

1987

Uniform CPA examination. Questions and unofficial answers, 1987 November

American Institute of Certified Public Accountants. Board of Examiners

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Uniform CPA Examination

November 1987

Questions and
Unofficial Answers

Uniform CPA Examination

November 1987

**Questions and
Unofficial Answers**

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FOREWORD

The Uniform CPA Examination is prepared by the Board of Examiners of the American Institute of Certified Public Accountants and is used by the examining boards of all fifty states of the United States, the District of Columbia, Puerto Rico, Guam, and the Virgin Islands as a prerequisite for issuance of CPA certificates. This booklet contains the questions and unofficial answers of the November 1987 Uniform Certified Public Accountant Examination.

Although the questions and unofficial answers may be used for many purposes, the principal reason for their publication is to aid candidates in preparing for the examination. Candidates are also encouraged to read *Information for CPA Candidates*, which describes the content, grading, and other administrative aspects of the Uniform CPA Examination.

The unofficial answers were prepared by the staff of the examinations division and reviewed by the Board of Examiners but are not purported to be official positions of the American Institute of Certified Public Accountants. Each of the unofficial answers is accompanied by its maximum point value assigned by the Board of Examiners for grading purposes.

George R. Dick, *Vice President — Review & Regulation*
American Institute of Certified Public Accountants

November 1987

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FUTURE CPA EXAMINATION DATES

1988 — May 4, 5, 6 November 2, 3, 4	1993 — May 5, 6, 7 November 3, 4, 5	1998 — May 6, 7, 8 November 4, 5, 6
1989 — May 3, 4, 5 November 1, 2, 3	1994 — May 4, 5, 6 November 2, 3, 4	1999 — May 5, 6, 7 November 3, 4, 5
1990 — May 2, 3, 4 November 7, 8, 9	1995 — May 3, 4, 5 November 1, 2, 3	2000 — May 3, 4, 5 November 1, 2, 3
1991 — May 8, 9, 10 November 6, 7, 8	1996 — May 8, 9, 10 November 6, 7, 8	
1992 — May 6, 7, 8 November 4, 5, 6	1997 — May 7, 8, 9 November 5, 6, 7	

Candidates can facilitate their study of past CPA examination questions by using the index on pages 76 through 82 in conjunction with the five-year index contained in *Selected Questions and Unofficial Answers Indexed to Content Specification Outlines*.

Information about *Selected Questions and Unofficial Answers Indexed to Content Specification Outlines* and an order form are printed on page 83.

NOVEMBER 1987

CONTENTS

Examination in Accounting Practice — Part I

Question 1	2	Answer 1	53
Question 2	5	Answer 2	53
Question 3	7	Answer 3	53
Question 4	11	Answer 4	54
Question 5	12	Answer 5	56

Examination in Accounting Practice — Part II

Question 1	15	Answer 1	57
Question 2	17	Answer 2	57
Question 3	19	Answer 3	57
Question 4	22	Answer 4	58
Question 5	23	Answer 5	59

Examination in Auditing

Question 1	26	Answer 1	61
Question 2	32	Answer 2	62
Question 3	32	Answer 3	62
Question 4	33	Answer 4	63
Question 5	33	Answer 5	64

Examination in Business Law
(Commercial Law)

Question 1	35	Answer 1	65
Question 2	42	Answer 2	66
Question 3	43	Answer 3	66
Question 4	43	Answer 4	67
Question 5	44	Answer 5	67

Examination in Accounting Theory
(Theory of Accounts)

Question 1	46	Answer 1	68
Question 2	51	Answer 2	69
Question 3	52	Answer 3	69
Question 4	52	Answer 4	70
Question 5	52	Answer 5	70

Suggested References	71
Index	76

EXAMINATION IN ACCOUNTING PRACTICE — PART I

November 4, 1987; 1:30 to 6:00 P.M.

NOTE TO CANDIDATES: Suggested time allotments are as follows:

All questions are required:	<i>Point</i>	<i>Estimated Minutes</i>	
	<i>Value</i>	<i>Minimum</i>	<i>Maximum</i>
No. 1	10	45	55
No. 2	10	45	55
No. 3	10	45	55
No. 4	10	40	50
No. 5	10	45	55
Total	<u>50</u>	<u>220</u>	<u>270</u>

INSTRUCTIONS TO CANDIDATES

(Disregard of these instructions may be considered as indicating inefficiency in accounting work.)

1. You must arrange the papers in numerical order of the questions. If more than one page is required for an answer, write "continued" at the bottom of the page. Number pages consecutively. For instance, if 12 pages are used for your answers, the objective answer sheet is page 1 and your other pages should be numbered 2 through 12.
2. Answer **all** objective-type items on the printed answer sheet provided for that purpose. It is to your advantage to attempt all questions even if you are uncertain of the answer. You are likely to get the highest score if you omit no answers. Since objective items are computer-graded, your comments and calculations associated with them are not considered. Be certain that you have entered your answers on the objective answer sheet before the examination time is up.
3. Support **all** problem-type answers with properly labeled and legible calculations that can be identified as sources of amounts in formal schedules, entries, worksheets, or other answers, to show how your final answer was derived. Computation sheets should identify the question to which they relate, be placed immediately following the answer to that question, and be numbered in sequence with the other pages. Failure to enclose supporting calculations may result in loss of grading points because it may be impossible to determine how your amounts were computed.
4. A CPA is continually confronted with the necessity of expressing opinions and conclusions in written reports in clear, unequivocal language. Although the primary purpose of the examination is to test the candidate's knowledge and application of the subject matter, the ability to organize and present such knowledge in acceptable written language may be considered by the examiners.

*Prepared by the Board of Examiners of the American Institute of Certified Public Accountants
and adopted by the examining boards of all states, the District of Columbia, Guam,
Puerto Rico, and the Virgin Islands of the United States.*

Instructions

Questions Number 1, 2, and 3 each consist of 20 multiple choice items. Select the **best** answer for each of the items. Use a soft pencil, preferably No. 2, to blacken the appropriate circle on the separate printed answer sheet to indicate your answer. **Mark only one answer for each item. Answer all items.** Your grade will be based on the total number of your correct answers for each question.

The following is an example of the manner in which the answer sheet should be marked:

Item

97. Gross billings for merchandise sold by Baker Company to its customers last year amounted to \$5,260,000; sales returns and allowances reduced the amounts owed by \$160,000. How much were net sales last year for Baker Company?

- a. \$4,800,000
- b. \$5,100,000
- c. \$5,200,000
- d. \$5,260,000

Answer Sheet

97. (a) (c) (d)

Number 1 (Estimated time — 45 to 55 minutes)

Select the **best** answer for each of the following items relating to a **variety of financial accounting problems.**

Items to be Answered

1. Apex Corporation's checkbook balance on December 31, 1986, was \$160,000. The same date Apex held the following items in its safe:
 - A \$5,000 check payable to Apex, dated January 2, 1987, that was not included in the December 31 checkbook balance.
 - A \$3,500 check payable to Apex, deposited December 22 and included in the December 31 checkbook balance, that was returned by the bank on December 30 marked NSF. The check was redeposited January 2, 1987, and cleared January 7.
 - A \$25,000 check, payable to a supplier and drawn on Apex's account, that was dated and recorded December 31, but was not mailed until January 15, 1987.

In its December 31, 1986 balance sheet, Apex should report cash at

- a. \$156,500
- b. \$161,500
- c. \$181,500
- d. \$185,000

2. During 1985 Garr Company purchased marketable equity securities as a short-term investment. At December 31, 1985, the balance in the allowance to reduce marketable equity securities to market was \$23,000. There were no security transactions during 1986. Pertinent information at December 31, 1986, is as follows:

<u>Security</u>	<u>Cost</u>	<u>Market value</u>
A	\$245,000	\$230,000
B	180,000	182,000
	<u>\$425,000</u>	<u>\$412,000</u>

In its 1986 income statement, Garr should report a (an)

- a. Recovery of unrealized loss of \$8,000.
- b. Recovery of unrealized loss of \$10,000.
- c. Unrealized loss of \$13,000.
- d. Unrealized loss of \$15,000.

3. On July 1, 1986, Fox Company purchased 400 of the \$1,000 face amount, 8% bonds of Dey Corporation for \$369,200 to yield 10% per annum. The bonds, which mature on July 1, 1991, pay interest semiannually on January 1 and July 1. Fox uses the interest method of amortization and the bonds are appropriately recorded as a long-term investment. The bonds should be reported on Fox's December 31, 1986 balance sheet at

- a. \$397,540
- b. \$374,120
- c. \$371,660
- d. \$366,740

4. On January 1, 1986, Mann Company's allowance for doubtful accounts had a credit balance of \$30,000. During 1986 Mann charged \$64,000 to doubtful accounts expense, wrote off \$46,000 of uncollectible accounts receivable, and unexpectedly recovered \$12,000 of bad debts written off in the prior year. The allowance for doubtful accounts balance at December 31, 1986, would be

- a. \$48,000
- b. \$60,000
- c. \$64,000
- d. \$94,000

5. Kemp Company had the following consignment transactions during December 1986:

Inventory shipped on consignment to	
Ashe Company	\$9,000
Freight paid by Kemp	450
Inventory received on consignment from	
Fenn Company	6,000
Freight paid by Fenn	250

No sales of consigned goods were made through December 31, 1986. Kemp's December 31, 1986 balance sheet should include consigned inventory at

- a. \$9,450
- b. \$9,000
- c. \$6,250
- d. \$6,000

Accounting Practice — Part I

6. On January 1, 1987, Beal Corporation adopted a plan to accumulate funds for a new plant building to be erected beginning July 1, 1992, at an estimated cost of \$1,200,000. Beal intends to make five equal annual deposits in a fund that will earn interest at 8% compounded annually. The first deposit is made on July 1, 1987. Present value and future amount factors are as follows:

Present value of 1 at 8% for 5 periods	0.68
Present value of 1 at 8% for 6 periods	0.63
Future amount of ordinary annuity of 1 at 8% for 5 periods	5.87
Future amount of annuity in advance of 1 at 8% for 5 periods	6.34

Beal should make five annual deposits (rounded) of

- a. \$151,200
- b. \$163,200
- c. \$189,300
- d. \$204,400

7. On December 31, 1986, Park Company sold used equipment to Ott Corp. and received a noninterest bearing note requiring payment of \$5,000 annually for ten years. The first payment is due December 31, 1987, and the prevailing rate of interest for this type of note at date of issuance is 12%. Present value factors are as follows:

Present value of 1 at 12% for 10 periods	0.322
Present value of ordinary annuity of 1 at 12% for 10 periods	5.650

In its December 31, 1986 balance sheet, Park should report the carrying amount of the note at

- a. \$16,100
- b. \$21,750
- c. \$28,250
- d. \$50,000

8. Bloy Company pays all salaried employees on a biweekly basis. Overtime pay, however, is paid in the next biweekly period. Bloy accrues salaries expense only at its December 31 year end. Data relating to salaries earned in December 1986 are as follows:

- Last payroll was paid on 12/26/86, for the 2-week period ended 12/26/86.
- Overtime pay earned in the 2-week period ended 12/26/86 was \$4,200.
- Remaining work days in 1986 were December 29, 30, and 31, on which days there was no overtime.
- The recurring biweekly salaries total \$75,000.

Assuming a five-day work week, Bloy should record a liability at December 31, 1986, for accrued salaries of

- a. \$22,500
- b. \$26,700
- c. \$45,000
- d. \$49,200

9. Dart Company's accounting records indicated the following information:

Inventory, 1/1/86	\$ 500,000
Purchases during 1986	2,500,000
Sales during 1986	3,200,000

A physical inventory taken on December 31, 1986, resulted in an ending inventory of \$575,000. Dart's gross profit on sales has remained constant at 25% in recent years. Dart suspects some inventory may have been taken by a new employee. At December 31, 1986, what is the estimated cost of missing inventory?

- a. \$ 25,000
- b. \$100,000
- c. \$175,000
- d. \$225,000

10. Wall Company bought a trademark from Black Corporation on January 1, 1986, for \$112,000. An independent consultant retained by Wall estimated that the remaining useful life is 50 years. Its unamortized cost on Black's accounting records was \$56,000. Wall decided to write off the trademark over the maximum period allowed. How much should be amortized for the year ended December 31, 1986?

- a. \$1,120
- b. \$1,400
- c. \$2,240
- d. \$2,800

11. West Company adopted a defined benefit pension plan on January 1, 1986. West amortizes the prior service cost over 16 years and funds prior service cost by making equal payments to the fund trustee at the end of each of the first ten years. The service (normal) cost is fully funded at the end of each year. The following data are available for 1986:

Service (normal) cost for 1986	\$110,000
Prior service cost:	
Amortized	41,700
Funded	57,200

West's prepaid pension cost at December 31, 1986, is

- a. \$0
- b. \$15,500
- c. \$41,700
- d. \$57,200

12. On September 1, 1985, Pine Company issued a note payable to National Bank in the amount of \$1,800,000, bearing interest at 12%, and payable in three equal annual principal payments of \$600,000. On this date the bank's prime rate was 11%. The first interest and principal payment was made on September 1, 1986. At December 31, 1986, Pine should record accrued interest payable of

- a. \$44,000
- b. \$48,000
- c. \$66,000
- d. \$72,000

Examination Questions — November 1987

13. Lee Company's current liabilities at December 31, 1986, totaled \$1,500,000 before any necessary year-end adjustment relating to the following:

- On December 23, 1986, a vendor authorized Lee to return, for full credit, goods shipped and billed at \$45,000 on December 10, 1986. The returned goods were shipped by Lee on December 29, 1986. A \$45,000 credit memo was received and recorded by Lee on January 7, 1987.
- During December 1986, Lee received \$75,000 from Marr, a customer, as an advance payment for a bottling machine which Lee will construct to Marr's specifications. From this transaction Lee has a \$75,000 credit balance in its account receivable from Marr at December 31, 1986.

At December 31, 1986, what amount should Lee report as total current liabilities?

- a. \$1,455,000
- b. \$1,470,000
- c. \$1,530,000
- d. \$1,575,000

14. Glen Apparel Shop, Inc. sells gift certificates redeemable only when merchandise is purchased. The certificates have an expiration date two years after issuance date. Upon redemption or expiration, Glen recognizes the unearned revenue as realized. Data for 1986 are as follows:

Unearned revenue, 1/1/86	\$ 75,000
Gift certificates sold	250,000
Gift certificates redeemed	205,000
Expired gift certificates	15,000
Cost of goods sold	60%

At December 31, 1986, Glen should report unearned revenue of

- a. \$ 42,000
- b. \$100,000
- c. \$105,000
- d. \$120,000

15. Ryan, Inc. began operations on January 1, 1986, and appropriately uses the installment method of accounting. The following data are available for 1986:

Installment accounts receivable, 12/31/86	\$ 600,000
Installment sales for 1986	1,050,000
Gross profit on sales	40%

Under the installment method, Ryan's deferred gross profit at December 31, 1986, would be

- a. \$360,000
- b. \$270,000
- c. \$240,000
- d. \$180,000

16. Included in Kerr Corporation's liability account balances at December 31, 1986, were the following:

14% note payable issued October 1, 1986, maturing September 30, 1987	\$250,000
16% note payable issued April 1, 1984, payable in six equal annual installments of \$100,000 beginning April 1, 1985	400,000

Kerr's December 31, 1986, financial statements were issued on March 31, 1987. On January 15, 1987, the entire \$400,000 balance of the 16% note was refinanced by issuance of a long-term obligation payable in a lump-sum. In addition, on March 10, 1987, Kerr consummated a noncancelable agreement with the lender to refinance the 14%, \$250,000 note on a long-term basis, on readily determinable terms that have not yet been implemented. Both parties are financially capable of honoring the agreement, and there have been no violations of the agreement's provisions. On the December 31, 1986 balance sheet, the amount of the notes payable that Kerr should classify as short-term obligations is

- a. \$0
- b. \$100,000
- c. \$250,000
- d. \$350,000

17. Dix, Inc., a calendar-year corporation, reported the following operating income (loss) before income tax for its first three years of operations:

1984	\$100,000
1985	(200,000)
1986	400,000

There are no permanent or timing differences between operating income (loss) for financial and income tax reporting purposes. When filing its 1985 tax return, Dix did not elect to forgo the carryback of its loss for 1985. Assume a 40% tax rate for all years. What amount should Dix report as its income tax liability at December 31, 1986?

- a. \$160,000
- b. \$120,000
- c. \$ 80,000
- d. \$ 60,000

18. On December 31, 1986, Lane, Inc. sold equipment to Noll, and simultaneously leased it back for 12 years. Pertinent information at this date is as follows:

Sales price	\$480,000
Carrying amount	360,000
Estimated remaining economic life	15 years

At December 31, 1986, how much should Lane report as deferred revenue from the sale of the equipment?

- a. \$0
- b. \$110,000
- c. \$112,000
- d. \$120,000

19. Cobb Company sells appliance service contracts agreeing to repair appliances for a two-year period. Cobb's past experience is that, of the total dollars spent for repairs on service contracts, 40% is incurred evenly during the first contract year and 60% evenly during the second contract year. Receipts from service contract sales for the two years ended December 31, 1986, are as follows:

1985	\$500,000
1986	600,000

Receipts from contracts are credited to unearned service contract revenue. Assume that all contract sales are made evenly during the year. What amount should Cobb report as unearned service contract revenue at December 31, 1986?

- a. \$360,000
- b. \$470,000
- c. \$480,000
- d. \$630,000

20. On January 1, 1983, Cory, Inc. purchased a building for \$1,800,000. For 1986 the building was depreciated \$60,000 for financial statement reporting. For income tax reporting, Cory uses the ACRS and is allowed a cost recovery deduction of \$145,000 for 1986. Assume an income tax rate of 40%. At December 31, 1986, what amount should Cory add to its deferred income tax liability?

- a. \$34,000
- b. \$36,000
- c. \$51,000
- d. \$58,000

Number 2 (Estimated time — 45 to 55 minutes)

Select the best answer for each of the following items relating to a variety of financial accounting problems.

Items to be Answered

21. Lake Construction Company has consistently used the percentage-of-completion method of recognizing income. During 1985 Lake entered into a fixed-price contract to construct an office building for \$10,000,000. Information relating to the contract is as follows:

	<i>At December 31,</i>	
	<u>1985</u>	<u>1986</u>
Percentage of completion	20%	60%
Estimated total cost at completion	\$7,500,000	\$8,000,000
Income recognized (cumulative)	500,000	1,200,000

Contract costs incurred during 1986 were

- a. \$3,200,000
- b. \$3,300,000
- c. \$3,500,000
- d. \$4,800,000

22. Among the items reported on Neal Corporation's income statement for the year ended December 31, 1986, are the following:

Interest received on municipal bonds	\$10,000
Amortization of goodwill	18,000

Timing differences for interperiod tax allocation amount to

- a. \$28,000
- b. \$18,000
- c. \$10,000
- d. \$0

23. On December 30, 1986, Frey Company leased equipment from Hull. Pertinent lease transaction data are as follows:

- The estimated seven-year useful equipment life coincides with the lease term.
- The first of the seven equal annual \$200,000 lease payments was paid on December 31, 1986.
- Hull's implicit interest rate of 12% is known to Frey.
- Frey's incremental borrowing rate is 14%.
- Present values of an annuity of 1 in advance for seven periods are 5.11 at 12%, and 4.89 at 14%, respectively.

At inception of the lease, Frey should record a capitalized lease liability of

- a. \$1,400,000
- b. \$1,022,000
- c. \$ 978,000
- d. \$0

24. On December 31, 1985, Roe Company leased a machine under a capital lease for a period of ten years, contracting to pay \$100,000 on signing the lease and \$100,000 annually on December 31 of the next nine years. The present value at December 31, 1985, of the ten lease payments over the lease term discounted at 10% was \$676,000. At December 31, 1986, Roe's total capital lease liability is

- a. \$486,000
- b. \$518,400
- c. \$533,600
- d. \$607,960

25. On June 30, 1987, Town, Inc. had outstanding 10%, \$1,000,000 face amount, 15-year bonds maturing on June 30, 1995. Interest is paid on June 30 and December 31, and bond discount and bond issue costs are amortized on these dates. The unamortized balances on June 30, 1987, of bond discount and bond issue costs were \$55,000 and \$20,000, respectively. Town reacquired all of these bonds at 96 on June 30, 1987, and retired them. Ignoring income taxes, how much gain or loss should Town record on the bond retirement?

- a. Loss of \$15,000.
- b. Loss of \$35,000.
- c. Gain of \$ 5,000.
- d. Gain of \$40,000.

26. On January 1, 1987, Colt Company issued ten-year bonds with a face amount of \$1,000,000 and a stated interest rate of 8% payable annually on January 1. The bonds were priced to yield 10%. Present value factors are as follows:

	At 8%	At 10%
Present value of 1 for 10 periods	0.463	0.386
Present value of an ordinary annuity of 1 for 10 periods	6.710	6.145

The total issue price (rounded) of the bonds was

- a. \$1,000,000
- b. \$ 980,000
- c. \$ 920,000
- d. \$ 880,000

27. During 1986 Cain Corporation incurred the following costs in connection with the issuance of bonds:

Printing and engraving	\$ 15,000
Legal fees	80,000
Fees paid to independent accountants for registration information	10,000
Commissions paid to underwriter	150,000

What amount should be recorded as a deferred charge to be amortized over the term of the bonds?

- a. \$ 15,000
- b. \$150,000
- c. \$245,000
- d. \$255,000

28. On January 1, 1987, Wolf, Inc. issued its 10% bonds in the face amount of \$500,000, that mature on January 1, 1997. The bonds were issued for \$443,000 to yield 12%, resulting in bond discount of \$57,000. Wolf uses the interest method of amortizing bond discount. Interest is payable July 1 and January 1. For the six months ended June 30, 1987, Wolf should report bond interest expense at

- a. \$25,000
- b. \$26,580
- c. \$27,850
- d. \$28,420

29. Ward, Inc. had outstanding 10%, \$1,000,000 face amount convertible bonds maturing on December 31, 1991, on which interest is paid December 31 and June 30. After amortization through June 30, 1987, the unamortized balance in the bond premium account was \$30,000. On that date, bonds with a face amount of \$500,000 were converted into 20,000 shares of \$20 par common stock. Ward incurred expenses of \$10,000 in connection with the conversion. Recording the conversion by the book value (carrying amount) method, Ward should credit additional paid-in capital for

- a. \$120,000
- b. \$115,000
- c. \$105,000
- d. \$100,000

30. Ball Corporation had the following infrequent gains during 1986:

- A \$240,000 gain on sale of a plant facility; Ball continues similar operations at another location.
- A \$90,000 gain on repayment of a long-term note denominated in a foreign currency.
- A \$190,000 gain on reacquisition and retirement of bonds.

In its 1986 income statement, how much should Ball report as total infrequent gains which are not considered extraordinary?

