan 30 next year).
- Brokerage and other acquisition costs are included in the cost basis of the investment.
- For simplicity, dividend income and realized gains are recognized in income when received/realized. Available-for-sale securities acquisition and sale entries follow that approach (i.e., realized gain

recognized in income at sale).

- Use accounts: Short-Term Investments (for notes and trading securities that are short-term), Available-for-Sale Investments (for long-term AFS equities), Interest Revenue, Dividend Revenue, Gain on Sale of Investments, Brokerage Expense (if recorded separately), Cash.

a. Feb 15 — Purchase American General 120-day short-term notes at par, Rs. 150,000; 10% interest; classified held-to-maturity (short-term).

Journal entry (Feb 15, 2021):

Dr Short-Term Investments	150,000
Cr Cash	
150,000	

(To record purchase of 120-day American General notes at par)

b. Mar 22 — Buy 700 shares of Frain Industries common stock at Rs. 25 per share plus Rs. 250 brokerage (classified as long-term available-for-sale).

Cost calculation: $700 \times 25 = 17,500$; brokerage = 250; total cost = 17,750.

Journal entry (Mar 22, 2021):

Dr Available-for-Sale Investments — Frain Industries	17,750
Cr Cash	17,750

(To record purchase of 700 shares of Frain Industries including brokerage)

c. June 15 — Receive principal and 120 days' interest from American General for the notes purchased in (a).

Interest on Rs.150,000 for 120 days at 10% p.a. =
 $150,000 \times 0.10 \times (120/360) = 5,000$.
Total cash received = principal 150,000 + interest 5,000 = 155,000.

Journal entry (June 15, 2021):

Dr Cash	155,000
Cr Short-Term Investments	150,000
Cr Interest Revenue	5,000

(To record receipt of principal and interest on matured short-term note)

d. July 30 — Purchase MP3 Electronics 8% notes at par, Rs. 50,000; dated July 30, 2021, maturing Jan 30, 2022 (classified as trading securities).

Because the note matures within one year and is trading,

use Short-Term Investments per instruction.

Journal entry (July 30, 2021):

Dr Short-Term Investments	50,000
Cr Cash	50,000

(To record purchase of MP3 Electronics 8% notes at par)

e. Sept 1 — Received Rs. 0.50 per share cash dividend on the 700 Frain shares purchased in (b).

Dividend received = $700 \times 0.50 = 350$.

Journal entry (Sept 1, 2021):

Dr Cash	350
Cr Dividend Revenue	350

(To record cash dividend received on Frain Industries shares)

f. Oct 8 — Sold 350 shares of Frain Industries common stock for Rs. 32 per share, less a Rs. 175 brokerage fee.

Proceeds gross = $350 \times 32 = 11,200$; brokerage = 175;
net cash received = $11,200 - 175 = 11,025$.

Cost basis: total cost of 700 shares = 17,750 → cost per share = $17,750 / 700 = 25.357142\dots$; cost of 350 shares = $17,750 \times (350/700) = 8,875$.

Realized gain = net proceeds 11,025 – cost 8,875 = 2,150.

Journal entry (Oct 8, 2021):

Dr Cash	11,025
Dr Brokerage Expense (or reduce proceeds if recorded separately) ..	175 (<i>optional if brokerage was expensed separately; here brokerage already reduced from cash so treat as part of cash entry</i>)
Cr Available-for-Sale Investments — Frain Industries ..	8,875
Cr Gain on Sale of Investments	2,150

(To record sale of 350 Frain shares; cost removed and gain recognized)

Note: If you prefer to show gross cash and record brokerage separately, you could:

Dr Cash	11,200
Dr Brokerage Expense	175
Cr Available-for-Sale Investments	8,875
Cr Gain on Sale	2,150

g. Oct 30 — Received check from MP3 Electronics for three months' interest on the notes purchased in (d).

Interest on Rs.50,000 at 8% for 3 months = $50,000 \times 0.08 \times (3/12) = 1,000$.

Journal entry (Oct 30, 2021):

Dr Cash	1,000
Cr Interest Revenue	1,000

(To record receipt of three months' interest on MP3 Electronics notes)

If required, summary of cash flows related to these investment transactions during 2021:

- Cash outflows: Feb 15 (150,000), Mar 22 (17,750), Jul 30 (50,000) = 217,750 total cash invested.
- Cash inflows: June 15 (155,000 principal + interest), Sept 1 (350 dividend), Oct 8 (11,025 net proceeds), Oct 30 (1,000 interest) = 167,375 total cash received (excluding any remaining principal collected in Jan 2022 for MP3).
- Realized gain on Frain sale recognized = Rs. 2,150.