

Solution:

(1)

| Particulars | Debit | Credit |
|------------------|---------|---------|
| Equipment | 788,000 | |
| To Cash | | 200,000 |
| To Notes Payable | | 588,000 |

(2)

Let us now consider the rate of interest. Note that the equipment can now be bought for 788,000. Thus, we get

$$800,000 = 588,000 \times (1 + r)^2 \Rightarrow r = 0.166$$

Thus, we have the interest calculated in the first year to be:

$$\text{Interest of first year} = \$588,000 \times 0.166 = \$97,608$$

$$\text{Interest of second year} = \$588,000 \times 1.166 \times 0.166 = \$113,810$$

Entry for first year's interest expense:

| Particulars | Debit | Credit |
|------------------|--------|--------|
| Interest Expense | 97,608 | |
| To Notes Payable | | 97,608 |

Entry for second year's interest expense & lump sum payment:

| Particulars | Debit | Credit |
|------------------|---------|---------|
| Interest Expense | 114,392 | |
| To Notes Payable | | 114,392 |
| Notes Payable | 788,000 | |
| To Cash | | 788,000 |