- a. \$520,000
- b. \$430,000
- c. \$330,000
- d. \$280,000

31. Kent Corp. carries \$10,000,000 comprehensive public liability insurance with a \$200,000 deductible clause. A suit for personal injury damages was brought against Kent in 1986. Kent's counsel believes it probable that the insurance company will settle out of court for an estimated amount of \$350,000. At December 31, 1986, Kent should report an accrued liability of

- a. \$350,000
- b. \$200,000
- c. \$150,000
- d. \$0

32. On July 1, 1986, Day Company purchased Parr Corp. ten-year, 8% bonds with a face amount of \$400,000 for \$358,000, which included \$8,000 of accrued interest. The bonds, which mature on April 1, 1994, pay interest semiannually on April 1 and October 1. Using the interest method, Day recorded bond discount amortization of \$1,500 for the six months ended December 31, 1986. From this long-term investment, Day should report 1986 revenue of

- a. \$14,000
- b. \$14,500
- c. \$16,000
- d. \$17,500

33. Adam Company received dividends from its common stock investments during the year ended December 31, 1986, as follows:

- A stock dividend of 200 shares from Brock Corp. was received on July 25, 1986, on which date the market price of Brock's shares was \$20 per share. Adam owns less than 1% of Brock's common stock.
- A cash dividend of \$60,000 from Celt Corp., in which Adam owns a 25% interest. A majority of Celt's directors are also directors of Adam.

What amount of dividend revenue should Adam report in its 1986 income statement?

- a. \$0
- b. \$ 4,000
- c. \$60,000
- d. \$64,000

Accounting Practice — Part I

34. On June 30, 1987, Dorr, Inc. declared and issued a 10% common stock dividend. Prior to the dividend, Dorr had 30,000 shares of \$10 par common stock issued and outstanding. The market price of Dorr's common stock on June 30, 1987, was \$27 per share. As a result of this stock dividend, by what amount should Dorr's total stockholders' equity increase or (decrease)?

- a. (\$81,000)
- b. \$51,000
- c. \$30,000
- d. \$0

35. On November 5, 1986, a Dunn Corp. truck was in an accident with an auto driven by Bell. Dunn received notice on January 12, 1987, of a lawsuit for \$700,000 damages for personal injuries suffered by Bell. Dunn Corp.'s counsel believes it is probable that Bell will be awarded an estimated amount in the range between \$200,000 and \$450,000, and that \$300,000 is a better estimate of potential liability than any other amount. Dunn's accounting year ends on December 31, and the 1986 financial statements were issued on March 2, 1987. What amount of loss should Dunn accrue at December 31, 1986?

- a. \$0
- b. \$200,000
- c. \$300,000
- d. \$450,000

36. Clay Company assigns patent rights, for which advance royalties are received in some cases and, in others, royalties are remitted within 60 days after each license year end. The following data are available from Clay's accounting records:

	<i>At December 31,</i>	
	<u>1985</u>	<u>1986</u>
Royalties receivable	\$75,000	\$80,000
Unearned royalties	45,000	65,000

During 1986 Clay received royalty remittances of \$250,000. In its 1986 income statement, Clay should report royalty revenue of

- a. \$225,000
- b. \$230,000
- c. \$235,000
- d. \$255,000

37. Conn Company purchased a new machine for \$480,000 on January 1, 1986, and leased it to East the same day. The machine has an estimated 12-year life, and will be depreciated \$40,000 per year. The lease is for a three-year period expiring January 1, 1989, at an annual rental of \$85,000. Additionally, East paid \$30,000 to Conn as a lease bonus to obtain the three-year lease. For 1986 Conn incurred insurance expense of \$8,000 for the leased machine. What is Conn's 1986 operating profit on this leased asset?

- a. \$67,000
- b. \$55,000
- c. \$47,000
- d. \$37,000

38. Mill Company began operations on January 1, 1985, and appropriately uses the installment method of accounting. The following data are available for 1985 and 1986:

	<u>1985</u>	<u>1986</u>
Installment sales	\$1,200,000	\$1,500,000
Cash collections from:		
1985 sales	400,000	500,000
1986 sales	—	600,000
Gross profit on sales	30%	40%

The realized gross profit for 1986 is

- a. \$240,000
- b. \$390,000
- c. \$440,000
- d. \$600,000

39. Rex Company accepted a \$10,000, 2% interest bearing note from Brooks Company on December 31, 1986, in exchange for a machine with a list price of \$8,000 and a cash price of \$7,500. The note is payable on December 31, 1988. In its 1986 income statement, Rex should report the sale at

- a. \$ 7,500
- b. \$ 8,000
- c. \$10,000
- d. \$10,400

40. On February 24, 1986, Bart Company purchased 2,000 shares of Winn Corp.'s newly issued 6% cumulative \$75 par preferred stock for \$152,000. Each share carried one detachable stock warrant entitling the holder to acquire at \$10, one share of Winn no-par common stock. On February 25, 1986, the market price of the preferred stock ex-warrants was \$72 a share and the market price of the stock warrants was \$8 a warrant. On December 29, 1986, Bart sold all the stock warrants for \$20,500. The gain on the sale of the stock warrants was

- a. \$0
- b. \$ 500
- c. \$4,500
- d. \$5,300

Number 3 (Estimated time — 45 to 55 minutes)

Select the best answer for each of the following items relating to a variety of financial accounting problems.

Items to be Answered

41. On October 1, 1986, Poe Corporation's operating plant, located in Kansas, was destroyed by an earthquake. The portion of the resultant loss not covered by insurance was \$1,400,000. Poe's income tax rate for 1986 is 40%. In Poe's income statement for the year ended December 31, 1986, this event should be reported as an extraordinary loss of

- a. \$0
- b. \$ 560,000
- c. \$ 840,000
- d. \$1,400,000

42. The following information was taken from Kay Company's accounting records for the year ended December 31, 1986:

Increase in raw materials inventory	\$ 15,000
Decrease in finished goods inventory	35,000
Raw materials purchased	430,000
Direct-labor payroll	200,000
Factory overhead	300,000
Freight-out	45,000

There was no work-in-process inventory at the beginning or end of the year. Kay's 1986 cost of goods sold is

- a. \$950,000
- b. \$965,000
- c. \$975,000
- d. \$995,000

43. Korn Company incurred the following costs during 1986:

Modification to the formulation of a chemical product	\$135,000
Trouble-shooting in connection with breakdowns during commercial production	150,000
Design of tools, jigs, molds and dies involving new technology	170,000
Seasonal or other periodic design changes to existing products	185,000
Laboratory research aimed at discovery of new technology	215,000

In its income statement for the year ended December 31, 1986, Korn should report research and development expense of

- a. \$520,000
- b. \$470,000
- c. \$385,000
- d. \$335,000

44. Orr Corporation had a realized foreign exchange loss of \$13,000 for the year ended December 31, 1986, and must also determine whether the following items will require year-end adjustment:

- Orr had a \$7,000 gain resulting from the translation of the accounts of its wholly owned foreign subsidiary for the year ended December 31, 1986.
- Orr had an account payable to an unrelated foreign supplier payable in the supplier's local currency. The U.S. dollar equivalent of the payable was \$60,000 on the October 31, 1986 invoice date, and it was \$64,000 on December 31, 1986. The invoice is payable on January 30, 1987.

In Orr's 1986 consolidated income statement, what amount should be included as foreign exchange loss?

- a. \$ 6,000
- b. \$10,000
- c. \$13,000
- d. \$17,000

45. Strand, Inc. provides an incentive compensation plan under which its president receives a bonus equal to 10% of the corporation's income in excess of \$200,000 before income tax but after deduction of the bonus. If income before income tax and bonus is \$640,000 and the tax rate is 40%, the amount of the bonus would be

- a. \$40,000
- b. \$44,000
- c. \$58,180
- d. \$64,000

46. Clark Company's allowance for doubtful accounts had a credit balance of \$12,000 at December 31, 1985. Clark accrues doubtful accounts expense at 4% of credit sales. During 1986 Clark's credit sales amounted to \$1,500,000, and uncollectible accounts totaling \$48,000 were written off. The aging of accounts receivable indicated that a \$50,000 allowance for doubtful accounts was required at December 31, 1986. Clark's doubtful accounts expense for 1986 would be

- a. \$48,000
- b. \$50,000
- c. \$60,000
- d. \$86,000

47. On May 15, 1986, Hart, Inc. approved a plan to dispose of a segment of its business. It is expected that the sale will occur on February 1, 1987, at a selling price of \$1,000,000. Disposal costs incurred by Hart totaled \$150,000, all of which were paid during 1986. The segment had actual or estimated operating losses as follows:

1/ 1/86 to 5/14/86	\$130,000
5/15/86 to 12/31/86	50,000
1/ 1/87 to 1/31/87	15,000

The carrying amount of the segment at the date of sale was expected to be \$1,750,000. Ignore the income tax effects. What amount should Hart report as a loss on disposal of the segment in its 1986 income statement?

- a. \$0
- b. \$900,000
- c. \$915,000
- d. \$965,000

48. At December 31, 1985, Lex, Inc. had 600,000 shares of common stock outstanding. On April 1, 1986, an additional 180,000 shares of common stock were issued for cash. Lex also had \$5,000,000 of 8% convertible bonds outstanding at December 31, 1986, which are convertible into 150,000 shares of common stock. The bonds were considered common stock equivalents at the time of issuance and are dilutive in the 1986 earnings per share computation. No bonds were issued or converted into common stock during 1986. What is the number of shares that should be used in computing primary earnings per share for 1986?

- a. 735,000
- b. 780,000
- c. 885,000
- d. 930,000

Items 49 and 50 are based on the following data:

Munn Corporation's income statement for the year ended December 31, 1986, shows pretax income of \$300,000. The following items are treated differently on the tax return and in the accounting records:

	<u>Tax return</u>	<u>Accounting records</u>
Warranty expense	\$170,000	\$185,000
Depreciation expense	150,000	100,000
Premiums on officers' life insurance	None	60,000

Assume that Munn's tax rate for 1986 is 40%.

49. What is the current portion of Munn's total income tax expense for 1986?

- a. \$106,000
- b. \$120,000
- c. \$130,000
- d. \$144,000

50. What is the deferred portion of Munn's total income tax expense for 1986?

- a. \$ 6,000
- b. \$14,000
- c. \$20,000
- d. \$24,000

51. On January 1, 1986, Farr, Inc. changed to the straight-line method of depreciation from an accelerated method of depreciation for its machinery and equipment. The accumulated depreciation through December 31, 1985, was \$600,000 higher than if the straight-line method had been used. The change was made for financial statement reporting but not for income tax reporting. Farr's income tax rate is 40% for 1985 and 1986. In Farr's 1986 income statement, the cumulative effect of this change in accounting principle should be reported at

- a. \$600,000
- b. \$360,000
- c. \$240,000
- d. \$0

52. Rand, Inc. had 20,000 shares of common stock outstanding at January 1, 1986. On May 1, 1986, it issued 10,500 shares of common stock. Outstanding all year were 10,000 shares of nonconvertible preferred stock on which a dividend of \$4 per share was paid in December 1986. Net income for 1986 was \$96,700. Rand's earnings per share for 1986 are

- a. \$1.86
- b. \$2.10
- c. \$2.84
- d. \$3.58

53. Dean Company uses the retail inventory method to estimate its inventory for interim statement purposes. Data relating to the computation of the inventory at July 31, 1987, are as follows:

	<u>Cost</u>	<u>Retail</u>
Inventory, 2/1/87	\$ 180,000	\$ 250,000
Purchases	1,020,000	1,575,000
Markups, net		175,000
Sales		1,705,000
Estimated normal shoplifting losses		20,000
Markdowns, net		125,000

Under the approximate lower of average cost or market retail method, Dean's estimated inventory at July 31, 1987 is

- a. \$ 90,000
- b. \$ 96,000
- c. \$102,000
- d. \$150,000

Items 54 and 55 are based on the following data:

Rice Wholesaling Corp. accounts for inventory on a FIFO basis. There were 8,000 units in inventory on January 1, 1986. Costs were incurred and goods purchased as follows during 1986:

<u>1986</u>	<u>Historical costs</u>	<u>Units purchased</u>	<u>Units sold</u>
1st quarter	\$ 410,000	7,000	7,500
2nd quarter	550,000	8,500	7,300
3rd quarter	425,000	6,500	8,200
4th quarter	630,000	9,000	7,000
	<u>\$2,015,000</u>	<u>31,000</u>	<u>30,000</u>

Rice estimates that the current cost per unit of inventory was \$57 at January 1, 1986, and \$71 at December 31, 1986.

54. In Rice's voluntary supplementary information restated into current cost, the December 31, 1986 inventory should be reported at

- a. \$576,000
- b. \$585,000
- c. \$630,000
- d. \$639,000

55. In Rice's voluntary supplementary information restated into current cost, the cost of goods sold for 1986 would be

- a. \$1,920,000
- b. \$1,944,000
- c. \$2,100,000
- d. \$2,130,000

Items 56 and 57 are based on the following data:

On January 1, 1986, Fay Corporation established an employee stock ownership plan (ESOP). Selected transactions relating to the ESOP during 1986 were as follows:

- On April 1, 1986, Fay contributed \$30,000 cash and 3,000 shares of its \$10 par common stock to the ESOP. On this date the market price of the stock was \$18 a share.
- On October 1, 1986, the ESOP borrowed \$100,000 from Union National Bank and acquired 5,000 shares of Fay's common stock in the open market at \$17 a share. The note is for one year, bears interest at 10%, and is guaranteed by Fay.
- On December 15, 1986, the ESOP distributed 6,000 shares of Fay common stock to employees of Fay in accordance with the plan formula.

56. In its 1986 income statement, how much should Fay report as compensation expense relating to the ESOP?

- a. \$184,000
- b. \$120,000
- c. \$ 84,000
- d. \$ 60,000

57. In Fay's December 31, 1986 balance sheet, how much should be reported as a reduction of shareholders' equity and as an endorsed note payable in respect of the ESOP?

<u>Reduction of shareholders' equity</u>	<u>Endorsed note payable</u>
a. \$0	\$0
b. \$0	\$100,000
c. \$100,000	\$0
d. \$100,000	\$100,000

58. Flax Company's accounting records disclosed the following information as of and for the year ended December 31, 1986:

Net credit sales	\$3,150,000
Net cash sales	630,000
Accounts receivable at beginning	500,000
Accounts receivable at end	900,000

Flax's accounts receivable turnover is

- a. 5.4 times.
- b. 4.5 times.
- c. 4.2 times.
- d. 3.5 times.

59. Cord Corporation discloses supplementary industry segment information for its two reportable segments. Data for 1986 are available as follows:

	<u>Segment E</u>	<u>Segment W</u>
Sales	\$750,000	\$250,000
Traceable operating expenses	325,000	130,000

Additional 1986 expenses are as follows:

Indirect operating expenses	\$120,000
General corporate expenses	100,000

Appropriately selected common expenses are allocated to segments based on the ratio of each segment's sales to total sales. The 1986 operating profit for segment E was

- a. \$260,000
- b. \$335,000
- c. \$395,000
- d. \$425,000

60. On December 31, 1985 and 1986, Taft Corporation had 100,000 shares of common stock and 50,000 shares of noncumulative and nonconvertible preferred stock issued and outstanding. Additional information is as follows:

Stockholders' equity at 12/31/86	\$4,500,000
Net income year ended 12/31/86	1,200,000
Dividends on preferred stock year ended 12/31/86	300,000
Market price per share of common stock at 12/31/86	72

The price-earnings ratio on common stock at December 31, 1986 was

- a. 5 to 1.
- b. 6 to 1.
- c. 8 to 1.
- d. 9 to 1.

Question Number 4 Begins on Page 11

Number 4 (Estimated time — 40 to 50 minutes)

The plant asset and accumulated depreciation accounts of Pell Corporation had the following balances at December 31, 1985:

	<i>Plant asset</i>	<i>Accumulated depreciation</i>
Land	\$ 350,000	\$ —
Land improvements	180,000	45,000
Building	1,500,000	350,000
Machinery and equipment	1,158,000	405,000
Automobiles	150,000	112,000

Depreciation methods and useful lives

Land improvements — Straight-line; 15 years.

Building — 150% declining balance; 20 years.

Machinery and equipment — Straight-line; ten years.

Automobiles — 150% declining balance; three years.

Depreciation is computed to the nearest month. No salvage values are recognized.

Transactions during 1986

- On January 2, 1986, machinery and equipment were purchased at a total invoice cost of \$260,000, which included a \$5,500 charge for freight. Installation costs of \$27,000 were incurred.
- On March 31, 1986, a machine purchased for \$58,000 on January 2, 1982, was sold for \$36,500.
- On May 1, 1986, expenditures of \$50,000 were made to repave parking lots at Pell's plant location. The work was necessitated by damage caused by severe winter weather.
- On November 1, 1986, Pell acquired a tract of land with an existing building in exchange for 10,000 shares of Pell's \$20 par common stock, that had a market price of \$38 a share on this date. Pell paid legal fees and title insurance totaling \$23,000. The last property tax bill indicated assessed values of \$240,000 for land and \$60,000 for building. Shortly after acquisition, the building was razed at a cost of \$35,000 in anticipation of new building construction in 1987.
- On December 31, 1986, Pell purchased a new automobile for \$15,250 cash and trade-in of an automobile purchased for \$18,000 on January 2, 1985. The new automobile has a cash value of \$19,000.

Required:

a. Prepare a schedule analyzing the changes in each of the plant assets during 1986, with detailed supporting computations. **Disregard the related accumulated depreciation accounts.**

b. For each asset classification, prepare a schedule showing depreciation expense for the year ended December 31, 1986.

c. Prepare a schedule showing the gain or loss from each asset disposal that would be recognized in Pell's income statement for the year ended December 31, 1986.

Question Number 5 Begins on Page 12

Number 5 (Estimated time — 45 to 55 minutes)

Presented below are the condensed statements of financial position of Public Relations Associates as of December 31, 1986 and 1985, and the condensed statement of income for the year ended December 31, 1986.

Public Relations Associates
CONDENSED STATEMENTS OF FINANCIAL POSITION
December 31, 1986 and 1985

	<u>1986</u>	<u>1985</u>	<i>Net change increase (decrease)</i>
<u><i>Assets</i></u>			
Cash	\$ 326,000	\$ 140,000	\$186,000
Accounts receivable, net	223,000	184,000	39,000
Investment in King, Inc., at equity	275,000	233,000	42,000
Property and equipment	635,000	550,000	85,000
Accumulated depreciation	(95,000)	(65,000)	(30,000)
Excess cost over book value of investment in King (net)	76,000	78,000	(2,000)
Total assets	<u>\$1,440,000</u>	<u>\$1,120,000</u>	<u>\$320,000</u>
<u><i>Liabilities and Partners' Equity</i></u>			
Accounts payable and accrued expenses	\$ 160,000	\$ 135,000	\$ 25,000
Mortgage payable	125,000	135,000	(10,000)
Partners' equity	1,155,000	850,000	305,000
Total liabilities and partners' equity	<u>\$1,440,000</u>	<u>\$1,120,000</u>	<u>\$320,000</u>

Public Relations Associates
CONDENSED STATEMENT OF INCOME
For the Year Ended December 31, 1986

Fee revenue	\$1,332,000
Operating expenses	<u>970,000</u>
Operating income	362,000
Equity in earnings of King, Inc. (net of \$2,000 amortization of excess cost over book value)	<u>88,000</u>
Net income	<u>\$ 450,000</u>

Number 5 (continued)

Additional information:

- On December 31, 1985, partners' capital and profit sharing percentages were as follows:

	<u>Capital</u>	<u>Profit sharing %</u>
Burr	\$510,000	60%
Cox	340,000	40%
	<u>\$850,000</u>	

- On January 1, 1986, the partners admitted Davis to the partnership for a cash payment of \$170,000 to Public Relations Associates. In addition, Davis paid a \$100,000 cash bonus directly to Burr and Cox. This amount was divided \$60,000 to Burr and \$40,000 to Cox. The new profit sharing arrangement is as follows:

Burr	50%
Cox	30%
Davis	20%

- On July 1, 1986, Public Relations Associates purchased an office computer for \$85,000 which included \$10,000 for sales tax, delivery, and installation. There were no dispositions of property and equipment during 1986.
- Throughout 1986, Public Relations Associates owned 25% of the common stock of King, Inc. During 1986, King paid cash dividends totaling \$192,000 and reported net income of \$360,000. Public's 1986 amortization of excess cost over book value in King was \$2,000.
- Partners' drawings for 1986 were as follows:

Burr	\$140,000
Cox	100,000
Davis	75,000
	<u>\$315,000</u>

Required:

- a. Using the cash concept of funds, prepare a statement of changes in financial position of Public Relations Associates for the year ended December 31, 1986.
- b. Prepare an analysis of changes in partners' capital accounts for the year ended December 31, 1986.

EXAMINATION IN ACCOUNTING PRACTICE — PART II

November 5, 1987; 1:30 to 6:00 P.M.

NOTE TO CANDIDATES: Suggested time allotments are as follows:

All questions are required:	<i>Point Value</i>	<i>Estimated Minutes</i>	
		<i>Minimum</i>	<i>Maximum</i>
No. 1	10	45	55
No. 2	10	45	55
No. 3	10	45	55
No. 4	10	45	55
No. 5	10	40	50
Total	50	220	270

INSTRUCTIONS TO CANDIDATES

(Disregard of these instructions may be considered as indicating inefficiency in accounting work.)

- | | |
|---|---|
| <p>1. You must arrange the papers in numerical order of the questions. If more than one page is required for an answer, write "continued" at the bottom of the page. Number pages consecutively. For instance, if 12 pages are used for your answers, the objective answer sheet is page 1 and your other pages should be numbered 2 through 12.</p> <p>2. Answer all objective-type items on the printed answer sheet provided for that purpose. It is to your advantage to attempt all questions even if you are uncertain of the answer. You are likely to get the highest score if you omit no answers. Since objective items are computer-graded, your comments and calculations associated with them are not considered. Be certain that you have entered your answers on the objective answer sheet before the examination time is up.</p> <p>3. Support all problem-type answers with properly labeled and legible calculations that can be identified as sources of amounts in formal schedules, entries, worksheets, or other answers, to</p> | <p>show how your final answer was derived. Computation sheets should identify the question to which they relate, be placed immediately following the answer to that question, and be numbered in sequence with the other pages. Failure to enclose supporting calculations may result in loss of grading points because it may be impossible to determine how your amounts were computed.</p> <p>4. For Question Number 5 be sure to include the completed tear-out worksheet in the proper sequence with other answer sheets.</p> <p>5. A CPA is continually confronted with the necessity of expressing opinions and conclusions in written reports in clear, unequivocal language. Although the primary purpose of the examination is to test the candidate's knowledge and application of the subject matter, the ability to organize and present such knowledge in acceptable written language may be considered by the examiners.</p> |
|---|---|

*Prepared by the Board of Examiners of the American Institute of Certified Public Accountants
and adopted by the examining boards of all states, the District of Columbia, Guam,
Puerto Rico, and the Virgin Islands of the United States.*

Instructions

Questions Number 1, 2, and 3 each consist of 20 multiple choice items. Select the best answer for each of the items. Use a soft pencil, preferably No. 2, to blacken the appropriate circle on the separate printed answer sheet to indicate your answer. Mark only one answer for each item. Answer all items. Your grade will be based on the total number of your correct answers for each question.

The following is an example of the manner in which the answer sheet should be marked:

Item

97. Gross billings for merchandise sold by Baker Company to its customers last year amounted to \$5,260,000; sales returns and allowances reduced the amounts owed by \$160,000. How much were net sales last year for Baker Company?

- a. \$4,800,000
- b. \$5,100,000
- c. \$5,200,000
- d. \$5,260,000

Answer Sheet

97. (a) ● (c) (d)

Number 1 (Estimated time — 45 to 55 minutes)

Select the best answer for each of the following items relating to the federal taxation of individuals, estates, and trusts. The answers should be based on the Internal Revenue Code and Tax Regulations in effect for the tax period specified in the item. If no tax period is specified, use the current Internal Revenue Code and Tax Regulations. If 1987 is indicated as the tax year, assume that the year has ended.

Items to be Answered

1. John Budd files a joint return with his wife. Budd's employer pays 100% of the cost of all employees' group-term life insurance under a qualified plan. Under this plan, the maximum amount of tax-free coverage that may be provided for Budd by his employer is

- a. \$100,000
- b. \$ 50,000
- c. \$ 10,000
- d. \$ 5,000

2. In 1987, Al Oran bought a paved vacant lot adjacent to his retail store for use as a customers' parking lot at a cost of \$15,000. In addition, Oran bought new store fixtures costing \$8,000. What portion of these assets constitutes capital assets?

- a. \$0
- b. \$ 8,000
- c. \$15,000
- d. \$23,000

3. Emil Gow owns a two-family house which has two identical apartments. Gow lives in one apartment and rents out the other. In 1987, the rental apartment was fully occupied and Gow received \$7,200 in rent. During the year ended December 31, 1987, Gow paid the following:

Real estate taxes	\$6,400
Painting of rental apartment	800
Annual fire insurance premium	600

In 1987, depreciation for the entire house was determined to be \$5,000. What amount should Gow include in his adjusted gross income for 1987?

- a. \$2,900
- b. \$ 800
- c. \$ 400
- d. \$ 100

4. With regard to tax recognition of alimony in connection with a 1987 divorce, which one of the following statements is correct?

- a. The divorced couple may be members of the same household at the time payments are made.
- b. Payments may be made either in cash or in property.
- c. If the payor spouse pays premiums for insurance on his life as a requirement under the divorce agreement, the premiums are alimony if the payor spouse owns the policy.
- d. Payments must terminate at the death of the payee spouse.

5. For the year ended December 31, 1986, Don Raff earned \$1,000 interest at Ridge Savings Bank on a certificate of deposit scheduled to mature in 1988. In January 1987, before filing his 1986 income tax return, Raff incurred a forfeiture penalty of \$500 for premature withdrawal of the funds. Raff should treat this \$500 forfeiture penalty as a

- a. Reduction of interest earned in 1986, so that only \$500 of such interest is taxable on Raff's 1986 return.
- b. Deduction from 1987 adjusted gross income, deductible only if Raff itemizes his deductions for 1987.
- c. Penalty not deductible for tax purposes.
- d. Deduction from gross income in arriving at 1987 adjusted gross income.

6. Under the cash method of reporting, an individual should report gross income

- a. Only for the year in which income is actually received in cash.
- b. Only for the year in which income is actually received either in cash or in property.
- c. For the year in which income is either actually or constructively received in cash only.
- d. For the year in which income is either actually or constructively received either in cash or in property.

Examination Questions — November 1987

7. The following information pertains to installment sales of personal use property made by Fred Dale in his retail furniture store:

<u>Year of sale</u>	<u>Installment sales</u>	<u>Gross profit</u>	<u>Collections in 1987</u>
1985	\$ 50,000	\$15,000	\$10,000
1986	100,000	40,000	30,000
1987	150,000	75,000	40,000

These sales were **not** under a revolving credit plan. Under the installment method, Dale should report gross profit for 1987 of

- a. \$ 35,000
- b. \$ 75,000
- c. \$ 80,000
- d. \$130,000

8. Under a \$150,000 insurance policy on her deceased father's life, Mary Green is to receive \$12,000 per year for 15 years. Of the \$12,000 received in 1987, the amount subject to income tax is

- a. \$0
- b. \$ 1,000
- c. \$ 2,000
- d. \$12,000

9. In 1987, Gail Judd received the following dividends from

Benefit Life Insurance Co., on Gail's life insurance policy (Total dividends received have not yet exceeded accumulated premiums paid)	\$100
Safe National Bank, on bank's common stock	300
Roe Mfg. Corp., a Delaware corporation, on preferred stock	500

What amount of dividend income should Gail report in her 1987 income tax return?

- a. \$900
- b. \$800
- c. \$500
- d. \$300

10. Paul Crane, age 25, and single with no dependents, had an adjusted gross income of \$30,000 in 1987, exclusive of \$2,000 in unemployment compensation benefits received in 1987. The amount of Crane's unemployment compensation benefits taxable for 1987 is

- a. \$2,000
- b. \$1,000
- c. \$ 500
- d. \$0

Items 11 through 13 are based on the following data:

Alan Curtis, a U.S. citizen, died on March 1, 1987, leaving an adjusted gross estate with a fair market value of \$1,400,000 at the date of death. Under the terms of Alan's will, \$375,000 was bequeathed outright to his widow, free of all estate and inheritance taxes. The remainder of Alan's estate was left to his mother. Alan made no taxable gifts during his lifetime.

11. Disregarding extensions of time for filing, within how many months after the date of Alan's death is the federal estate tax return due?

- a. 2½
- b. 3½
- c. 9
- d. 12

12. In computing the taxable estate, the executor of Alan's estate should claim a marital deduction of

- a. \$ 250,000
- b. \$ 375,000
- c. \$ 700,000
- d. \$1,025,000

13. If the executor of Alan's estate elects the alternate valuation method, all remaining undistributed property included in the gross estate must be valued as of how many months after Alan's death?

- a. 12
- b. 9
- c. 6
- d. 3

14. Smith and Jones, both U.S. citizens, died in 1987. Neither made any lifetime gifts. At the dates of death, Smith's gross estate was \$510,000, and Jones' gross estate was \$610,000. A federal estate tax return must be filed for

	<u>Smith</u>	<u>Jones</u>
a.	Yes	Yes
b.	No	No
c.	Yes	No
d.	No	Yes

15. If a taxpayer omits from his or her income tax return an amount that exceeds 25% of the gross income reported on the return, the Internal Revenue Service can issue a notice of deficiency within a maximum period of

- a. 3 years from the date the return was filed, if filed before the due date.
- b. 3 years from the date the return was due, if filed by the due date.
- c. 6 years from the date the return was filed, if filed before the due date.
- d. 6 years from the date the return was due, if filed by the due date.

16. Ben Carr, a calendar-year taxpayer, was 65 years old on December 30, 1986. Ben filed his 1986 individual income tax return on April 1, 1987, and attached a check for the balance of tax due as shown on the return. On August 15, 1987, Ben realized that he had inadvertently failed to claim the additional exemption to which he was entitled by virtue of having attained age 65 in 1986. In order for Ben to recover the tax that he would have saved by claiming the extra exemption, he must file a refund claim no later than

- December 31, 1987.
- April 1, 1990.
- April 15, 1990.
- August 15, 1990.

17. In 1987, Sam Dunn provided more than half the support for his wife, his father's brother, and his cousin. Sam's wife was the only relative who was a member of Sam's household. None of the relatives had any income, nor did any of them file an individual or a joint return. All of these relatives are U.S. citizens. Which of these relatives should be claimed as a dependent or dependents on Sam's 1987 return?

- Only his wife.
- Only his father's brother.
- Only his cousin.
- His wife, his father's brother, and his cousin.

Items 18 through 20 are based on the following data:

In 1980, Iris King bought a diamond necklace for her own use, at a cost of \$10,000. In 1987, when the fair market value was \$12,000, Iris gave this necklace to her daughter, Ruth. No gift tax was due.

- Ruth's holding period for this gift
 - Starts in 1987.
 - Starts in 1980.
 - Depends on whether the necklace is sold by Ruth at a gain or at a loss.
 - Is irrelevant because Ruth received the necklace for no consideration of money or money's worth.
- This diamond necklace is a
 - Capital asset.
 - Section 1231 asset.
 - Section 1245 asset.
 - Section 1250 asset.
- If Ruth sells this diamond necklace in 1988 for \$13,000, Ruth's recognized gain would be
 - \$3,000
 - \$2,000
 - \$1,000
 - \$0

Number 2 (Estimated time — 45 to 55 minutes)

Select the best answer for each of the following items relating to the federal taxation of corporations, partnerships, and exempt organizations. The answers should be based on the Internal Revenue Code and Tax Regulations in effect for the tax period specified in the item. If no tax period is specified, use the *current* Internal Revenue Code and Tax Regulations. If 1987 is indicated as the tax year, assume that the year has ended.

Items to be Answered

Items 21 through 26 are based on the following data:

Eric Bay was the sole stockholder of Lee Corp., an accrual basis taxpayer engaged principally in retailing operations. Lee's retained earnings at December 31, 1986, amounted to \$2,000,000. For the year ended December 31, 1987, Lee's book income, before income taxes, was \$600,000. Included in the computation of this \$600,000 were the following:

Gain on sale of land used in business	\$ 20,000
Loss on sale of long-term investments in marketable securities	30,000
Dividend income from unaffiliated taxable domestic corporations	4,000
Keyman insurance premiums paid on Bay's life (Lee is beneficiary)	1,000
Group term life insurance premiums paid on \$25,000 life insurance policies for employees (employees' dependents are beneficiaries)	15,000
Contribution to State University (authorized by Board of Directors in December 1987; to be paid March 3, 1988)	100,000
Amortization of organization costs (total organization costs of \$6,000 were incurred in January 1984, and are being amortized over a 10-year period for financial statement purposes)	600

In 1980, Lee had reacquired 1,000 shares of its own \$10 par common stock at a cost of \$25,000. This stock was held as treasury stock until May 1987, when it was reissued to James Smith at its fair market value of \$33,000.

- In computing taxable income for 1987, Lee should deduct a net capital loss of
 - \$15,000
 - \$10,000
 - \$ 5,000
 - \$0

22. The dividend income Lee should include in its 1987 taxable income is

- a. \$4,000
- b. \$3,200
- c. \$ 800
- d. \$0

23. In computing taxable income for 1987, what amount should Lee deduct for keyman and group life insurance premiums?

- a. \$ 8,000
- b. \$15,000
- c. \$15,500
- d. \$16,000

24. With regard to Lee's contribution to State University, Lee can

- a. Not deduct any portion of the \$100,000 in 1987, because the contribution was not paid until 1988.
- b. Deduct the entire \$100,000 in its 1987 return.
- c. Elect to carry back to 1986 a portion of the \$100,000 that does not exceed the deduction ceiling for 1986 and 1987.
- d. Elect to deduct in its 1987 return any portion of the \$100,000 that does not exceed the deduction ceiling for 1987.

25. In computing taxable income for 1987, what is the maximum deduction that Lee can claim for organization costs, assuming that the appropriate election was made on a timely basis?

- a. \$1,200
- b. \$ 600
- c. \$ 300
- d. \$0

26. How much should Lee report in its 1987 return as long-term capital gain on the issuance of its treasury stock to Smith?

- a. \$0
- b. \$ 8,000
- c. \$23,000
- d. \$33,000

27. Tau Corp., which has been operating since 1980, has an October 31 year end, which coincides with its natural business year. On May 15, 1987, Tau filed the required form to elect S corporation status. All of Tau's stockholders consented to the election, and all other requirements were met. The earliest date that Tau can be recognized as an S corporation is

- a. November 1, 1986.
- b. May 15, 1987.
- c. November 1, 1987.
- d. November 1, 1988.

28. For the year ended December 31, 1987, Bard Corp.'s income per accounting records, before federal income taxes, was \$450,000 and included the following:

State corporate income tax refunds	\$ 4,000
Life insurance proceeds on officer's death	15,000
Net loss on sale of securities bought for investment in 1976	20,000

Bard's 1987 taxable income was

- a. \$435,000
- b. \$451,000
- c. \$455,000
- d. \$470,000

29. In the filing of a consolidated income tax return for a corporation and its wholly-owned subsidiaries, intercompany dividends between the parent and subsidiary corporations are

- a. Fully taxable.
- b. Included in taxable income to the extent of 80%.
- c. Included in taxable income to the extent of 20%.
- d. Not taxable.

30. If a corporation's tentative minimum tax exceeds the regular tax, the excess amount is

- a. Carried back to the preceding taxable year.
- b. Carried back to the third preceding taxable year.
- c. Payable in addition to the regular tax.
- d. Subtracted from the regular tax.

31. If an exempt organization is a charitable trust, then unrelated business income is

- a. Not subject to tax.
- b. Taxed at rates applicable to corporations.
- c. Subject to tax even if such income is less than \$1,000.
- d. Subject to tax only for the amount of such income in excess of \$1,000.

32. Which one of the following statements is correct with regard to exempt organizations?

- a. An organization is automatically exempt from tax merely by meeting the statutory requirements for exemption.
- b. Exempt organizations that are required to file annual information returns must disclose the identity of all substantial contributors, in addition to the amount of contributions received.
- c. An organization will automatically forfeit its exempt status if any executive or other employee of the organization is paid compensation in excess of \$150,000 per year, even if such compensation is reasonable.
- d. Exempt status of an organization may not be retroactively revoked.

33. To qualify as an exempt organization, the applicant
- Must fall into one of the specific classes upon which exemption is conferred by the Internal Revenue Code.
 - Can **not**, under any circumstances, be a foreign corporation.
 - Can **not**, under any circumstances, engage in lobbying activities.
 - Can **not** be exclusively a social club.
34. The personal holding company tax may be imposed
- As an alternative tax in place of the corporation's regularly computed tax.
 - If more than 50% of the corporation's stock is owned, directly or indirectly, by more than ten stockholders.
 - If at least 60% of the corporation's adjusted ordinary gross income for the taxable year is personal holding company income, and the stock ownership test is satisfied.
 - In conjunction with the accumulated earnings tax.
35. The accumulated earnings tax
- Should be self-assessed by filing a separate schedule along with the regular tax return.
 - Applies only to closely held corporations.
 - Can be imposed on S corporations that do not regularly distribute their earnings.
 - Can **not** be imposed on a corporation that has undistributed earnings and profits of less than \$150,000.
36. Pursuant to a plan of corporate reorganization adopted in June 1987, Lois Pell exchanged 100 shares of Ral Corp. common stock that she had purchased in March 1987 at a cost of \$10,000 for 150 shares of Lars Corp. common stock having a fair market value of \$12,000. Pell's recognized gain on this exchange was
- \$0.
 - \$2,000 ordinary income.
 - \$2,000 short-term capital gain.
 - \$2,000 long-term capital gain.
37. Dave Cole's adjusted basis for his interest in Marb Associates, a partnership, was \$50,000. This amount included \$20,000 of partnership liabilities for which Cole was personally liable. Marb had no unrealized receivables or substantially appreciated inventory. After having been paid his share of partnership income for the tax year, Cole sold his entire interest in Marb for \$40,000 cash and a release from all partnership liabilities. Cole's recognized gain or loss on the sale of his interest in Marb was
- \$0.
 - \$10,000 ordinary income.
 - \$10,000 capital gain.
 - \$10,000 capital loss.

Items 38 and 39 are based on the following data:

Mike Reed, a partner in Post Co., received the following distribution from Post:

	<i>Post's basis</i>	<i>Fair market value</i>
Cash	\$11,000	\$11,000
Land	5,000	12,500

Before this distribution, Reed's basis in Post was \$25,000.

38. If this distribution were nonliquidating, Reed's recognized gain or loss on the distribution would be
- \$11,000 gain.
 - \$ 9,000 loss.
 - \$ 1,500 loss.
 - \$0.

39. If this distribution were in complete liquidation of Reed's interest in Post, Reed's basis for the land would be
- \$14,000
 - \$12,500
 - \$ 5,000
 - \$ 1,500

-
40. Sara Loy is a member of a four-person equal partnership. In 1987, Sara sold 100 shares of a listed stock to the partnership for the stock's fair market value of \$20,000. Sara's basis for this stock, that was purchased in 1980, was \$14,000. Sara's recognized gain on the sale of this stock was
- \$0
 - \$1,500
 - \$4,500
 - \$6,000

Number 3 (Estimated time — 45 to 55 minutes)

Select the **best** answer for each of the following items relating to a **variety of not-for-profit and governmental accounting problems**.

Items to be Answered

41. Cura Hospital's property, plant, and equipment, net of depreciation, amounted to \$10,000,000, with related mortgage liabilities of \$1,000,000. What amount should be included in the restricted fund grouping?
- \$0
 - \$ 1,000,000
 - \$ 9,000,000
 - \$10,000,000

42. For the summer session of 1987, Ariba University assessed its students \$1,700,000 (net of refunds), covering tuition and fees for educational and general purposes. However, only \$1,500,000 was expected to be realized because scholarships totaling \$150,000 were granted to students, and tuition remissions of \$50,000 were allowed to faculty members' children attending Ariba. What amount should Ariba include in the unrestricted current funds as revenues from student tuition and fees?

- a. \$1,500,000
- b. \$1,550,000
- c. \$1,650,000
- d. \$1,700,000

43. Park College is sponsored by a religious group. Volunteers from this religious group regularly contribute their services to Park, and are paid nominal amounts to cover their commuting costs. During 1986, the total amount paid to these volunteers aggregated \$12,000. The gross value of services performed by them, determined by reference to lay-equivalent salaries, amounted to \$300,000. What amount should Park record as expenditures in 1986 for these volunteers' services?

- a. \$312,000
- b. \$300,000
- c. \$ 12,000
- d. \$0

44. Abbey University's unrestricted current funds comprised the following:

Assets	\$5,000,000
Liabilities (including deferred revenues of \$100,000)	3,000,000

The fund balance of Abbey's unrestricted current funds was

- a. \$1,900,000
- b. \$2,000,000
- c. \$2,100,000
- d. \$5,000,000

45. The following receipts were among those recorded by Kery College during 1986:

Unrestricted gifts	\$500,000
Restricted current funds (expended for current operating purposes)	200,000
Restricted current funds (not yet expended)	100,000

The amount that should be included in current funds revenues is

- a. \$800,000
- b. \$700,000
- c. \$600,000
- d. \$500,000

46. Palma Hospital's patient service revenues for services provided in 1986, at established rates, amounted to \$8,000,000 on the accrual basis. For internal reporting, Palma uses the discharge method. Under this method, patient service revenues are recognized only when patients are discharged, with no recognition given to revenues accruing for services to patients not yet discharged. Patient service revenues at established rates using the discharge method amounted to \$7,000,000 for 1986. According to generally accepted accounting principles, Palma should report patient service revenues for 1986 of

- a. Either \$8,000,000 or \$7,000,000, at the option of the hospital.
- b. \$8,000,000
- c. \$7,500,000
- d. \$7,000,000

47. The following information pertains to Wood Township's long-term debt:

Cash accumulations to cover payment of principal and interest on

General long-term obligations	\$350,000
Proprietary fund obligations	100,000

How much of these cash accumulations should be accounted for in Wood's debt service funds?

- a. \$0
- b. \$100,000
- c. \$350,000
- d. \$450,000

48. In 1986, Menton City received \$5,000,000 of bond proceeds to be used for capital projects. Of this amount, \$1,000,000 was expended in 1986. Expenditures for the \$4,000,000 balance were expected to be incurred in 1987. These bond proceeds should be recorded in capital projects funds for

- a. \$5,000,000 in 1986.
- b. \$5,000,000 in 1987.
- c. \$1,000,000 in 1986 and \$4,000,000 in 1987.
- d. \$1,000,000 in 1986 and in the general fund for \$4,000,000 in 1986.

49. Aviary Haven, a voluntary welfare organization funded by contributions from the general public, received unrestricted pledges of \$500,000 during 1986. It was estimated that 12% of these pledges would be uncollectible. By the end of 1986, \$400,000 of the pledges had been collected, and it was expected that \$40,000 more would be collected in 1987, with the balance of \$60,000 to be written off as uncollectible. Donors did not specify any periods during which the donations were to be used. What amount should Aviary include under public support in 1986 for net contributions?

- a. \$500,000
- b. \$452,000
- c. \$440,000
- d. \$400,000

Accounting Practice — Part II

50. During 1986, Shaw Hospital purchased medicines for hospital use totaling \$800,000. Included in this \$800,000 was an invoice of \$10,000 that was canceled in 1986 by the vendor because the vendor wished to donate this medicine to Shaw. This donation of medicine should be recorded as

- a. A \$10,000 reduction of medicine expense.
- b. An increase in other operating revenue of \$10,000.
- c. A direct \$10,000 credit to the general (unrestricted) funds balance.
- d. A \$10,000 credit to the restricted funds balance.

51. In 1986, Pyle Hospital received a \$250,000 pure endowment fund grant. Also in 1986, Pyle's governing board designated, for special uses, \$300,000 which had originated from unrestricted gifts. What amount of these resources should be accounted for as part of general (unrestricted) funds?

- a. \$0
- b. \$250,000
- c. \$300,000
- d. \$550,000

52. The following proceeds were received by Kew City from specific revenue sources that are legally restricted to expenditure for specified purposes:

Gasoline taxes to finance road repairs	\$400,000
Levies on affected property owners to finance sidewalk repairs	300,000

The amount that should be accounted for in Kew's special revenue funds is

- a. \$0
- b. \$300,000
- c. \$400,000
- d. \$700,000

53. Wells Township issued the following long-term obligations:

Revenue bonds to be repaid from admission fees collected by the township swimming pool	\$500,000
General obligation bonds issued for the township water and sewer fund which will service the debt	900,000

Although the above-mentioned bonds are expected to be paid from enterprise funds, the full faith and credit of Wells Township has been pledged as further assurance that the liabilities will be paid. What amount of these bonds should be accounted for in the general long-term debt account group?

- a. \$1,400,000
- b. \$ 900,000
- c. \$ 500,000
- d. \$0

54. Lake City operates a centralized data processing center through an internal service fund, to provide data processing services to Lake's other governmental units. In 1986, this internal service fund billed Lake's water and sewer fund \$100,000 for data processing services. How should the internal service fund record this billing?

	<i>Debit</i>	<i>Credit</i>
a. Memorandum entry only	—	—
b. Due from water and sewer fund	\$100,000	
Data processing department expenses		\$100,000
c. Intergovernmental transfers	\$100,000	
Interfund exchanges		\$100,000
d. Due from water and sewer fund	\$100,000	
Operating revenues control		\$100,000

55. Burr City has approved a special assessment project providing for total assessments of \$300,000, to be collected from affected property owners in five equal annual installments starting in 1987. The entry to be made to record the levy of assessments in 1987 is

	<i>Debit</i>	<i>Credit</i>
a. Special assessments receivable — current	\$ 60,000	
Special assessments receivable — deferred	240,000	
Revenues control		\$ 60,000
Deferred revenues		240,000
b. Special assessments receivable — current	\$ 60,000	
Revenues control		\$ 60,000
c. Special assessments receivable	\$300,000	
Revenues control		\$300,000
d. Special assessments receivable	\$300,000	
Deferred revenues		\$300,000

56. Dodd Village received a gift of a new fire engine from a local resident. The fair market value of this fire engine was \$200,000. The entry to be made in the general fixed assets account group for this gift is

	<i>Debit</i>	<i>Credit</i>
a. Machinery and equipment	\$200,000	
Investment in general fixed assets from private gifts		\$200,000
b. Investment in general fixed assets	\$200,000	
Gift revenue		\$200,000
c. General fund assets	\$200,000	
Private gifts		\$200,000
d. Memorandum entry only	—	—

Number 4 (Estimated time — 45 to 55 minutes)

Items 57 and 58 are based on the following information pertaining to the sale of equipment by Nous Foundation, a voluntary health and welfare organization:

Sales price	\$12,000
Cost	14,000
Carrying amount	10,000

Nous made the correct entry to record the \$2,000 gain on sale.

57. The additional entry that Nous should record in connection with this sale is

<u>Debit</u>	<u>Credit</u>
a. Fund balance — expended	Fund balance — unexpended
b. Fund balance — unexpended	Fund balance — expended
c. Excess revenues control	Sale of equipment
d. Current unrestricted funds	Fund balance — undesignated

58. The amount that should be debited and credited for the additional entry in connection with this sale is

- \$ 2,000
- \$10,000
- \$12,000
- \$14,000

59. The following funds are among those maintained by Arlon City:

Enterprise funds	\$2,000,000
Internal service funds	800,000

Arlon's proprietary funds amount to

- \$0
- \$ 800,000
- \$2,000,000
- \$2,800,000

60. Payne Hospital received an unrestricted bequest of \$100,000 in 1986. This bequest should be recorded as

- A memorandum entry only.
- Other operating revenue of \$100,000.
- Nonoperating revenue of \$100,000.
- A direct credit of \$100,000 to the fund balance.

Webb & Company is engaged in the preparation of income tax returns for individuals. Webb uses the weighted average method and actual costs for financial reporting purposes. However, for internal reporting, Webb uses a standard cost system. The standards, based on equivalent performance, have been established as follows:

Labor per return	5 hrs. @ \$20 per hr.
Overhead per return	5 hrs. @ \$10 per hr.

For March 1987 performance, budgeted overhead is \$49,000 for the standard labor hours allowed. The following additional information pertains to the month of March 1987:

Inventory data

Returns in process, March 1 (25% complete)	200
Returns started in March	825
Returns in process, March 31 (80% complete)	125

Actual cost data

Returns in process March 1:	
Labor	\$ 6,000
Overhead	2,500
Labor, March 1 to 31	
4,000 hours	89,000
Overhead, March 1 to 31	45,000

Required:

a. Using the weighted average method, compute the following for each cost element:

- Equivalent units of performance.
- Actual cost per equivalent unit.

b. Compute the actual cost of returns in process at March 31.

c. Compute the standard cost per return.
 d. Prepare a schedule for internal reporting analyzing March performance, using the following variances, and indicating whether these variances are favorable or unfavorable:

- Total labor.
- Labor rate.
- Labor efficiency.
- Total overhead.
- Overhead volume.
- Overhead budget.

Number 5 (Estimated time — 40 to 50 minutes)

The December 31, 1986 condensed balance sheets of Pym Corp. and its 90%-owned subsidiary, Sy Corp., are presented in the tear-out worksheet.

Additional information follows:

- Pym's investment in Sy was purchased for \$1,200,000 cash on January 1, 1986, and is accounted for by the equity method.
- At January 1, 1986, Sy's retained earnings amounted to \$600,000, and its common stock amounted to \$200,000.
- Sy declared a \$1,000 cash dividend in December 1986, payable in January 1987.
- As of December 31, 1986, Pym had not recorded any portion of Sy's 1986 net income or dividend declaration.
- Sy borrowed \$100,000 from Pym on June 30, 1986, with the note maturing on June 30, 1987, at 10% interest. Correct accruals have been recorded by both companies.
- During 1986, Pym sold merchandise to Sy at an aggregate invoice price of \$300,000, which included a profit of \$60,000. At December 31, 1986, Sy had not paid Pym for \$90,000 of these purchases, and 5% of the total merchandise purchased from Pym still remained in Sy's inventory.
- Pym's excess cost over book value of Pym's investment in Sy has appropriately been identified as goodwill and is to be amortized over 10 years.

Required:

Complete the tear-out worksheet for Pym Corp. and its subsidiary, Sy Corp., at December 31, 1986.

A formal consolidated balance sheet and journal entries are not required. Include the completed tear-out worksheet in the proper sequence with your other answer sheets.

Pym Corp. and Subsidiary
CONSOLIDATED BALANCE SHEET WORKSHEET
 December 31, 1986

	<i>Pym Corp.</i>	<i>Sy Corp.</i>	<i>Adjustments & Eliminations</i>		<i>Consolidated</i>
			<i>Debit</i>	<i>Credit</i>	
<i>Assets</i>					
Cash	75,000	15,000			
Accounts and other current receivables	410,000	120,000			
Merchandise inventory	920,000	670,000			
Plant and equipment (net)	1,000,000	400,000			
Investment in Sy Corp.	1,200,000				
Totals	3,605,000	1,205,000			
<i>Liabilities and Stockholders' Equity</i>					
Accounts payable and other current liabilities	140,000	305,000			
Common stock (\$10 par)	500,000	200,000			
Retained earnings	2,965,000	700,000			
Totals	3,605,000	1,205,000			

EXAMINATION IN AUDITING

November 5, 1987; 8:30 A.M. to 12:00 M.

NOTE TO CANDIDATES: Suggested time allotments are as follows:

All questions are required:	<u>Point Value</u>	<u>Estimated Minutes</u>	
		<u>Minimum</u>	<u>Maximum</u>
No. 1	60	90	110
No. 2	10	15	25
No. 3	10	15	25
No. 4	10	15	25
No. 5	<u>10</u>	<u>15</u>	<u>25</u>
Total	<u>100</u>	<u>150</u>	<u>210</u>

INSTRUCTIONS TO CANDIDATES

(Disregard of these instructions may be considered as indicating inefficiency in accounting work.)

1. You must arrange the papers in numerical order of the questions. If more than one page is required for an answer, write "continued" at the bottom of the page. Number pages consecutively. For instance, if 12 pages are used for your answers, the objective answer sheet is page 1 and your other pages should be numbered 2 through 12.
- ments and calculations associated with them are not considered. Be certain that you have entered your answers on the objective answer sheet before the examination time is up.
2. Answer all objective-type items on the printed answer sheet provided for that purpose. It is to your advantage to attempt all questions even if you are uncertain of the answer. You are likely to get the highest score if you omit no answers. Since objective items are computer-graded, your com-
3. A CPA is continually confronted with the necessity of expressing opinions and conclusions in written reports in clear, unequivocal language. Although the primary purpose of the examination is to test the candidate's knowledge and application of the subject matter, the ability to organize and present such knowledge in acceptable written language may be considered by the examiners.

*Prepared by the Board of Examiners of the American Institute of Certified Public Accountants
and adopted by the examining boards of all states, the District of Columbia, Guam,
Puerto Rico, and the Virgin Islands of the United States.*

Number 1 (Estimated time — 90 to 110 minutes)

Instructions

Select the **best** answer for each of the following items. Use a soft pencil, preferably No. 2, to blacken the appropriate circle on the separate printed answer sheet to indicate your answer. **Mark only one answer for each item. Answer all items.** Your grade will be based on the total number of your correct answers.

The following is an example of the manner in which the answer sheet should be marked:

Item

96. One of the generally accepted auditing standards specifies that the auditor should
- Inspect all property and equipment acquired during the year.
 - Charge fair fees based on cost.
 - Make a proper study and evaluation of the existing internal accounting controls.
 - Count client petty cash funds.

Answer Sheet

96. (a) (b) (c) (d)

Items to be Answered

- An auditor has been asked to report on the balance sheet of Kane Company but not on the other basic financial statements. The auditor will have access to all information underlying the basic financial statements. Under these circumstances, the auditor
 - May accept the engagement because such engagements merely involve limited reporting objectives.
 - May accept the engagement but should disclaim an opinion because of an inability to apply the procedures considered necessary.
 - Should refuse the engagement because there is a client-imposed scope limitation.
 - Should refuse the engagement because of a departure from generally accepted auditing standards.
- When a question arises about an entity's continued existence, the auditor should consider factors tending to mitigate the significance of contrary information concerning the entity's alternative means for maintaining adequate cash flow. An example of such a factor is the
 - Possibility of purchasing certain assets rather than leasing them.
 - Capability of extending the due dates of existing loans.
 - Feasibility of operating at increased levels of production.
 - Marketability of property and equipment that management plans to keep.

- For which of the following events would the auditor appropriately issue a report that contains the standard phrase concerning consistency?
 - A change in the percentage used to calculate the provision for warranty expense.
 - Correction of a mistake in the application of a generally accepted accounting principle.
 - A change in the method of accounting for specific subsidiaries that constitute the group of companies for which consolidated statements are presented.
 - A change from an accounting principle that is **not** generally accepted to one that is generally accepted.
- The objective of auditing procedures applied to segment information is to provide the auditor with a reasonable basis for concluding whether
 - The information is useful for comparing a segment of one enterprise with a similar segment of another enterprise.
 - Sufficient evidential matter has been obtained to allow the auditor to be associated with the segment information.
 - A separate opinion on the segment information is necessary due to inconsistent application of accounting principles.
 - The information is presented in conformity with the FASB Statement on segment information in relation to the financial statements taken as a whole.
- The prior year's financial statements of YZ, Inc., which were audited by Pate, CPA, are presented for comparative purposes without Pate's audit report. Jennings, CPA, the successor auditor, should indicate in the current year audit report that the prior year's financial statements were examined by another auditor
 - Only if Pate's opinion was other than unqualified.
 - But should **not** indicate the type of opinion expressed by Pate.
 - Only if the prior year's financial statements have been restated.
 - But should **not** name Pate as the predecessor auditor.
- An auditor who is determining the scope of work to be performed concerning possible related party transactions should
 - Assume that transactions with related parties are outside the ordinary course of business.
 - Determine whether transactions with related parties would have taken place if the parties had **not** been related.
 - Obtain an understanding of management responsibilities and the relationship of each of the parties to the total entity.
 - Establish a basis of accounting principles different from that which would have been appropriate had the parties **not** been related.

7. Financial statements compiled without audit or review by an accountant should be accompanied by a report stating that
- The financial statements have **not** been audited or reviewed and, accordingly, the accountant expresses only limited assurance on them.
 - A compilation is limited to presenting in the form of financial statements information that is the representation of management.
 - The accountant is **not** aware of any material modifications that should be made to the financial statements for them to conform with generally accepted accounting principles.
 - A compilation is less in scope than a review, and substantially less in scope than an examination in accordance with generally accepted auditing standards.
8. If the auditor believes that financial statements prepared on the entity's income tax basis are **not** suitably titled, the auditor should
- Issue a disclaimer of opinion.
 - Explain in the notes to the financial statements the terminology used.
 - Issue a compilation report.
 - Modify the auditor's report to disclose any reservations.
9. An auditor's report on financial statements prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles should include all of the following **except**
- Reference to the note to the financial statements that describes how the basis of preparation differs from generally accepted accounting principles.
 - Disclosure of the fact that the financial statements are **not** intended to be presented in conformity with generally accepted accounting principles.
 - An opinion as to whether the basis of accounting used is appropriate under the circumstances.
 - An opinion as to whether the financial statements are presented fairly in conformity with the basis of accounting described.
10. When third party use of prospective financial statements is expected, an accountant may **not** accept an engagement to
- Perform a review.
 - Perform a compilation.
 - Perform an examination.
 - Apply agreed-upon procedures.
11. Which of the following is a prospective financial statement for general use upon which an accountant may appropriately report?
- Financial projection.
 - Partial presentation.
 - Pro forma financial statement.
 - Financial forecast.
12. The party responsible for assumptions identified in the preparation of prospective financial statements is usually
- A third-party lending institution.
 - The client's management.
 - The reporting accountant.
 - The client's independent auditor.
13. In which of the following reports should an accountant **not** express negative or limited assurance?
- A standard review report on financial statements of a nonpublic entity.
 - A standard compilation report on financial statements of a nonpublic entity.
 - A standard comfort letter on financial information included in a registration statement of a public entity.
 - A standard review report on interim financial statements of a public entity.
14. Baker, the continuing auditor of AC Resources, a publicly held company, has been requested to report on the system of internal accounting control. The report is to be based solely on the study and evaluation of internal accounting control that Baker made in the audit of AC's financial statements, even though the study and evaluation is not sufficient for expressing an opinion on the system taken as a whole. Baker intends to describe the limited purpose of the study and evaluation and to disclaim an opinion on the system taken as a whole. In these circumstances, Baker
- May report provided the report indicates it is intended solely for management or other specified parties.
 - May report provided the report is included with the basic financial statements distributed to the stockholders.
 - May **not** report because there is **no** basis for determining whether material errors or irregularities may occur and be detected.
 - May **not** report because it would be a violation of generally accepted auditing standards.
15. Which of the following statements is correct regarding the auditor's responsibilities for supplementary information required by the FASB?
- Because the supplementary information is a required part of the basic financial statements, the auditor should apply normal auditing procedures.
 - The omission of, but **not** deficiencies in, supplementary information should be disclosed in the opinion paragraph of the auditor's report.
 - Because the supplementary information is **not** a required part of the basic financial statements, the auditor should apply only certain limited procedures.
 - The omission of supplementary information ordinarily requires the auditor to issue an adverse opinion, but mere deficiencies require an "except for" qualified opinion.

16. A flowchart is most frequently used by an auditor in connection with the
- Preparation of generalized computer audit programs.
 - Review of the client's internal accounting controls.
 - Use of statistical sampling in performing an audit.
 - Performance of analytical review procedures of account balances.
17. Audits of certain governmental entities are required to be performed in accordance with generally accepted government auditing standards (GAGAS). These standards do **not** require, as part of an auditor's report, the identification of
- Significant internal accounting and administrative controls designed to provide reasonable assurance that federal programs are being administered in compliance with applicable laws and regulations.
 - Material weaknesses discovered as a result of the study and evaluation of the internal control systems.
 - Sampling methods used to test the internal controls designed to detect errors and irregularities.
 - Significant internal accounting and administrative controls that were **not** evaluated, and the reasons why they were **not** evaluated.
18. If requested to perform a review engagement for a nonpublic entity in which an accountant has an immaterial direct financial interest, the accountant is
- Not independent and, therefore, may issue a review report, but may **not** issue an auditor's opinion.
 - Not independent and, therefore, may **not** issue a review report.
 - Not independent and, therefore, may **not** be associated with the financial statements.
 - Independent because the financial interest is immaterial and, therefore, may issue a review report.
19. An auditor strives to achieve independence in appearance in order to
- Maintain public confidence in the profession.
 - Become independent in fact.
 - Comply with the generally accepted auditing standards of field work.
 - Maintain an unbiased mental attitude.
20. In planning a new engagement, which of the following is **not** a factor that affects the auditor's judgment as to the quantity, type, and content of working papers?
- The auditor's estimated occurrence rate of attributes.
 - The auditor's preliminary evaluations of risk based on discussions with the client.
 - The content of the client's representation letter.
 - The type of report to be issued by the auditor.
21. According to the AICPA Code of Professional Ethics, may a CPA who is in partnership with non-CPAs sign a report with the firm name and below it affix the CPA's own signature with the designation "Certified Public Accountant"?
- No, because a CPA should **not** form a partnership with non-CPAs.
 - No, because it would appear that all partners were associated with the report when only one actually is associated.
 - Yes, provided the non-CPA partners adhere to the professional standards concerning quality control.
 - Yes, provided it is clear that the partnership itself is **not** being held out as composed entirely of CPAs.
22. Which one of the following is an enforceable set of pronouncements of an authoritative body designated to establish accounting principles, according to the AICPA Code of Professional Ethics?
- AICPA Statements on Standards for Accounting and Review Services.
 - AICPA Statements of Position.
 - FASB Interpretations.
 - FASB Statements of Financial Accounting Concepts.
23. The risk that an auditor's procedures will lead to the conclusion that a material error does **not** exist in an account balance when, in fact, such error does exist is referred to as
- Audit risk.
 - Inherent risk.
 - Control risk.
 - Detection risk.
24. Because an examination in accordance with generally accepted auditing standards is influenced by the possibility of material errors, the auditor should conduct the examination with an attitude of
- Professional responsiveness.
 - Conservative advocacy.
 - Objective judgment.
 - Professional skepticism.
25. With respect to errors and irregularities, the auditor should plan to
- Search for errors that would have a material effect and for irregularities that would have either material or immaterial effect on the financial statements.
 - Search for irregularities that would have a material effect and for errors that would have either material or immaterial effect on the financial statements.
 - Search for errors or irregularities that would have a material effect on the financial statements.
 - Discover errors or irregularities that have either material or immaterial effect on the financial statements.

26. The element of the audit planning process most likely to be agreed upon with the client before implementation of the audit strategy is the determination of the
- Methods of statistical sampling to be used in confirming accounts receivable.
 - Pending legal matters to be included in the inquiry of the client's attorney.
 - Evidence to be gathered to provide a sufficient basis for the auditor's opinion.
 - Schedules and analyses to be prepared by the client's staff.
27. As lower acceptable levels of both audit risk and materiality are established, the auditor should plan more work on individual accounts to
- Find smaller errors.
 - Find larger errors.
 - Increase the tolerable error in the accounts.
 - Decrease the risk of overreliance.
28. The most likely explanation why the auditor's examination **cannot** reasonably be expected to bring all illegal acts by the client to the auditor's attention is that
- Illegal acts are perpetrated by management override of internal accounting controls.
 - Illegal acts by clients often relate to operating aspects rather than accounting aspects.
 - The client's system of internal accounting control may be so strong that the auditor performs only minimal substantive testing.
 - Illegal acts may be perpetrated by the only person in the client's organization with access to both assets and the accounting records.
29. A CPA should **not** submit unaudited financial statements of a nonpublic company to a client or others unless, as a minimum, the CPA complies with the provisions applicable to
- Compilation engagements.
 - Review engagements.
 - Statements on auditing standards.
 - Attestation standards.
30. The underwriter of a securities offering may request that an auditor perform specified procedures and supply certain assurances concerning unaudited information contained in a registration statement. The auditor's response to such a request is commonly called a
- Report under federal security statutes.
 - Comfort letter.
 - Review of interim financial information.
 - Compilation report for underwriters.
31. An audit working paper that reflects the major components of an amount reported in the financial statements is referred to as a(an)
- Lead schedule.
 - Supporting schedule.
 - Audit control account.
 - Working trial balance.
32. When considering the use of management's written representations as audit evidence about the completeness assertion, an auditor should understand that such representations
- Complement, but do **not** replace, substantive tests designed to support the assertion.
 - Constitute sufficient evidence to support the assertion when considered in combination with reliance on internal accounting controls.
 - Are **not** part of the evidential matter considered to support the assertion.
 - Replace reliance on internal accounting controls as evidence to support the assertion.
33. One reason why an auditor makes an analytical review of the client's operations is to identify
- Improper separation of accounting and other financial duties.
 - Weaknesses of a material nature in the system of internal accounting control.
 - Unusual transactions.
 - Non-compliance with prescribed control procedures.
34. After accounting for a sequence of inventory tags, an auditor traces a sample of tags to the physical inventory listing to obtain evidence that all items
- Included in the listing have been counted.
 - Represented by inventory tags are included in the listing.
 - Included in the listing are represented by inventory tags.
 - Represented by inventory tags are bona fide.
35. Which of the following statements ordinarily is included among the written client representations obtained by the auditor?
- Sufficient evidential matter has been made available to permit the issuance of an unqualified opinion.
 - Compensating balances and other arrangements involving restrictions on cash balances have been disclosed.
 - Management acknowledges responsibility for illegal actions committed by employees.
 - Management acknowledges that there are **no** material weaknesses in internal accounting controls.
36. An attorney responding to an auditor as a result of the client's letter of audit inquiry may appropriately limit the response to
- Items which have high probability of being resolved to the client's detriment.
 - Asserted claims and pending or threatened litigation.
 - Legal matters subject to unsettled points of law, uncorroborated information, or other complex judgments.
 - Matters to which the attorney has given substantive attention in the form of legal consultation or representation.

37. An auditor's program for the examination of long-term debt should include steps that require the
- Inspection of the accounts payable subsidiary ledger.
 - Investigation of credits to the bond interest income account.
 - Verification of the existence of the bondholders.
 - Examination of any bond trust indenture.

38. Hill has decided to use Probability Proportional to Size (PPS) sampling, sometimes called dollar-unit sampling, in the audit of a client's accounts receivable balances. Hill plans to use the following PPS sampling table:

TABLE
Reliability Factors for Errors of Overstatement

Number of over-statement errors	Risk of Incorrect Acceptance				
	1%	5%	10%	15%	20%
0	4.61	3.00	2.31	1.90	1.61
1	6.64	4.75	3.89	3.38	3.00
2	8.41	6.30	5.33	4.72	4.28
3	10.05	7.76	6.69	6.02	5.52
4	11.61	9.16	8.00	7.27	6.73

Additional Information

Tolerable error
(net of effect of expected error) \$ 24,000
 Risk of incorrect acceptance 20%
 Number of errors allowed 1
 Recorded amount of accounts receivable ... \$240,000
 Number of accounts 360

What sample size should Hill use?

- 120
- 108
- 60
- 30

39. While substantive tests may support the accuracy of underlying records, these tests frequently provide **no** affirmative evidence of segregation of duties because
- Substantive tests rarely guarantee the accuracy of the records if only a sample of the transactions has been tested.
 - The records may be accurate even though they are maintained by persons having incompatible functions.
 - Substantive tests relate to the entire period under audit, but compliance tests ordinarily are confined to the period during which the auditor is on the client's premises.
 - Many computerized procedures leave **no** audit trail of who performed them, so substantive tests may necessarily be limited to inquiries and observation of office personnel.

40. An accountant has been asked to issue a review report on the balance sheet of a nonpublic company but not to report on the other basic financial statements. The accountant may **not** do so
- Because compliance with this request would result in an incomplete review.
 - Because compliance with this request would result in a violation of the ethical standards of the profession.
 - If the scope of the inquiry and analytical procedures has been restricted.
 - If the review of the balance sheet discloses material departures from generally accepted accounting principles.

41. Inquiry and analytical procedures ordinarily performed during a review of a nonpublic entity's financial statements include
- Analytical procedures designed to identify material weaknesses in internal accounting control.
 - Inquiries concerning actions taken at meetings of the stockholders and the board of directors.
 - Analytical procedures designed to test the accounting records by obtaining corroborating evidential matter.
 - Inquiries of knowledgeable outside parties such as the client's attorneys and bankers.

42. The use of fidelity bonds may indemnify a company from embezzlement losses. The use also
- Reduces the company's need to obtain expensive business interruption insurance.
 - Protects employees who made unintentional errors from possible monetary damages resulting from such errors.
 - Allows the company to substitute the fidelity bonds for various parts of internal accounting control.
 - Reduces the possibility of employing persons with dubious records in positions of trust.

43. An auditor evaluates the existing system of internal accounting control primarily to
- Ascertain whether errors and irregularities exist.
 - Determine the extent of compliance testing that should be performed.
 - Determine the extent of substantive testing that should be performed.
 - Make constructive suggestions to the client for improvement.

44. An auditor is **least** likely to test for compliance with the internal accounting control that provides for
- Segregation of the functions of recording disbursements and reconciling the bank account.
 - Comparison of receiving reports and vendors' invoices with purchase orders.
 - Approval of the purchase and sale of marketable securities.
 - Classification of revenue and expense transactions by product line.

Auditing

45. An auditor's purpose for performing compliance testing is to provide reasonable assurance that
- The controls on which the auditor plans to rely are being applied as perceived during the preliminary evaluation.
 - The risk that the auditor may unknowingly fail to modify the opinion on the financial statements is minimized.
 - Transactions are executed in accordance with management's authorization and access to assets is limited by a segregation of functions.
 - Transactions are recorded as necessary to permit the preparation of the financial statements in conformity with generally accepted accounting principles.
46. A conceptually logical approach to the auditor's evaluation of internal accounting control consists of the following four steps:
- Determine whether the necessary procedures are prescribed and are being followed satisfactorily.
 - Consider the types of errors and irregularities that could occur.
 - Determine the internal accounting control procedures that should prevent or detect errors and irregularities.
 - Evaluate any weakness to determine its effect on the nature, timing, or extent of auditing procedures to be applied and suggestions to be made to the client.
- What should be the order in which these four steps are performed?
- III, IV, I, II
 - III, I, II, IV
 - II, III, I, IV
 - II, I, III, IV
47. The most likely result of ineffective internal accounting controls in the revenue cycle is that
- Fictitious transactions could be recorded, causing an understatement of revenues and overstatement of receivables.
 - Irregularities in recording transactions in the subsidiary accounts could result in a delay in goods shipped.
 - Omission of shipping documents could go undetected, causing an understatement of inventory.
 - Final authorization of credit memos by personnel in the sales department could permit an employee defalcation scheme.
48. An auditor generally tests physical security controls over inventory by
- Test counts and cutoff procedures.
 - Examination and reconciliation.
 - Inspection and recomputation.
 - Inquiry and observation.
49. CPA firms should establish quality control policies and procedures for professional development in order to provide reasonable assurance that
- Employees promoted possess the appropriate characteristics to perform competently.
 - Personnel will have the knowledge required to fulfill responsibilities assigned.
 - The extent of supervision and review in a given instance will be appropriate.
 - Association with a client whose management lacks integrity will be minimized.
50. Which of the following internal accounting control procedures would most likely allow for a reduction in the scope of the auditor's tests of depreciation expense?
- Review and approval of the periodic equipment depreciation entry by a supervisor who does **not** actively participate in its preparation.
 - Comparison of equipment account balances for the current year with the current-year budget and prior-year actual balances.
 - Review of the miscellaneous income account for salvage credits and scrap sales of partially depreciated equipment.
 - Authorization of payment of vendors' invoices by a designated employee who is independent of the equipment receiving function.
51. Which of the following statements is correct concerning the auditor's required communication of material weaknesses in internal accounting control?
- If the auditor does **not** become aware of any material weaknesses during the examination, that fact must be communicated.
 - Weaknesses reported at interim dates should be tested for correction before completion of the engagement.
 - Although written communication is preferable, the auditor may communicate the findings orally.
 - Weaknesses reported at interim dates must be repeated in the communication at the completion of the engagement.
52. The accountant's report expressing an opinion on an entity's system of internal accounting control should state that the
- Study and evaluation of the system of internal accounting control was conducted in accordance with generally accepted auditing standards.
 - Establishment and maintenance of the system of internal accounting control are the responsibilities of management.
 - Inherent limitations of any system of internal accounting control may prevent the preparation of financial statements in accordance with generally accepted accounting principles.
 - Client's management has provided assurance that the expected benefits of the internal accounting control procedures are in excess of their related costs.

53. For the most effective internal accounting control, monthly bank statements should be received directly from the banks and reviewed by the
- Controller.
 - Cash receipts accountant.
 - Cash disbursements accountant.
 - Internal auditor.
54. An auditor would consider internal accounting control over a client's payroll procedures to be ineffective if the payroll department supervisor is responsible for
- Hiring subordinate payroll department employees.
 - Having custody over unclaimed paychecks.
 - Updating employee earnings records.
 - Applying pay rates to time tickets.
55. Which of the following departments should have the responsibility for authorizing payroll rate changes?
- Personnel.
 - Payroll.
 - Treasurer.
 - Timekeeping.
56. An auditor selects a sample from the file of shipping documents to determine whether invoices were prepared. This test is performed to satisfy the audit objective of
- Accuracy.
 - Completeness.
 - Control.
 - Existence.
57. When assessing the tolerable rate, the auditor should consider that, while deviations from control procedures increase the risk of material errors, such deviations do not necessarily result in errors. This explains why
- A recorded disbursement that does **not** show evidence of required approval may nevertheless be a transaction that is properly authorized and recorded.
 - Deviations would result in errors in the accounting records only if the deviations and the errors occurred on different transactions.
 - Deviations from pertinent control procedures at a given rate ordinarily would be expected to result in errors at a higher rate.
 - A recorded disbursement that is properly authorized may nevertheless be a transaction that contains a material error.
58. The expected population deviation rate of client billing errors is 3%. The auditor has established a tolerable rate of 5%. In the review of client invoices the auditor should use
- Stratified sampling.
 - Variable sampling.
 - Discovery sampling.
 - Attribute sampling.
59. The risk of incorrect acceptance and the risk of over-reliance on internal accounting control relate to the
- Preliminary estimates of materiality levels.
 - Allowable risk of tolerable error.
 - Efficiency of the audit.
 - Effectiveness of the audit.
60. When audited financial statements are presented in a document containing other information, the auditor
- Has an obligation to perform auditing procedures to corroborate the other information.
 - Is required to issue an "except for" qualified opinion if the other information has a material misstatement of fact.
 - Should read the other information to consider whether it is inconsistent with the audited financial statements.
 - Has **no** responsibility for the other information because it is **not** part of the basic financial statements.

Number 2 (Estimated time — 15 to 25 minutes)

Green, CPA, has been engaged to audit the financial statements of Star Manufacturing, Inc. Star is a medium-sized entity that produces a wide variety of household goods. All acquisitions of materials are processed through the purchasing, receiving, accounts payable, and treasury functions.

Required:

Prepare the "Purchases" segment of the internal accounting control questionnaire to be used in the evaluation of Star's internal accounting control system. Each question should elicit either a yes or no response.

Do **not** prepare the receiving, accounts payable, or treasury segments of the internal accounting control questionnaire.

Do **not** discuss the internal accounting controls over purchases.

Number 3 (Estimated time — 15 to 25 minutes)

MLG Company's auditor received directly from the banks, confirmations and cut-off statements with related checks and deposit tickets for MLG's three general-purpose bank accounts. The auditor determined that internal accounting control over cash was satisfactory and will be relied upon. The proper cut-off of external cash receipts and disbursements was established. No bank accounts were opened or closed during the year.

Required:

Prepare the audit program of substantive procedures to verify MLG's bank balances. Ignore any other cash accounts.

Auditing

Number 4 (Estimated time — 15 to 25 minutes)

Microcomputer software has been developed to improve the efficiency and effectiveness of the audit. Electronic spreadsheets and other software packages are available to aid in the performance of audit procedures otherwise performed manually.

Required:

Describe the potential benefits to an auditor of using microcomputer software in an audit as compared to performing an audit without the use of a computer.

Number 5 (Estimated time — 15 to 25 minutes)

The auditor's standard report consists of a statement describing the nature of the examination, usually in an opening "scope" paragraph, and an expression of the auditor's opinion, usually in a closing "opinion" paragraph. There are circumstances where the auditor's standard report is modified by adding one or more separate explanatory paragraphs, and/or modifying the wording of the scope paragraph or opinion paragraph.

For purposes of this question, assume the auditor is independent and has previously expressed an unqualified opinion on the prior year's financial statements. For the current year, only single-year (not comparative) statements are presented.

Required:

Identify the circumstances necessitating modification of the auditor's standard report. For each circumstance indicate the types of opinion that would be appropriate and describe the report modifications. Organize the answer as indicated in the following example:

<i>Circumstances</i>	<i>Type of Opinion</i>	<i>Report Modification</i>
1. The financial statements are materially affected by a departure from generally accepted accounting principles.	1. The auditor should express an "except for" qualified opinion or an adverse opinion.	1. The auditor should explain the basis and effects of the departure in an explanatory paragraph and modify the opinion paragraph.

EXAMINATION IN BUSINESS LAW

(Commercial Law)

November 6, 1987; 8:30 A.M. to 12:00 M.

NOTE TO CANDIDATES: Suggested time allotments are as follows:

All questions are required:	<i>Point Value</i>	<i>Estimated Minutes</i>	
		<i>Minimum</i>	<i>Maximum</i>
No. 1	60	110	130
No. 2	10	15	20
No. 3	10	15	20
No. 4	10	15	20
No. 5	10	15	20
Total	<u>100</u>	<u>170</u>	<u>210</u>

INSTRUCTIONS TO CANDIDATES

(Disregard of these instructions may be considered as indicating inefficiency in accounting work.)

1. You must arrange the papers in numerical order of the questions. If more than one page is required for an answer, write "continued" at the bottom of the page. Number pages consecutively. For instance, if 12 pages are used for your answers, the objective answer sheet is page 1 and your other pages should be numbered 2 through 12.
2. Answer all objective-type items on the printed answer sheet provided for that purpose. It is to your advantage to attempt all questions even if you are uncertain of the answer. You are likely to get the highest score if you omit no answers. Since objective items are computer-graded, your comments and calculations associated with them are not considered. Be certain that you have entered your answers on the objective answer sheet before the examination time is up.
3. A CPA is continually confronted with the necessity of expressing opinions and conclusions in written reports in clear, unequivocal language. Although the primary purpose of the examination is to test the candidate's knowledge and application of the subject matter, the ability to organize and present such knowledge in acceptable written language may be considered by the examiners.

Prepared by the Board of Examiners of the American Institute of Certified Public Accountants and adopted by the examining boards of all states, the District of Columbia, Guam, Puerto Rico, and the Virgin Islands of the United States.

Number 1 (Estimated time — 110 to 130 minutes)

Instructions

Select the **best** answer for each of the following items. Use a soft pencil, preferably No. 2, to blacken the appropriate circle on the separate printed answer sheet to indicate your answer. **Mark only one answer for each item. Answer all items.** Your grade will be based on the total number of your correct answers.

The following is an example of the manner in which the answer sheet should be marked:

Item

99. The text of the letter from Bridge Builders, Inc., to Allied Steel Co. follows:

We offer to purchase 10,000 tons of No. 4 steel pipe at today's quoted price for delivery two months from today. Your acceptance must be received in five days.

Bridge Builders intended to create a (an)

- a. Option contract.
- b. Unilateral contract.
- c. Bilateral contract.
- d. Joint contract.

Answer Sheet

99. (a) (b) (c) (d)

Items to be Answered

1. On June 1, 1986, Nord Corp. engaged Milo & Co., CPAs, to perform certain management advisory services for nine months for a \$45,000 fee. The terms of their oral agreement required Milo to commence performance any time before October 1, 1986. On June 30, 1987, after Milo completed the work to Nord's satisfaction, Nord paid Milo \$30,000 by check. Nord conspicuously marked on the check that it constituted payment in full for all services rendered. Nord has refused to pay the remaining \$15,000 arguing that, although it believes the \$45,000 fee is reasonable, it had received bids of \$30,000 and \$38,000 from other firms to perform the same services as Milo. Milo endorsed and deposited the check. If Milo commences an action against Nord for the remaining \$15,000, Milo will be entitled to recover

- a. \$0 because there has been an enforceable accord and satisfaction.
- b. \$0 because the statute of frauds has **not** been satisfied.
- c. \$8,000 because \$38,000 was the highest other bid.
- d. \$15,000 because it is the balance due under the agreement.

2. Blue purchased a travel agency business from Drye. The purchase price included payment for Drye's goodwill. The agreement contained a covenant prohibiting Drye from competing with Blue in the travel agency business. Which of the following statements regarding the covenant is **not** correct?

- a. The restraint must be **no** more extensive than is reasonably necessary to protect the goodwill purchased by Blue.
- b. The geographic area to which it applies must be reasonable.
- c. The time period for which it is to be effective must be reasonable.
- d. The value to be assigned to it is the excess of the price paid over the seller's cost of all tangible assets.

3. With regard to an agreement for the sale of real estate, the statute of frauds

- a. Requires that the entire agreement be in a single writing.
- b. Requires that the purchase price be fair and adequate in relation to the value of the real estate.
- c. Does **not** require that the agreement be signed by all parties.
- d. Does **not** apply if the value of the real estate is less than \$500.

4. Sisk contracted to sell Bleu a building for \$470,000. If Sisk wishes to avoid the contract based on undue influence, one element that Sisk must prove is that Bleu

- a. Induced Sisk to sell the building by unfair persuasion.
- b. Was in a fiduciary relationship with Sisk.
- c. Misrepresented material facts to Sisk.
- d. Made improper threats to Sisk.

5. Park entered into a contract to sell Reed a parcel of land. Park was aware that Reed was purchasing the land with the intention of building a high-rise office building. Park was also aware of the fact that a subsurface soil condition would prevent such construction. The condition was extremely unusual and not readily discoverable in the course of normal inspections or soil evaluations. Park did not disclose the existence of the condition to Reed, nor did Reed make any inquiry of Park as to the suitability of the land for the intended development. Park's silence as to the soil condition

- a. Renders the contract voidable at Reed's option.
- b. Entitles Reed only to money damages.
- c. Renders the contract void.
- d. Does **not** affect the validity of the contract.

6. In general, which of the following is **least** likely to be considered a security under the Securities Act of 1933?

- a. General partnership interests.
- b. Warrants.
- c. Limited partnership interests.
- d. Treasury stock.

7. One of the elements necessary to recover damages if there has been a material misstatement in a registration statement filed pursuant to the Securities Act of 1933 is that the

- a. Issuer and plaintiff be in privity of contract with each other.
- b. Issuer failed to exercise due care in connection with the sale of the securities.
- c. Plaintiff suffered a loss.
- d. Plaintiff gave value for the security.

8. After the filing of the registration statement with the SEC but prior to the effective date, the underwriter is allowed to do which of the following?

- I. Make oral offers to sell the security.
- II. Issue a preliminary prospectus ("red herring").

- a. I only.
- b. II only.
- c. I and II.
- d. Neither I nor II.

9. Rey Corp.'s management intends to solicit proxies relating to its annual meeting at which directors will be elected. Rey is subject to the registration and reporting requirements of the Securities Exchange Act of 1934. As a result, Rey must furnish its shareholders with

- a. A copy of its registration statement and bylaws.
- b. A preliminary copy of its proxy statement at the same time it is filed with the SEC.
- c. An annual report containing its audited statements of income for the five most recent years.
- d. An annual report containing its audited balance sheets for the two most recent years.

10. Pix is offering to issue \$10 million of its securities pursuant to Regulation D of the Securities Act of 1933. Under the applicable provisions of Regulation D,

- a. Each investor must be an accredited investor.
- b. Pix may make a general solicitation in connection with the offering.
- c. The securities may be debentures.
- d. Pix must be a corporation.

11. Harp Corp. is offering to issue \$450,000 of its securities pursuant to Regulation D of the Securities Act of 1933. Harp is not required to deliver a disclosure document in the states where the offering is being conducted. The exemption for small issues of \$500,000 or less (Rule 504) under Regulation D

- a. Requires that the issuer be subject to the reporting requirements of the Securities Exchange Act of 1934.
- b. Does **not** require that any specific information be furnished to investors.
- c. Permits the use of general solicitation.
- d. Requires that each investor be a sophisticated investor or be represented by a purchaser representative.

12. The reporting requirements of the Securities Exchange Act of 1934 and its rules

- a. Apply only to issuers, underwriters, and dealers.
- b. Apply to a corporation that registered under the Securities Act of 1933 but that did **not** register under the Securities Exchange Act of 1934.
- c. Require all corporations engaged in interstate commerce to file an annual report.
- d. Require all corporations engaged in interstate commerce to file quarterly audited financial statements.

Items 13 and 14 are based on the following information:

During the calendar year 1987, Nix estimates having \$5,000 of gross earnings from self-employment and \$4,800 of allowable deductions attributable to such income. Nix expects to earn the self-employment income as a sole proprietor rendering management advisory services.

13. For this question only, if Nix receives in 1987 wages of \$40,000 as an employee of Pace Corp., the amount of self-employment earnings subject to social security taxes would be

- a. \$0
- b. \$ 200
- c. \$3,800
- d. \$5,000

14. For this question only, if Nix receives in 1987 wages of \$5,000, the amount of self-employment earnings subject to the federal unemployment tax would be

- a. \$0
- b. \$ 200
- c. \$3,800
- d. \$5,000

15. In general, which of the following is **not** an available method of complying with a state's workers' compensation statute for a private employer?

- a. Self-insurance by the employer.
- b. Participation in the state insurance fund.
- c. Participation in a federal insurance fund.
- d. Purchase of insurance from a private insurer.

16. On June 16, 1987, Eble placed 800 shares of Singh Corp.'s common stock in a trust for the benefit of Eble's child. On June 1, 1987, Singh's board of directors had declared a cash dividend of \$2 per share on Singh's common stock. Payment was made on July 30, 1987 to shareholders of record on June 30, 1987. What amount of the dividend should be allocated to trust income?

- a. \$0
- b. \$ 800
- c. \$1,200
- d. \$1,600

Items 17 and 18 are based on the following information:

Rita Ryan died leaving a will naming her children, John and Dale, as the sole beneficiaries. In her will, Rita designated John as the executor of her estate and excused John from posting a bond as executor. At the time of Rita's death, she owned a parcel of land with her sister, Ann, as joint tenants with right of survivorship.

17. With respect to Rita's interest in the land, it will pass to
- John and Dale outside Rita's estate by operation of law.
 - John and Dale through Rita's estate after the will is probated.
 - Ann through Rita's estate after the will is probated.
 - Ann outside Rita's estate by operation of law.
18. In general, John as executor, must
- Post a bond despite the provision to the contrary in Rita's will.
 - Serve without compensation because John is also a named beneficiary in the will.
 - File a final account of the administration of the estate.
 - Relinquish the duties because of the conflict of interest as executor and beneficiary.

-
19. In general, which of the following statements is correct with respect to a limited partnership?
- A limited partner will be personally liable for partnership debts incurred in the ordinary course of the partnership's business.
 - A limited partner is unable to participate in the management of the partnership in the same manner as general partners and still retain limited liability.
 - A limited partner's death or incompetency will cause the partnership to dissolve.
 - A limited partner is an agent of the partnership and has the authority to bind the partnership to contracts.
20. Unless otherwise provided for in the partnership agreement, the assignment of a partner's interest in a general partnership will
- Result in the termination of the partnership.
 - Not affect the assigning partner's liability to third parties for obligations existing at the time of the assignment.
 - Transfer the assigning partner's rights in specific partnership property to the assignee.
 - Transfer the assigning partner's right to bind the partnership to contracts to the assignee.

- Equally among the partners irrespective of the allocation of partnership profits.
 - In the same manner as partnership profits.
 - In proportion to the partners' capital contributions.
 - In proportion to the partners' capital contributions and outstanding loan balances.
22. The apparent authority of a partner to bind the partnership in dealing with third parties
- Would permit a partner to submit a claim against the partnership to arbitration.
 - Must be derived from the express powers and purposes contained in the partnership agreement.
 - Will be effectively limited by a formal resolution of the partners of which third parties are aware.
 - Will be effectively limited by a formal resolution of the partners of which third parties are unaware.

Items 23 and 24 are based on the following information:

Frey entered into a contract with Cara Corp. to purchase televisions on behalf of Lux, Inc. Lux authorized Frey to enter into the contract in Frey's name without disclosing that Frey was acting on behalf of Lux.

23. If Lux repudiates the contract, Cara may
- Obtain specific performance, compelling Lux to perform on the contract.
 - Hold Frey liable on the contract whether or not Cara discovers that Lux is the principal.
 - Hold Frey liable on the contract but only if Cara fails to discover that Lux was the principal.
 - Not hold Lux liable because proof that Lux was the principal will be barred by the parol evidence rule.
24. If Cara repudiates the contract, which of the following statements concerning liability on the contract is **not** correct?
- Frey may hold Cara liable and obtain money damages.
 - Frey may hold Cara liable and obtain specific performance.
 - Lux may hold Cara liable upon disclosing the agency relationship with Frey.
 - Cara will be free from liability to Lux if Frey fraudulently stated that he was acting on his own behalf.

25. Dart Corp. dismissed Ritz as its general sales agent. Dart notified all of Ritz's known customers by letter. Bing Corp., a retail outlet located outside of Ritz's previously assigned sales territory, had never dealt with Ritz. However, Bing knew of Ritz as a result of various business contacts. After his dismissal, Ritz sold Bing goods, to be delivered by Dart, and received from Bing a cash deposit for 20% of the purchase price. It was not unusual for an agent in Ritz's previous position to receive cash deposits. In an action by Bing against Dart on the sales contract, Bing will

- a. Win, because Dart's notice was inadequate to terminate Ritz's apparent authority.
- b. Win, because a principal is an insurer of an agent's acts.
- c. Lose, because Ritz lacked any express or implied authority to make the contract.
- d. Lose, because Ritz's conduct constituted a fraud for which Dart is **not** liable.

Items 26 and 27 are based on the following information:

Brown & Co., CPAs, issued an unqualified opinion on the financial statements of its client, King Corp. Based on the strength of King's financial statements, Safe Bank loaned King \$500,000. Brown was unaware that Safe would receive a copy of the financial statements or that they would be used in obtaining a loan by King. King defaulted on the loan.

26. If Safe commences an action for negligence against Brown, and Brown is able to prove that it conducted the audit in conformity with GAAS, Brown will

- a. Be liable to Safe because Safe relied on the financial statements.
- b. Be liable to Safe because the statute of frauds has been satisfied.
- c. Not be liable to Safe because there is a conclusive presumption that following GAAS is the equivalent of acting reasonably and with due care.
- d. Not be liable to Safe because there was a lack of privity of contract.

27. If Safe commences an action for common law fraud against Brown, then to be successful, Safe must prove in addition to other elements that it

- a. Was in privity of contract with Brown.
- b. Was **not** contributorily negligent.
- c. Was in privity of contract with King.
- d. Justifiably relied on the financial statements.

28. One of the elements necessary to hold a CPA liable to a client for conducting an audit negligently is that the CPA

- a. Acted with scienter or guilty knowledge.
- b. Was a fiduciary of the client.
- c. Failed to exercise due care.
- d. Executed an engagement letter.

29. In general, the third party (primary) beneficiary rule as applied to a CPA's legal liability in conducting an audit is relevant to which of the following causes of action against a CPA?

	<u>Fraud</u>	<u>Constructive fraud</u>	<u>Negligence</u>
a.	Yes	Yes	No
b.	Yes	No	No
c.	No	Yes	Yes
d.	No	No	Yes

30. If a CPA recklessly departs from the standards of due care when conducting an audit, the CPA will be liable to third parties who were unknown to the CPA based on

- a. Strict liability.
- b. Gross negligence.
- c. Negligence.
- d. Breach of contract.

Items 31 and 32 are based on the following information:

West & Co., CPAs, rendered an unqualified opinion on the financial statements of Pride Corp., which were included in Pride's registration statement filed with the SEC. Subsequently, Hex purchased 500 shares of Pride's preferred stock, which were acquired as part of a public offering subject to the Securities Act of 1933. Hex has commenced an action against West based on the Securities Act of 1933 for losses resulting from misstatements of facts in the financial statements included in the registration statement.

31. Which of the following elements must Hex prove to hold West liable?

- a. West rendered its opinion with knowledge of material misstatements.
- b. West performed the audit negligently.
- c. Hex relied on the financial statements included in the registration statement.
- d. The misstatements were material.

32. Which of the following defenses would be **least** helpful to West in avoiding liability to Hex?

- a. West was **not** in privity of contract with Hex.
 - b. West conducted the audit in accordance with GAAS.
 - c. Hex's losses were caused by factors other than the misstatements.
 - d. Hex knew of the misstatements when Hex acquired the preferred stock.
-

33. In preparing Watt's 1986 individual income tax return, Stark, CPA, took a deduction contrary to a Tax Court decision that had disallowed a similar deduction. Stark's position was adopted in good faith and with a reasonable belief that the Tax Court decision failed to conform to the Internal Revenue Code. Under the circumstances, Stark will
- Not be liable for a preparer penalty unless the understatement of taxes is at least 25% of Watt's tax liability.
 - Not be liable for a preparer penalty if Stark exercised due diligence.
 - Be liable for the preparer's negligence penalty.
 - Be liable for the preparer's penalty because of Stark's intentional disregard of the Tax Court decision.
34. In preparing Tint's 1986 individual income tax return, Boe, CPA, took a \$3,000 deduction for unreimbursed travel and entertainment expenses, which Tint stated he paid in 1986. Boe has no reason to believe that documentation of the travel and entertainment expenses is inadequate or non-existent. In order to avoid the preparer's negligence penalty, Boe
- May rely solely on Tint's statement as to the amount of the deduction.
 - Must be advised by Tint that the documentation exists.
 - Must examine the documentation.
 - Must maintain copies of the documentation in its file.
35. If a CPA is engaged by an attorney to assist in the defense of a tax fraud case involving the attorney's client, information obtained by the CPA from the client after being engaged
- Is **not** privileged because the matter involves a federal issue.
 - Is **not** privileged because the majority of jurisdictions do **not** recognize an accountant-client privilege.
 - Will be deemed privileged communications under certain circumstances.
 - Will be deemed privileged communications provided that the CPA prepared the client's tax return.
36. Bond Corp. issued a negotiable warehouse receipt to Grey for goods stored in Bond's warehouse. Grey's goods were lost due to Bond's failure to exercise such care as a reasonably careful person would under like circumstances. The state in which this transaction occurred follows the UCC rule with respect to a warehouseman's liability for lost goods. The warehouse receipt is silent on this point. Under the circumstances, Bond is
- Liable because it was negligent.
 - Liable because it is strictly liable for any loss.
 - Not liable unless Grey can establish that Bond was grossly negligent.
 - Not liable because the warehouse receipt was negotiable.
37. With respect to the sale of goods, the warranty of title
- Provides that the seller deliver the goods free from any lien of which the buyer lacked knowledge at the time of contracting.
 - Provides that the seller can **not** disclaim the warranty if the sale is made to a bona fide purchaser for value.
 - Applies only if the seller is a merchant.
 - Applies only if it is in writing and signed by the seller.
38. In order to establish a cause of action based upon strict liability in tort for personal injuries resulting from the use of a defective product, one of the elements the plaintiff must prove is that the seller (defendant)
- Was engaged in the business of selling the product.
 - Failed to exercise due care.
 - Defectively designed the product.
 - Was in privity of contract with the plaintiff.
39. Sand Corp. sold and delivered a photocopier to Barr for use in Barr's business. According to their agreement, Barr may return the copier within 30 days. During the 30-day period, if Barr has **not** returned the copier or indicated acceptance of it, which of the following statements is correct with respect to risk of loss and title?
- Risk of loss and title passed to Barr.
 - Risk of loss and title remain with Sand.
 - Risk of loss passed to Barr but title remains with Sand.
 - Risk of loss remains with Sand but title passed to Barr.
40. An oral agreement concerning the sale of goods entered into without consideration is binding if the agreement
- Is a firm offer made by a merchant who promises to hold the offer open for 30 days.
 - Is a waiver of the non-breaching party's rights arising out of a breach of the contract.
 - Contradicts the terms of a subsequent written contract that is intended as the complete and exclusive agreement of the parties.
 - Modifies the price in an existing, enforceable contract from \$525 to \$475.
41. Wurke, Inc., manufactures and sells household appliances on credit directly to wholesalers, retailers, and consumers. Wurke can perfect its security interest in the appliances without having to file a financing statement or take possession of the appliances if the sale is made by Wurke to
- Retailers.
 - Wholesalers that then sell to distributors for resale.
 - Consumers.
 - Wholesalers that then sell to buyers in the ordinary course of business.

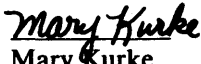
42. In order for a security interest in goods to attach, one of the requirements is that the debtor must
- Sign a financing statement that adequately describes the goods.
 - Sign a security agreement that adequately describes the goods.
 - Receive the goods from the creditor.
 - Have rights in the goods.

43. On May 8, Westar Corp. sold 20 typewriters to Saper for use in Saper's business. Saper paid for the typewriters by executing a promissory note that was secured by the typewriters. Saper also executed a security agreement. On May 9, Saper filed a petition in bankruptcy and a trustee was appointed. On May 16, Westar filed a financing statement covering the typewriters. Westar claims that it has a superior interest in the typewriters. The trustee in bankruptcy disagrees. Which of the parties is correct?
- The trustee, because the filing of a petition in bankruptcy cuts off Westar's rights as of the date of filing.
 - The trustee, because the petition was filed prior to Westar's filing of the financing statement.
 - Westar, because it perfected its security interest within ten days after Saper took possession of the typewriters.
 - Westar, because its security interest was automatically perfected upon attachment.

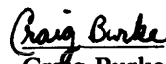
44. Bean defaulted on a promissory note payable to Gray Co. The note was secured by a piece of equipment owned by Bean. Gray perfected its security interest on May 29, 1987. Bean had also pledged the same equipment as collateral for another loan from Smith Co. after he had given the security interest to Gray. Smith's security interest was perfected on June 30, 1987. Bean is current in his payments to Smith. Subsequently, Gray took possession of the equipment and sold it at a private sale to Walsh, a good faith purchaser for value. Walsh will take the equipment
- Free of Smith's security interest because Bean is current in his payments to Smith.
 - Free of Smith's security interest because Walsh acted in good faith and gave value.
 - Subject to Smith's security interest because the equipment was sold at a private sale.
 - Subject to Smith's security interest because Smith is a purchase money secured creditor.

45. Which of the following negotiable instruments is subject to the provisions of the UCC Article on Commercial Paper?
- Bearer bond containing a maturity date of December 1, 1987.
 - Bill of lading payable to order.
 - Installment note payable on the first day of each month.
 - Warehouse receipt.

46. The following instrument has been received by Gary Gold:

October 30, 1987
To: Bill Blake P.O. Box 37 Dubuque, Iowa
Pay to the order of Gary Gold <u>Five Thousand and no/100 Dollars</u>
 Mary Kurke

- Which of the following is correct?
- As the drawer, Blake is primarily liable on the instrument.
 - The instrument is a negotiable note.
 - The instrument is payable on demand.
 - As the drawee, Blake is secondarily liable on the instrument.
47. In order to negotiate bearer paper, one must
- Endorse the paper.
 - Endorse and deliver the paper with consideration.
 - Deliver the paper.
 - Deliver and endorse the paper.
48. A company has in its possession the following instrument:

\$500.00	Dayton, Ohio	October 2, 1987
Sixty days after date I promise to pay to the order of		
Cash		
<u>Five hundred</u>		Dollars
at <u>Miami, Florida</u>		
Value received with interest at the rate of nine percent per annum.		
This instrument is secured by a conditional sales contract.		
<u>No. 11</u>	<u>Due December 1, 1987</u>	 Craig Burke

- This instrument is
- Not negotiable until December 1, 1987.
 - A negotiable bearer note.
 - A negotiable time draft.
 - A non-negotiable note since it states that it is secured by a conditional sales contract.

49. One of the requirements necessary to qualify as a holder of a negotiable bearer check is that the transferee must

- a. Take the check in good faith.
- b. Give value for the check.
- c. Have possession of the check.
- d. Receive the check that was originally made payable to bearer.

50. A holder in due course of a negotiable promissory note will take the note subject to which of the following defenses?

- a. Fraud in the inducement.
- b. Failure of consideration.
- c. Unauthorized signature.
- d. Breach of contract.

51. Fine Bank loaned Aker \$80,000 to purchase a condominium. Aker executed a promissory note and a mortgage that encumbered the condominium. Fine failed to record the mortgage. With respect to the above transaction, Fine

- a. Will hold legal title to the condominium until the note is paid.
- b. Must file a financing statement to perfect its security interest in the condominium, because the condominium is personal property.
- c. Must sign the note and mortgage in order for them to be effective.
- d. Is entitled to collect the \$80,000 from Aker despite its failure to record the mortgage.

52. Lusk borrowed \$20,000 from Marco Finance. The loan was secured by a mortgage on a four-unit apartment building owned by Lusk. The proceeds of the loan were used by Lusk to purchase a business. The mortgage was duly recorded 60 days after Marco loaned the money to Lusk. Six months after borrowing the money from Marco, Lusk leased one of the apartments to Rudd for \$800 per month. Neither Rudd nor Lusk notified Marco of the lease. Subsequently, Lusk defaulted on the note to Marco and Marco has commenced foreclosure proceedings. Under the circumstances,

- a. Marco's mortgage is junior to Rudd's lease because the mortgage was **not** a purchase money mortgage.
- b. Marco's mortgage is junior to Rudd's lease because Marco failed to record the mortgage for 60 days after the closing.
- c. Rudd's lease is subject to Marco's mortgage because Marco recorded its mortgage prior to the time Rudd's leasehold interest arose.
- d. Rudd's lease is subject to Marco's mortgage because of the failure to notify Marco of the lease.

53. Which of the following factors is **least** significant in determining whether an item of personal property has become a fixture?

- a. The extent of injury that would be caused to the real property by the removal of the item.
- b. The value of the item.
- c. The manner of attachment.
- d. The adaptability of the item to the real estate.

Items 54 and 55 are based on the following information:

Hill, Knox, and Lark own a building as joint tenants with the right of survivorship. Hill donated her interest in the building to Care Charity by executing and delivering a deed to Care. Both Knox and Lark refused to consent to Hill's transfer to Care. Subsequently, Hill and Knox died.

54. As a result of Hill's transfer to Care, Care acquired

- a. A $\frac{1}{3}$ interest in the building as a joint tenant.
- b. A $\frac{1}{3}$ interest in the building as a tenant in common.
- c. No interest in the building because Knox and Lark refused to consent to the transfer.
- d. No interest in the building because it failed to qualify as a bona fide purchaser for value.

55. As a result of Hill's and Knox's death,

- a. Lark owns the entire interest in the building.
- b. Lark owns a $\frac{2}{3}$ interest in the building as a tenant in common.
- c. Care and Lark each own a $\frac{1}{2}$ interest in the building as joint tenants.
- d. Knox's heirs and Lark each own a $\frac{1}{3}$ interest in the building as tenants in common.

56. Drake Corp. entered into a five-year lease with Samon that provided for Drake's occupancy of three floors of a high-rise office building at a monthly rent of \$16,000. The lease provided that "lessee may sublet the premises but only with the landlord's (Samon's) prior written consent". The lease was silent as to whether Drake could assign the lease. Which of the following statements is correct?

- a. Subletting of the premises with Samon's consent will relieve Drake from its obligation to pay rent.
- b. Assignment of the lease with Samon's consent will relieve Drake from its obligation to pay rent.
- c. Samon may refuse to consent to a subsequent sublet even if she has consented to a prior sublet.
- d. Subletting of the premises without Samon's consent is void.

57. A purchaser of a building who receives real estate title insurance will

- a. Not have coverage for the title exceptions listed in the policy.
- b. Have coverage for title defects that result from events that happen after the effective date of the policy.
- c. Be entitled to transfer the policy to subsequent owners since the policy runs with the property being insured.
- d. Take title to the building free and clear of all record defects since all exceptions to title must be cleared prior to closing.

58. In general, the coinsurance feature of property insurance

- a. Is fixed at a minimum of 80% by law.
- b. Is an additional refinement of the insurable interest requirement.
- c. Precludes the insured from insuring for less than the coinsurance percentage.
- d. Prevents the insured from insuring for a minimal amount and recovering the full amount of losses.

59. With respect to property insurance, the insurable interest requirement

- a. Need only be satisfied at the time the policy is issued.
- b. Must be satisfied both at the time the policy is issued and at the time of the loss.
- c. Will be satisfied only if the insured owns the property in fee simple absolute.
- d. Will be satisfied by an insured who possesses a leasehold interest in the property.

60. On May 5, Sly purchased a warehouse for \$100,000. Sly immediately insured the warehouse in the amount of \$40,000 with Riff Insurance Co. Six months later, Sly obtained additional fire insurance on the warehouse in the amount of \$10,000 from Beek Insurance Co. Both policies contained an 80% coinsurance clause. Sly failed to notify Riff of the policy with Beek. Two years later, while both policies were still in effect, a fire caused by Sly's negligence resulted in \$20,000 of damage to the warehouse. At the time of the loss, the warehouse had a fair market value of \$50,000. Which of the following will prevent Sly from obtaining the full \$20,000 from Riff?

- a. Sly's negligence in causing the fire.
- b. Sly's failure to satisfy the coinsurance clause.
- c. Sly's failure to notify Riff of the policy with Beek.
- d. Sly's purchase of insurance from Beek.

Number 2 (Estimated time — 15 to 20 minutes)

On May 1, Starr Corp., a manufacturer and supplier of computers, mailed a proposed contract to Magic, Inc., offering to sell 20 items of specified computer equipment for \$18,000. Magic was engaged in the business of selling computers to the public. Magic accepted Starr's offer by executing and returning the contract to Starr. Starr failed to sign the contract.

On May 15, Starr advised Magic by telephone that, due to certain market conditions, the price of computer parts had increased. Therefore, in order to avoid a loss on the sale to Magic, Starr requested an increase in the sales price to \$20,000, which was orally agreed to by Magic. On May 17, Starr sent to Magic a signed letter acknowledging this agreement. Magic did not respond to the letter.

On September 15, Starr notified Magic that the equipment was ready for delivery. Due to substantial changes in computer technology subsequent to May 15, Magic indicated that it no longer wanted the equipment and that it would not pay for it. Starr was unable to resell the computer equipment for any price despite its reasonable efforts to do so. Therefore, Starr commenced a breach of contract action against Magic. Magic asserted the following defenses:

- The May 1 written contract between Starr and Magic is not enforceable because of the statute of frauds.
- Even if the May 1 contract is enforceable, the May 15 oral agreement to change the price of the equipment is not enforceable because the agreement lacked consideration and failed to satisfy the statute of frauds.
- In any event, Starr is not entitled to recover the full sales price because the equipment is still in Starr's possession.

Required: Discuss Magic's assertions, indicating whether each is correct or incorrect and setting forth the reasons for any conclusions stated.

Number 3 (Estimated time — 15 to 20 minutes)

On July 1, 1986, Mix was petitioned by Able into bankruptcy under the liquidation provisions of the Bankruptcy Code. Able and Baker are unsecured creditors of Mix, owed \$20,000 and \$40,000 respectively. Mix also owes Carr \$80,000, secured by a valid perfected security interest in bankruptcy on Mix's machinery, valued at \$20,000. Mix has no other debts, except for 1986 federal income taxes.

Shortly after the filing of the petition Lang was appointed trustee in Mix's bankruptcy. In Lang's capacity as trustee, Lang:

- Engaged Ring & Co., CPAs, as the accountants for the bankruptcy estate.
- Included as part of the bankruptcy estate, an inheritance that Mix became entitled to receive on December 15, 1986 and that Mix actually received on January 15, 1987.

Lang has sold the property in the estate (including the sale of Mix's machinery for \$20,000, which Carr consented to) and now the sole asset of the estate is \$60,000 cash. Lang wishes to distribute the \$60,000 so as to satisfy the following claims and expenses of the estate:

• Unsecured claim for 1986 federal income taxes	\$ 6,000
• Carr's claim	80,000
• Able's and Baker's claims	60,000
• Expenses necessary to maintain and sell the unsecured property of the estate	1,000
• Ring's fee for services rendered	3,000

There are no other claims.

Required: Answer the following, setting forth reasons for any conclusions stated.

a. Under the facts, were the requirements necessary for the filing of a valid petition in bankruptcy met? Discuss.

b. Discuss whether Lang's actions in engaging Ring and including the inheritance in the bankruptcy estate were proper.

c. Indicate the order in which the \$60,000 should be distributed to satisfy the claims and expenses of the bankruptcy estate, assuming all necessary court approvals have been obtained.

Number 4 (Estimated time — 15 to 20 minutes)

On April 1, Sam Stieb signed and mailed to Bold Corp. an offer to sell Bold a parcel of land for \$175,000. On April 5, Bold called Stieb and requested that Stieb keep the offer open until June 1, by which time Bold would be able to determine whether financing for the purchase was available. That same day, Stieb signed and mailed a letter indicating that he would hold the offer open until June 1 if Bold mailed Stieb \$100 by April 20.

On April 17, Stieb sent Bold a signed letter revoking his offers dated April 1 and April 5. Bold received that letter on April 19. However, Bold had already signed and mailed on April 18 its acceptance of Stieb's offer of April 5 along with a check for \$100. Stieb received the check and letter of acceptance on April 20.

On May 15, Bold wrote Stieb stating that the \$175,000 purchase price was too high but that it would be willing to purchase the land for \$160,000. Upon receipt, Stieb immediately sent a telegram to Bold indicating that he had already revoked his offer and that even if his revocation was not effective he considered Bold's offer a counteroffer which he would not accept. Otherwise, Stieb did nothing as a result of Bold's May 15 letter.

On May 25, Bold executed and delivered the original contract of April 1 to Stieb without any variation of the original terms.

Stieb does not wish to sell the land to Bold because he has received another offer for \$200,000. In order to avoid the sale to Bold for \$175,000, Stieb asserts the following:

- Bold could not validly accept Stieb's offer dated April 5 because \$100 was inadequate consideration to hold the offer open until April 20.
- Stieb's offer dated April 5 had terminated because he had revoked the offer prior to Bold's acceptance.
- Even if his revocation was not effective, Bold's letter of May 15 was a counteroffer, which automatically terminated Bold's right to accept Stieb's offer of April 1.

Required: Discuss Stieb's assertions, indicating whether such assertions are correct or incorrect and setting forth the reasons for any conclusions stated.

Number 5 (Estimated time — 15 to 20 minutes)

Mace, Inc., wishes to acquire Creme Corp., a highly profitable company with substantial retained earnings. Creme is incorporated in a state that recognizes the concepts of stated capital (legal capital) and capital surplus.

In conjunction with the proposed acquisition, Mace engaged Gold & Co., CPAs, to audit Creme's financial statements. Gold began analyzing Creme's stated capital account and was provided the following data:

- Creme was initially capitalized in 1980 by issuing 40,000 shares of common stock, 50¢ par value, at \$15 per share. The total number of authorized shares was fixed at 100,000 shares.
- Costs to organize Creme were \$15,000.
- During 1982, Creme's board of directors declared and distributed a 5% common stock dividend. The fair market value of the stock at that time was \$20 per share.
- On June 1, 1983, the president of Creme exercised a stock option to purchase 1,000 shares of common stock at \$21 per share when the market price was \$25 per share.
- During 1984, Creme's board of directors declared and distributed a 2-for-1 stock split on its common stock when the market price was \$28 per share.
- During 1985, Creme acquired as treasury stock 5,000 shares of its common stock at a market price of \$30 per share. Creme uses the cost method of accounting and reporting for treasury stock.
- During 1986, Creme reissued 3,000 shares of the treasury stock at the market price of \$32 per share.

Required: Answer the following, setting forth reasons for any conclusions stated.

a. Discuss what effect each of the transactions described above would have on stated capital (legal capital), indicating the dollar amount of change.

b. Discuss the requirements necessary to properly declare and pay cash dividends.

EXAMINATION IN ACCOUNTING THEORY

(Theory of Accounts)

November 6, 1987; 1:30 to 5:00 P.M.

NOTE TO CANDIDATES: Suggested time allotments are as follows:

All questions are required:	<u>Point Value</u>	<u>Estimated Minutes</u>	
		<u>Minimum</u>	<u>Maximum</u>
No. 1	60	90	110
No. 2	10	15	25
No. 3	10	15	25
No. 4	10	15	25
No. 5	10	15	25
Total	<u>100</u>	<u>150</u>	<u>210</u>

INSTRUCTIONS TO CANDIDATES

(Disregard of these instructions may be considered as indicating inefficiency in accounting work.)

1. You must arrange the papers in numerical order of the questions. If more than one page is required for an answer, write "continued" at the bottom of the page. Number pages consecutively. For instance, if 12 pages are used for your answers, the objective answer sheet is page 1 and your other pages should be numbered 2 through 12.
2. Answer **all** objective-type items on the printed answer sheet provided for that purpose. It is to your advantage to attempt all questions even if you are uncertain of the answer. You are likely to get the highest score if you omit no answers. Since objective items are computer-graded, your comments and calculations associated with them are not considered. Be certain that you have entered your answers on the objective answer sheet before the examination time is up.
3. A CPA is continually confronted with the necessity of expressing opinions and conclusions in written reports in clear, unequivocal language. Although the primary purpose of the examination is to test the candidate's knowledge and application of the subject matter, the ability to organize and present such knowledge in acceptable written language may be considered by the examiners.

*Prepared by the Board of Examiners of the American Institute of Certified Public Accountants
and adopted by the examining boards of all states, the District of Columbia, Guam,
Puerto Rico, and the Virgin Islands of the United States.*

Number 1 (Estimated time — 90 to 110 minutes)

Instructions

Select the **best** answer for each of the following items relating to a **variety of issues in accounting**. Use a soft pencil, preferably No. 2, to blacken the appropriate circle on the separate printed answer sheet to indicate your answer. **Mark only one answer for each item. Answer all items.** Your grade will be based on the total number of your correct answers.

The following is an example of the manner in which the answer sheet should be marked:

Item

99. The financial statement which summarizes the financial position of a company is the
- Income statement.
 - Balance sheet.
 - Statement of changes in financial position.
 - Retained earnings statement.

Answer Sheet

99. (a) ● (c) (d)

Items to be Answered

1. A company records inventory at the gross invoice price. Theoretically, how should the following affect the costs in inventory?

	<u>Warehousing costs</u>	<u>Cash discounts available</u>
a.	Increase	Decrease
b.	No effect	Decrease
c.	No effect	No effect
d.	Increase	No effect

2. During periods of rising prices, when the FIFO inventory cost flow method is used, a perpetual inventory system would

- Not be permitted.
- Result in a higher ending inventory than a periodic inventory system.
- Result in the same ending inventory as a periodic inventory system.
- Result in a lower ending inventory than a periodic inventory system.

3. The original cost of an inventory item is above the replacement cost. The replacement cost is above the net realizable value. Under the lower of cost or market method, the inventory item should be reported at its

- Original cost.
- Replacement cost.
- Net realizable value.
- Net realizable value less the normal profit margin.

4. A company is constructing an asset for its own use. Construction began in 1985. The asset is being financed entirely with a specific new borrowing. Construction expenditures were made in 1985 and 1986 at the end of each quarter. The total amount of interest cost capitalized in 1986 should be determined by applying the interest rate on the specific new borrowing to the

- Total accumulated expenditures for the asset in 1985 and 1986.
- Average accumulated expenditures for the asset in 1985 and 1986.
- Average expenditures for the asset in 1986.
- Total expenditures for the asset in 1986.

5. A depreciable asset has an estimated 15% salvage value. At the end of its estimated useful life, the accumulated depreciation would equal the original cost of the asset under which of the following depreciation methods?

	<u>Productive output</u>	<u>Sum of the years' digits</u>
a.	Yes	No
b.	No	No
c.	No	Yes
d.	Yes	Yes

6. A lessee incurred costs to construct walkways to improve leased property. The estimated useful life of the walkways is fifteen years. The remaining term of the nonrenewable lease is twenty years. The walkway costs should be

- Capitalized as leasehold improvements and depreciated over twenty years.
- Capitalized as leasehold improvements and depreciated over fifteen years.
- Capitalized as leasehold improvements and expensed in the year in which the lease expires.
- Expensed as incurred.

7. A company using the group depreciation method for its delivery trucks retired one of its delivery trucks after the average service life of the group was reached. Cash proceeds were received from a salvage company. The net carrying amount of these group asset accounts would be decreased by the

- Original cost of the truck.
- Original cost of the truck less the cash proceeds.
- Cash proceeds received.
- Cash proceeds received and original cost of the truck.

8. According to the FASB conceptual framework, comprehensive income includes which of the following?

	<u>Gross margin</u>	<u>Operating income</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

Accounting Theory

9. Legal fees incurred by a company in defending its patent rights should be capitalized when the outcome of the litigation is

	<u>Successful</u>	<u>Unsuccessful</u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

10. In a sale-leaseback transaction, the seller-lessee retains the right to substantially all of the remaining use of the equipment sold. The profit on the sale should be deferred and subsequently amortized by the lessee when the lease is classified as a(an)

	<u>Capital lease</u>	<u>Operating lease</u>
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

11. For a capital lease, the amount recorded initially by the lessee as a liability should

- a. Exceed the present value at the beginning of the lease term of minimum lease payments during the lease term.
- b. Exceed the total of the minimum lease payments during the lease term.
- c. Not exceed the fair value of the leased property at the inception of the lease.
- d. Equal the total of the minimum lease payments during the lease term.

12. Treasury stock was acquired for cash at a price in excess of its par value. The treasury stock was subsequently reissued for cash at a price in excess of its acquisition price. Assuming that the cost method of accounting for treasury stock transactions is used, what is the effect on retained earnings?

	<u>Acquisition of treasury stock</u>	<u>Reissuance of treasury stock</u>
a.	No effect	Increase
b.	No effect	No effect
c.	Increase	Decrease
d.	Decrease	Increase

13. The partnership agreement for the partnership of Somer and Primrose provided for interest on each partner's average capital investment. Somer's average capital investment was more than Primrose's average capital investment. Profit in excess of interest was allocated equally. If during the year the partnership had profits in excess of the interest on each partner's average capital investment, the amount of Somer's partnership capital would

- a. Increase the same as Primrose's.
- b. Increase more than Primrose's.
- c. Decrease the same as Primrose's.
- d. Decrease more than Primrose's.

14. A company changes from an accounting principle that is not generally accepted to one that is generally accepted. The effect of the change should be reported, net of applicable income taxes, in the current

- a. Income statement after income from continuing operations and before extraordinary items.
- b. Income statement after extraordinary items.
- c. Retained earnings statement as an adjustment of the opening balance.
- d. Retained earnings statement after net income but before dividends.

15. How would the declaration of a liquidating dividend by a corporation affect each of the following?

	<u>Contributed capital</u>	<u>Total stockholders' equity</u>
a.	No effect	Decrease
b.	Decrease	Decrease
c.	Decrease	No effect
d.	No effect	No effect

16. When should an anticipated loss on a long-term contract be recognized under the percentage-of-completion method and the completed-contract method, respectively?

	<u>Percentage-of-Completion</u>	<u>Completed-Contract</u>
a.	Over life of project	Contract complete
b.	Immediately	Contract complete
c.	Over life of project	Immediately
d.	Immediately	Immediately

17. A foreign subsidiary's functional currency is its local currency, which has not experienced significant inflation. The weighted average exchange rate for the current year would be the appropriate exchange rate for translating

	<u>Wages expense</u>	<u>Sales to customers</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

18. The effect of a material transaction that is infrequent in occurrence but not unusual in nature should be presented separately as a component of income from continuing operations when the transaction results in a

	<u>Gain</u>	<u>Loss</u>
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

19. A company issued for no consideration rights to its existing shareholders to purchase, for \$30 per share, unissued shares of \$15 par value common stock. The common stock account will be

- Credited when the rights are exercised.
- Credited when the rights are issued.
- Debited when the rights are exercised.
- Debited when the rights lapse.

20. A research and development activity for which the cost would be expensed as incurred is

- Modification of the design of a product.
- Trouble-shooting in connection with breakdowns during commercial production.
- Routine design of tools.
- Engineering follow-through in an early phase of commercial production.

21. An employer offered for a short period of time special termination benefits to some employees. The employees accepted the offer, which provided for immediate lump-sum payments and future payments at the end of the next two years. The amounts can be reasonably estimated. The amount of expense recognized this year should include

- One third of the lump-sum payments and one third of the present value of the future payments.
- Only the lump-sum payments.
- The lump-sum payments and the total of the future payments.
- The lump-sum payments and the present value of the future payments.

22. Which of the following should be used for inter-period tax allocation?

	<u>Comprehensive allocation</u>	<u>Partial allocation</u>
a.	No	No
b.	Yes	No
c.	Yes	Yes
d.	No	Yes

23. The cumulative effect on prior years' earnings of a change in accounting principle should be reported separately as a component of income after income from continuing operations, for a change from

- Completed-contract method of accounting for long-term construction-type contracts to the percentage-of-completion method.
- Percentage-of-completion method of accounting for long-term construction-type contracts to the completed-contract method.
- FIFO method of inventory pricing to the weighted-average method.
- LIFO method of inventory pricing to the weighted-average method.

24. A segment of a business has been discontinued during the year. The loss on disposal should

- Include operating losses of the current period up to the measurement date.
- Include employee relocation costs associated with the decision to dispose.
- Exclude severance pay associated with the decision to dispose.
- Exclude operating losses during the phase-out period.

25. Which of the following should be disclosed in the summary of significant accounting policies?

	<u>Composition of inventories</u>	<u>Depreciation expense</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

26. The effect of a change in accounting principle which is inseparable from the effect of a change in accounting estimate should be reported

- In the period of change and future periods if the change affects both.
- By restating the financial statements of all prior periods presented.
- By showing the pro forma effects of retroactive application.
- As a correction of an error.

27. Company N donated computer equipment to a university (a nonreciprocal transfer). The fair value of the computer equipment was determinable. The difference between the fair value of the nonmonetary asset transferred and its recorded amount at the date of donation should be recognized in Company N's income statement when the difference results in a

	<u>Gain</u>	<u>Loss</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

28. A business combination is accounted for properly as a pooling of interests. Which of the following expenses related to effecting the business combination should enter into the determination of net income of the combined corporation for the period in which the expenses are incurred?

	<u>Fees of finders and consultants</u>	<u>Registration fees</u>
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

29. A business combination occurs in the middle of the year. Results of operations for the year of combination would include the combined results of operations of the separate companies for the entire year if the business combination is a

	<u>Pooling of interests</u>	<u>Purchase</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

30. Rent may be accrued or deferred to provide an appropriate cost in each period for

	<u>Interim financial reporting</u>	<u>Year-end financial reporting</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

31. When the occurrence of a gain contingency is probable and its amount can be reasonably estimated, the gain contingency should be

- a. Recognized in the income statement and disclosed.
- b. Classified as an appropriation of retained earnings.
- c. Disclosed, but **not** recognized in the income statement.
- d. Neither recognized in the income statement nor disclosed.

32. In financial reporting for segments of a business enterprise, which of the following should be taken into account in computing the amount of an industry segment's identifiable assets?

	<u>Accumulated depreciation</u>	<u>Allowance for doubtful accounts</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

33. The if-converted method of computing earnings per share data assumes conversion of convertible securities as of the

- a. Beginning of the earliest period reported (or at time of issuance, if later).
- b. Beginning of the earliest period reported (regardless of time of issuance).
- c. Middle of the earliest period reported (regardless of time of issuance).
- d. Ending of the earliest period reported (regardless of time of issuance).

34. A decrease in net accounts receivable should be presented in a statement of changes in financial position prepared on a cash basis (indirect method) as a(an)

- a. Inflow and outflow of cash.
- b. Outflow of cash.
- c. Deduction from income from continuing operations.
- d. Addition to income from continuing operations.

35. A loss on the sale of machinery in the ordinary course of business should be presented in a statement of changes in financial position prepared on a cash basis (indirect method) as a(an)

- a. Deduction from income from continuing operations.
- b. Addition to income from continuing operations.
- c. Inflow and outflow of cash.
- d. Outflow of cash.

36. An employer sponsoring a defined benefit pension plan should

- a. Disclose the projected benefit obligation, identifying the accumulated benefit obligation and the vested benefit obligation.
- b. Disclose the projected benefit obligation, identifying the accumulated benefit obligation but **not** the vested benefit obligation.
- c. Disclose the projected benefit obligation, identifying the vested benefit obligation but **not** the accumulated benefit obligation.
- d. Not disclose the projected benefit obligation.

37. For a compensatory stock option plan for which the date of grant and the measurement date are different, the stock options outstanding account should be reduced at the

- a. Adoption date of the plan.
- b. Date of grant.
- c. Measurement date.
- d. Exercise date.

38. How are trade receivables used in the calculation of each of the following?

	<u>Acid test (quick) ratio</u>	<u>Receivable turnover</u>
a.	Denominator	Denominator
b.	Not used	Numerator
c.	Numerator	Numerator
d.	Numerator	Denominator

39. Personal financial statements should include a

	<u>Statement of financial condition</u>	<u>Statement of changes in financial position</u>
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

40. When combined financial statements are prepared for a group of related companies, intercompany transactions and intercompany profits or losses should be eliminated when the group is composed of

	<u>Commonly controlled companies</u>	<u>Unconsolidated subsidiaries</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

41. In a job order cost system using predetermined factory overhead rates, indirect materials usually are recorded initially as an increase in

- Work in process control.
- Factory overhead applied.
- Factory overhead control.
- Stores control.

42. Under the three-variance method for analyzing factory overhead, which of the following is used in the computation of the spending variance?

	<u>Actual factory overhead</u>	<u>Budget allowance based on actual hours</u>
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

43. Actual sales values at the split-off point for joint products Y and Z are not known. For purposes of allocating joint costs to products Y and Z, the relative sales value at split-off method is used. An increase in the costs beyond split-off occurs for product Z, while those of product Y remain constant. If the selling prices of finished products Y and Z remain constant, the percentage of the total joint costs allocated to Product Y and Product Z would

- Decrease for Product Y and Product Z.
- Decrease for Product Y and increase for Product Z.
- Increase for Product Y and Product Z.
- Increase for Product Y and decrease for Product Z.

44. Residual income is the

- Contribution margin of an investment center, less the imputed interest on the invested capital used by the center.
- Contribution margin of an investment center, plus the imputed interest on the invested capital used by the center.
- Income of an investment center, less the imputed interest on the invested capital used by the center.
- Income of an investment center, plus the imputed interest on the invested capital used by the center.

45. Direct materials cost is a

	<u>Period cost</u>	<u>Product cost</u>
a.	Yes	No
b.	No	No
c.	No	Yes
d.	Yes	Yes

46. In an income statement prepared as an internal report using the variable costing method, which of the following terms should appear?

	<u>Gross profit (margin)</u>	<u>Operating income</u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

47. When production levels are expected to decline within a relevant range, and a flexible budget is used, what effects would be anticipated with respect to each of the following?

	<u>Fixed costs per unit</u>	<u>Variable costs per unit</u>
a.	Increase	No change
b.	Increase	Increase
c.	No change	No change
d.	No change	Increase

48. In using cost-volume-profit analysis to calculate expected unit sales, which of the following should be added to fixed costs in the numerator?

- Predicted operating loss.
- Predicted operating profit.
- Unit contribution margin.
- Variable costs.

49. The capital budgeting technique known as accounting rate of return uses

	<u>Depreciation expense</u>	<u>Time value of money</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

50. A company is considering exchanging an old asset for a new asset. Ignoring income tax considerations, which of the following is (are) economically relevant to the decision?

	<u>Carrying amount of old asset</u>	<u>Disposal value of old asset</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

51. Under which basis of accounting for a governmental unit should revenues be recognized in the accounting period in which they become available and measurable?

	<u>Accrual basis</u>	<u>Modified accrual basis</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

52. The estimated revenues control account of a governmental unit is debited when

- The budget is closed at the end of the year.
- The budget is recorded.
- Actual revenues are recorded.
- Actual revenues are collected.

53. Which of the following accounts of a governmental unit is debited when a purchase order is approved?

- Appropriations control.
- Vouchers payable.
- Fund balance reserved for encumbrances.
- Encumbrances control.

54. Which of the following funds of a governmental unit recognizes revenues in the accounting period in which they become available and measurable?

- Nonexpendable trust.
- General.
- Enterprise.
- Internal service.

55. The debt service fund of a governmental unit is used to account for the accumulation of resources to pay, and the payment of, general long-term debt

	<u>Principal</u>	<u>Interest</u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

56. Which of the following funds of a governmental unit uses the same basis of accounting as an enterprise fund?

- Special revenue.
- Expendable trust.
- Capital projects.
- Internal service.

57. Which of the following not-for-profit organizations would use plant funds to account for land, buildings, equipment, and other capital assets?

	<u>Colleges and universities</u>	<u>Voluntary health and welfare organizations</u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

58. The comprehensive annual financial report (CAFR) of a governmental unit should contain a combined statement of revenue, expenditures, and changes in fund balances for

	<u>Account groups</u>	<u>Proprietary funds</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

59. A local governmental unit could use which of the following types of funds?

	<u>Fiduciary</u>	<u>Proprietary</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

60. The current funds group of a not-for-profit private university includes which of the following?

	<u>Agency funds</u>	<u>Plant funds</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

Number 2 (Estimated time — 15 to 25 minutes)

Tidal Company has significant amounts of trade accounts receivable. In March of this year, Tidal assigned specific trade accounts receivable to Herb Finance Company on a with recourse, nonnotification basis as collateral for a loan. Tidal signed a note and received 70 percent of the amount assigned. Tidal was charged a 5 percent finance fee and agreed to pay interest at 12 percent on the unpaid balance. Some specific accounts of the assigned receivables were written off as uncollectible. The remainder of the trade accounts receivable assigned were collected by Tidal in March and April of this year. Tidal paid Herb Finance in full at the end of April of this year.

Tidal also sold some special order merchandise and received a 90-day, 15 percent, interest-bearing note receivable on July 1 of this year. After 30 days, the note receivable was discounted with recourse at 18 percent at a bank.

Required:

a. How should Tidal account for the transactions described above for the assignment of trade accounts receivable?

b. 1. How should Tidal determine the amount of the discount for the note receivable?

2. How should the discounting transaction be accounted for?

Number 3 (Estimated time — 15 to 25 minutes)

Houston Company has a portfolio of marketable equity securities that it classifies as a current asset. Houston owns less than five percent of the outstanding voting stock of each company's securities in the portfolio. At the beginning of the year, the aggregate market value of the portfolio exceeded its aggregate cost. Cash dividends on these securities were received during the year. All cash dividends received represent distributions of earnings subsequent to Houston's acquisition of these securities. Some of the securities in the portfolio were sold during the year. At the end of the year, the aggregate cost of the portfolio exceeded its aggregate market value.

Houston owns forty percent of the outstanding voting stock of Joy Company. The remainder of Joy's outstanding voting stock is widely dispersed among unrelated investors.

Required:

- a. 1. How should Houston report the income statement effects of the cash dividends received during the year on the securities in the portfolio that it classifies as a current asset?
2. How should Houston report the income statement effects of the securities sold during the year?
- b. How should Houston report the effect of ownership of the portfolio that it classifies as a current asset in its balance sheet as of the end of the year and income statement for the year? Why? Do not discuss the cash dividends or the securities sold.
- c. Identify the method of accounting that Houston should use for its forty percent investment in the outstanding voting stock of Joy. Why is this method appropriate?

Number 4 (Estimated time — 15 to 25 minutes)

Spackenkill Company is a manufacturer of household appliances. During the year, the following information became available:

- Potential costs due to the discovery of a safety hazard related to one of its products — These costs are probable and can be reasonably estimated.
- Potential costs of new product warranty costs — These costs are probable but cannot be reasonably estimated.
- Potential costs due to the discovery of a possible product defect related to one of its products — These costs are reasonably possible and can be reasonably estimated.

Required:

- a. How should Spackenkill report the potential costs due to the discovery of a safety hazard? Why?
- b. How should Spackenkill report the potential costs of warranty costs? Why?
- c. How should Spackenkill report the potential costs due to the discovery of a possible product defect? Why?

Number 5 (Estimated time — 15 to 25 minutes)

On January 1, 1985, Brewster Company issued 2,000 of its five-year, \$1,000 face value, 11% bonds dated January 1 at an effective annual interest rate (yield) of 9%. Brewster uses the effective interest method of amortization. On December 31, 1986, the 2,000 bonds were extinguished early through acquisition in the open market by Brewster for \$1,980,000.

On July 1, 1985, Brewster issued 5,000 of its six-year, \$1,000 face value, 10% convertible bonds dated July 1 at an effective annual interest rate (yield) of 12%. The convertible bonds are convertible at the option of the investor into Brewster's common stock at a ratio of 10 shares of common stock for each bond. Brewster uses the effective interest method of amortization. On July 1, 1986, an investor in Brewster's convertible bonds tendered 1,500 bonds for conversion into 15,000 shares of Brewster's common stock which had a market value of \$105 per share at the date of the conversion.

Required:

- a. 1. Were the 11% bonds issued at par, at a discount, or at a premium? Why?
2. Would the amount of interest expense for the 11% bonds using the effective interest method of amortization be higher in the first or second year of the life of the bond issue? Why?
- b. 1. How should gain or loss on early extinguishment of debt be determined? Does the early extinguishment of the 11% bonds result in a gain or loss? Why?
2. How should Brewster report the early extinguishment of the 11% bonds on the 1986 income statement?
- c. 1. Would recording the conversion of the 10% convertible bonds into common stock under the book value method affect net income? What is the rationale for the book value method?
2. Would recording the conversion of the 10% convertible bonds into common stock under the market value method affect net income? What is the rationale for the market value method?

ANSWERS TO EXAMINATION
ACCOUNTING PRACTICE — PART I

November 4, 1987; 1:30 to 6:00 p.m.

Answer 1 (10 points)

- 1. c
- 2. b
- 3. c
- 4. b
- 5. a
- 6. c
- 7. c
- 8. b
- 9. a
- 10. d
- 11. b
- 12. b
- 13. c
- 14. c
- 15. c
- 16. a
- 17. b
- 18. d
- 19. d
- 20. a

Answer 2 (10 points)

- 21. b
- 22. d
- 23. b
- 24. c
- 25. b
- 26. d
- 27. d
- 28. b
- 29. c
- 30. c
- 31. b
- 32. d
- 33. a
- 34. d
- 35. c
- 36. c
- 37. c
- 38. b
- 39. a
- 40. d

Answer 3 (10 points)

- 41. c
- 42. a
- 43. a
- 44. d
- 45. a
- 46. d
- 47. d
- 48. c
- 49. c
- 50. b
- 51. b
- 52. b
- 53. a
- 54. d
- 55. a
- 56. c
- 57. d
- 58. b
- 59. b
- 60. c

The scores for the multiple choice questions were determined in accordance with the following scales:

Answer 1

Correct	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Score	0	1	1½	2	2½	3	3½	4	4½	5	5½	6	6½	7	7½	8	8½	9	9½	10	10

Answer 2

Correct	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Score	0	1½	2	2½	3	3½	4	4½	5	5½	6	6½	7	7½	8	8½	9	9½	10	10	10

Answer 3

Correct	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Score	0	1½	2	2½	3	3½	4	4½	5	5½	6	6½	7	7½	8	8½	9	9½	10	10	10

Answer 4 (10 points)

a.

Pell Corporation
ANALYSIS OF CHANGES IN PLANT ASSETS
For the Year Ended December 31, 1986

	<i>Balance</i> <u>12/31/85</u>	<i>Increase</i>	<i>Decrease</i>	<i>Balance</i> <u>12/31/86</u>
Land	\$ 350,000	\$438,000 [1]	\$ —	\$ 788,000
Land improvements	180,000	—	—	180,000
Building	1,500,000	—	—	1,500,000
Machinery and equipment	1,158,000	287,000 [2]	58,000	1,387,000
Automobiles	150,000	19,000 [3]	18,000	151,000
Total	<u>\$3,338,000</u>	<u>\$744,000</u>	<u>\$76,000</u>	<u>\$4,006,000</u>

Explanations of Amounts:

[1] Cost of land acquired 11/1/86	
Pell stock exchanged (10,000 × \$38)	\$380,000
Legal fees and title insurance	23,000
Razing existing building	35,000
	<u>\$438,000</u>
[2] Cost of machinery and equipment purchased 1/2/86	
Invoice cost	\$260,000
Installation cost	27,000
	<u>\$287,000</u>
[3] Cost recorded for new automobile 12/31/86	
Carrying amount of trade-in	
[\$18,000 – \$13,500 (depreciation 150% declining	
balance at rate of 50% for 2 years)]	\$ 4,500
Cash paid	15,250
Subtotal	\$19,750
Loss on trade-in	750
Cost recorded for new automobile	<u>\$19,000</u>

Answer 4 (continued)

b.

Pell Corporation
DEPRECIATION EXPENSE
For the Year Ended December 31, 1986

Land improvements			
Cost		\$ 180,000	
Straight-line rate [100% ÷ 15]		<u>× 6⅔%</u>	
Total depreciation on land improvements			<u>\$ 12,000</u>
Building			
Carrying amount 12/31/85 (\$1,500,000 – \$350,000)		\$1,150,000	
150% declining balance rate [(100% ÷ 20) × 1½]		<u>× 7½%</u>	
Total depreciation on building			<u>86,250</u>
Machinery and equipment			
Balance, 12/31/85	\$1,158,000		
Deduct machine sold 3/31/86	<u>58,000</u>	\$1,100,000	
Depreciation straight-line rate		<u>× 10%</u>	110,000
Purchased 1/2/86		287,000	
Depreciation		<u>× 10%</u>	28,700
Machine sold 3/31/86		58,000	
Depreciation from 1/1/ to 3/31/86 (10% × ¼)		<u>× 2.5%</u>	1,450
Total depreciation on machinery and equipment			<u>140,150</u>
Automobiles			
Carrying amount 12/31/85 (\$150,000 – \$112,000)		\$ 38,000	
150% declining balance rate [100% ÷ 3 × 1½]		<u>× 50%</u>	
Total depreciation on automobiles			<u>19,000</u>
Total depreciation expense for 1986			<u><u>\$257,400</u></u>

c.

Pell Corporation
GAIN OR LOSS FROM PLANT ASSET DISPOSALS
THAT WOULD BE RECOGNIZED IN INCOME STATEMENT
For the Year Ended December 31, 1986

	<i>Gain or (loss)</i>	
Sale of machine 3/31/86		
Selling price	\$36,500	
Carrying amount of machine sold		
[\$58,000 – \$24,650 (Depreciation 4¼ years × 10%)]	<u>33,350</u>	
Gain on sale		<u>3,150</u>
Trade-in of automobile 12/31/86		
Carrying amount of trade-in	\$ 4,500	
Trade-in allowed (\$19,000 – \$15,250)	<u>3,750</u>	[3]
Loss on trade-in	<u>\$ (750)</u>	
Gain from asset disposals	<u><u>\$ 2,400</u></u>	

Answer 5 (10 points)

a.

Public Relations Associates
STATEMENT OF CHANGES IN FINANCIAL POSITION
CASH BASIS
For the Year Ended December 31, 1986

Financial resources provided

Cash provided by operations			
Net income			\$450,000
Add (or deduct) items not affecting cash			
Depreciation	\$ 30,000		
Equity in net income of King, Inc.	(90,000)		
Amortization of excess cost over book value of investment in King	2,000		
Increase in accounts receivable	(39,000)		
Increase in accounts payable and accrued expenses	<u>25,000</u>		<u>(72,000)</u>
Cash provided by operations			378,000
Cash from other sources			
Capital investment by Davis			170,000
Dividends received from King, Inc.			<u>48,000</u>
Total financial resources provided			<u>596,000</u>

Financial resources used

Partners' drawings			315,000
Purchase of office equipment			85,000
Reduction of mortgage payable			<u>10,000</u>
Total financial resources used			<u>410,000</u>
 Increase in cash			 <u>\$186,000</u>

b.

Public Relations Associates
ANALYSIS OF CHANGES IN PARTNERS' CAPITAL ACCOUNTS
For the Year Ended December 31, 1986

	<u>Total</u>	<u>Burr</u>	<u>Cox</u>	<u>Davis</u>
Balance, December 31, 1985	\$ 850,000	\$510,000	\$340,000	\$ —
Capital investment	170,000	—	—	170,000
Distribution of net income	<u>450,000</u>	<u>225,000</u>	<u>135,000</u>	<u>90,000</u>
Balance before drawings	1,470,000	735,000	475,000	260,000
 Drawings	 <u>315,000</u>	 <u>140,000</u>	 <u>100,000</u>	 <u>75,000</u>
Balance, December 31, 1986	<u>\$1,155,000</u>	<u>\$595,000</u>	<u>\$375,000</u>	<u>\$185,000</u>

ANSWERS TO EXAMINATION
ACCOUNTING PRACTICE — PART II

November 5, 1987; 1:30 to 6:00 P.M.

Answer 1 (10 points)

- | | |
|-------|-------|
| 1. b | 11. c |
| 2. a | 12. b |
| 3. c | 13. c |
| 4. d | 14. d |
| 5. d | 15. d |
| 6. d | 16. c |
| 7. a | 17. b |
| 8. c | 18. b |
| 9. b | 19. a |
| 10. a | 20. a |

Answer 2 (10 points)

- | | |
|-------|-------|
| 21. d | 31. d |
| 22. c | 32. b |
| 23. b | 33. a |
| 24. d | 34. c |
| 25. a | 35. d |
| 26. a | 36. a |
| 27. c | 37. c |
| 28. c | 38. d |
| 29. d | 39. a |
| 30. c | 40. d |

Answer 3 (10 points)

- | | |
|-------|-------|
| 41. a | 51. c |
| 42. d | 52. c |
| 43. b | 53. d |
| 44. b | 54. d |
| 45. b | 55. a |
| 46. b | 56. a |
| 47. c | 57. a |
| 48. a | 58. b |
| 49. c | 59. d |
| 50. b | 60. c |

The scores for the multiple choice questions were determined in accordance with the following scales:

Answer 1

Correct	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Score	0	1½	2	2½	3	3½	4	4½	5	5½	6	6½	7	7½	8	8½	9	9½	10	10	10

Answer 2

Correct	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Score	0	1½	2	2½	3	3½	4	4½	5	5½	6	6½	7	7½	8	8½	9	9½	10	10	10

Answer 3

Correct	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Score	0	1½	2	2½	3	3½	4	4½	5	5½	6	6½	7	7½	8	8½	9	9½	10	10	10

Answer 4 (10 points)

Webb & Company
March 1987

a.

(1) Equivalent Units

	<u>Labor</u>	<u>Overhead</u>
Returns completed (200 + 825 - 125)	900	900
Returns in process, 3/31 (125 × 80%)	100	100
Equivalent units	<u>1,000</u>	<u>1,000</u>

(2) Actual Cost Per Equivalent Unit

	<u>Labor</u>	<u>Overhead</u>
Cost of returns in process, 3/1	\$ 6,000	\$ 2,500
Add: March costs	89,000	45,000
Total costs	95,000	47,500
Divided by weighted average equivalent units	÷ 1,000	÷ 1,000
Actual cost per equivalent unit	<u>\$95.00</u>	<u>\$47.50</u>

b. Actual Cost of Returns in Process at 3/31

Labor (125 returns × 80% × \$95.00)	\$ 9,500
Overhead (125 returns × 80% × \$47.50)	4,750
Total	<u>\$14,250</u>

c. Standard Cost Per Return

Labor (5 hrs. @ \$20)	\$100
Overhead (5 hrs. @ \$10)	50
Total	<u>\$150</u>

d. Analysis of March Performance

- (1) Total labor variance (actual minus standard)
\$89,000 - (950* × \$100) = \$6,000 favorable
- (2) Labor rate variance
[(89,000/4,000) - \$20] × 4,000 = \$9,000 unfavorable
- (3) Labor efficiency variance
[4,000 - (950* × 5)] × \$20 = \$15,000 favorable
- (4) Total overhead variance (actual minus standard)
\$45,000 - (950* × \$50) = \$2,500 favorable
- (5) Overhead volume variance
\$49,000 - (950* × \$50) = \$1,500 unfavorable
- (6) Overhead budget variance
\$45,000 - \$49,000 = \$4,000 favorable

	<u>Labor</u>	<u>Overhead</u>
*Equivalent units (weighted average method)	1,000	1,000
Less equivalent units beginning inventory (25% × 200)	50	50
Equivalent units for current production	<u>950</u>	<u>950</u>

Accounting Practice — Part II

Answer 5 (10 points)

Pym Corp. and Subsidiary
CONSOLIDATED BALANCE SHEET WORKSHEET
December 31, 1986

	<i>Pym Corp.</i>	<i>Sy Corp.</i>	<i>Adjustments & Eliminations</i>		<i>Consolidated</i>
			<i>Debit</i>	<i>Credit</i>	
<i>Assets</i>					
Cash	75,000	15,000			90,000
Accounts and other current receivables	410,000	120,000	[b] 900	[f] 900 [g] 5,000	335,000
Merchandise inventory	920,000	670,000		[h] 100,000 [i] 90,000	1,587,000
Plant and equipment (net)	1,000,000	400,000			1,400,000
Investment in Sy Corp.	1,200,000		[a] 90,900	[b] 900 [c] 480,000 [e] 810,000	
Goodwill			[c] 480,000	[d] 48,000	432,000
Totals	3,605,000	1,205,000			3,844,000
<i>Liabilities and Stockholders' Equity</i>					
Accounts payable and other current liabilities	140,000	305,000	[f] 900 [g] 5,000		249,100
Common stock (\$10 par)	500,000	200,000	[h] 100,000 [j] 90,000 [e] 200,000		500,000
Retained earnings	2,965,000	700,000	[d] 48,000 [e] 700,000 [i] 3,000	[a] 90,900	3,004,900
Minority interest, 10%				[e] 90,000	90,000
Totals	3,605,000	1,205,000	1,718,700	1,718,700	3,844,000

Answer 5 (continued)

Explanations of Worksheet Adjustments and Eliminations

[a]	To record net income of Sy Corp. accruing to Pym Corp.	
	Sy Corp.'s retained earnings at 12/31/86	\$700,000
	Sy Corp.'s retained earnings at 1/1/86	<u>600,000</u>
	Increase in retained earnings after dividend declaration	100,000
	Add dividend declaration	<u>1,000</u>
	Sy Corp.'s net income for the year ended 12/31/86	<u>101,000</u>
	Pym Corp.'s share, 90%	<u>\$ 90,900</u>
[b]	To record Pym Corp.'s share of dividend declared by Sy Corp.	
	90% of \$1,000	<u>\$900</u>
[c]	To record goodwill	
	Purchase price of 90% of Sy Corp.'s common stock	\$1,200,000
	Sy Corp.'s book value at 1/1/86	
	Common stock	\$200,000
	Retained earnings	<u>600,000</u>
	Total	<u>\$800,000</u>
	Pym Corp.'s share, 90%	<u>720,000</u>
	Goodwill	<u>\$ 480,000</u>
[d]	To record amortization of goodwill	
	10% of \$480,000	<u>\$48,000</u>
[e]	To eliminate 90% of Sy Corp.'s book value and record minority interest	
	Common stock	\$200,000
	Retained earnings at 12/31/86	<u>700,000</u>
	Total	<u>\$900,000</u>
	Pym Corp.'s share, 90%	<u>\$810,000</u>
	Minority interest, 10%	<u>90,000</u>
	Total	<u>\$900,000</u>
[f]	To eliminate intercompany dividend receivable and payable	
	90% of \$1,000	<u>\$900</u>
[g]	To eliminate intercompany accrued interest	
	\$100,000 @ 10% × ½ year	<u>\$5,000</u>
[h]	To eliminate intercompany loan	<u>\$100,000</u>
[i]	To eliminate intercompany profit in Sy Corp.'s 12/31 inventory	
	Sales from Pym Corp. to Sy Corp.	<u>\$300,000</u>
	5% remaining in Sy Corp.'s 12/31 inventory	<u>15,000</u>
	Multiply by 20% (60,000/300,000)	<u>\$ 3,000</u>
[j]	To eliminate intercompany trade accounts receivable and payable	<u>\$90,000</u>

ANSWERS TO EXAMINATION

AUDITING

November 5, 1987; 8:30 A.M. to 12:00 M.

Answer 1 (60 points)

- | | | | | | |
|-------|-------|-------|-------|-------|-------|
| 1. a | 11. d | 21. d | 31. a | 41. b | 51. c |
| 2. b | 12. b | 22. c | 32. a | 42. d | 52. b |
| 3. a | 13. b | 23. d | 33. c | 43. c | 53. d |
| 4. d | 14. a | 24. d | 34. b | 44. d | 54. b |
| 5. d | 15. c | 25. c | 35. b | 45. a | 55. a |
| 6. c | 16. b | 26. d | 36. d | 46. c | 56. b |
| 7. b | 17. c | 27. a | 37. d | 47. d | 57. a |
| 8. d | 18. b | 28. b | 38. d | 48. d | 58. d |
| 9. c | 19. a | 29. a | 39. b | 49. b | 59. d |
| 10. a | 20. c | 30. b | 40. c | 50. a | 60. c |

The scores for the multiple choice questions were determined in accordance with the following scales:

Correct	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Score	0	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24	25

Correct	21	22	23	24	25	26	27	28	29	30	31	32	33	34	35	36	37	38	39	40
Score	26	27	28	29	30	31	32	33	34	35	36	37	38	39	40	41	42	43	44	45

Correct	41	42	43	44	45	46	47	48	49	50	51	52	53	54	55	56	57	58	59	60	
Score	46	47	48	49	50	51	52	53	54	55	56	57	58	59	60	60	60	60	60	60	60

Answer 2 (10 points)

STAR MANUFACTURING, INC.
Purchases
Internal Accounting Control Questionnaire

<u>Question</u>	<u>Yes</u>	<u>No</u>
1. Are there written purchasing policies and procedures?		
2. Are purchase requisitions approved in accordance with management's authorization?		
3. Are purchases made from approved vendors?		
4. Are price quotations requested for purchases over an established amount?		
5. Are purchase commitments documented on written purchase order forms?		
6. Do purchase orders include adequate descriptions, terms, and instructions?		
7. Are purchase orders approved by authorized personnel before issuance?		
8. Are prenumbered purchase order forms periodically accounted for?		
9. Is a detailed listing of purchase orders maintained?		
10. Is the purchasing function independent of receiving, shipping, invoice processing, and treasury functions?		
11. Are there adequate safeguards over unissued purchase order forms?		
12. Are old items in the open purchase order file periodically investigated?		
13. Are vendors notified of conflict of interest policies?		

Answer 3 (10 points)

The auditor should

- Review answers to questions on confirmation requests to determine proper recognition in accounting records and the necessity for financial statement disclosure.
- Make inquiries as to compensating balances and restrictions.

- Obtain copies of the bank reconciliations as of the balance sheet date, and
 - Trace the adjusted book balances to the general ledger balances.
 - Compare the bank balances to the opening balances on the cut-off bank statements.
 - Compare the bank balances to the balances on the confirmations.
 - Trace amounts of deposits in transit to the cut-off bank statements and ascertain whether the time lags are reasonable.
 - Verify the clerical accuracy of the reconciliations.
 - Obtain explanation for unusual reconciling items, including checks drawn to "bearer," "cash," and related parties.
 - Trace checks dated prior to the end of the period that were returned with the cut-off statements to the list of outstanding checks.
 - Investigate outstanding checks that did not clear with the cut-off bank statements.
 - Examine a sample of checks for payee, amount, date, authorized signatures, and endorsements to determine any irregularities from company policy or accounting records.

- Prepare a bank transfer schedule from a review of the cash receipts and disbursements journals, bank statements, and related paid checks for the last few days before and the first few days after the year-end, and
 - Review the schedule to determine that the deposit and disbursement of each transfer is recorded in the proper period.
 - Trace incomplete transfers to the schedule of outstanding checks and deposits in transit.

Answer 4 (10 points)

The potential benefits to an auditor of using micro-computer software in an audit as compared to performing an audit without the use of a computer include the following:

1. Time may be saved by eliminating manual footing, cross-footing, and other routine calculations.
2. Calculations, comparisons, and other data manipulations are more accurately performed.
3. Analytical review calculations may be more efficiently performed.
4. The scope of analytical review procedures may be broadened.
5. Audit sampling may be facilitated.
6. Potential weaknesses in a client's internal accounting control system may be more readily identified.
7. Preparation and revision of flowcharts depicting the flow of financial transactions in a client's system may be facilitated.
8. Working papers may be easily stored and accessed.
9. Graphics capabilities may allow the auditor to generate, display, and evaluate various financial and nonfinancial relationships graphically.
10. Engagement-management information such as time budgets and the monitoring of actual time vs. budgeted amounts may be more easily generated and analyzed.
11. Customized working papers may be developed with greater ease.
12. Standardized audit correspondence such as engagement letters, client representation letters, and attorney letters may be stored and easily modified.
13. Supervisory-review time may be reduced.
14. Staff morale and productivity may be improved by reducing the time spent on clerical tasks.
15. Client's personnel may not need to manually prepare as many schedules and otherwise spend as much time assisting the auditor.
16. Computer-generated working papers are generally more legible and consistent.

Answer 5 (10 points)

<i>Circumstances</i>	<i>Type of Opinion</i>	<i>Report Modification</i>
2. The scope of the auditor's examination is affected by conditions that preclude the application of a necessary auditing procedure.	2. The auditor should express an "except for" qualified opinion or a disclaimer of opinion.	2. The auditor should indicate the scope limitation in the scope paragraph, give the substantive reasons for the limitation in an explanatory paragraph, and modify the opinion paragraph.
3. The auditor decides to make reference to the report of another auditor as a basis, in part, for expressing an opinion.	3. The auditor should express an unqualified opinion.	3. The auditor should disclose this division of responsibility in the scope paragraph and refer to the other auditor's report in the opinion paragraph.
4. The financial statements are affected by an alternative accounting treatment that is a departure from an accounting principle promulgated by the body designated by AICPA Council to establish such principles. The use of the promulgated principle would cause the financial statements to be misleading.	4. The auditor should express an unqualified opinion.	4. The auditor should give all of the substantive reasons why unusual circumstances justify the use of an alternative accounting treatment in an explanatory paragraph.
5. The generally accepted accounting principles have not been applied consistently.	5. The auditor should express an "except for" qualified opinion as to consistency.	5. The auditor should explicitly express concurrence by using the expression "with which we concur" in the opinion paragraph.
6. Uncertainties not susceptible of reasonable estimation affect the financial statements.	6. The auditor should express a "subject to" qualified opinion or a disclaimer of opinion.	6. The auditor should describe the uncertainty in an explanatory paragraph and modify the opinion paragraph.
7. The auditor wishes to emphasize a matter that is properly accounted for and adequately disclosed in the financial statements.	7. The auditor should express an unqualified opinion.	7. The auditor should describe the matter in an explanatory paragraph.

ANSWERS TO EXAMINATION

BUSINESS LAW

(Commercial Law)

November 6, 1987; 8:30 A.M. to 12:00 M.

Answer 1 (60 points)

- | | | | | | |
|-------|-------|-------|-------|-------|-------|
| 1. d | 11. b | 21. b | 31. d | 41. c | 51. d |
| 2. d | 12. b | 22. c | 32. a | 42. d | 52. c |
| 3. c | 13. a | 23. b | 33. b | 43. c | 53. b |
| 4. a | 14. a | 24. b | 34. b | 44. b | 54. b |
| 5. a | 15. c | 25. a | 35. c | 45. c | 55. b |
| 6. a | 16. d | 26. d | 36. a | 46. c | 56. c |
| 7. c | 17. d | 27. d | 37. a | 47. c | 57. a |
| 8. c | 18. c | 28. c | 38. a | 48. b | 58. d |
| 9. d | 19. b | 29. d | 39. b | 49. c | 59. d |
| 10. c | 20. b | 30. b | 40. d | 50. c | 60. d |

The scores for the multiple choice questions were determined in accordance with the following scales:

Correct	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Score	0	9	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24	25	26	27	28

Correct	21	22	23	24	25	26	27	28	29	30	31	32	33	34	35	36	37	38	39	40
Score	29	30	31	32	33	34	35	36	37	38	39	40	41	42	43	44	45	46	47	48

Correct	41	42	43	44	45	46	47	48	49	50	51	52	53	54	55	56	57	58	59	60
Score	49	50	51	52	53	54	55	56	57	58	59	60	60	60	60	60	60	60	60	60

Answer 2 (10 points)

Magic's first assertion, that the original contract between Starr and itself is not enforceable because of the statute of frauds, is incorrect. The sale of computer equipment is a transaction in goods and thus is governed by the UCC Sales Article. This Article provides that a contract for the sale of goods for the price of \$500 or more is not enforceable unless there is some writing sufficient to indicate that a contract for sale has been made between the parties which is signed by the party against whom enforcement is sought. Since the sales price is \$18,000, the statute of frauds applies. Magic's execution of the written contract will satisfy the statute of frauds since Magic is the party against whom enforcement of the contract is being sought.

Magic's second assertion, that the oral agreement to change the price of the equipment is not enforceable because the agreement lacked consideration and failed to satisfy the statute of frauds, is incorrect. Under the UCC Sales Article, an agreement to modify a contract for the sale of goods needs no consideration to be binding. However, the modification must meet the test of good faith, which is defined under the UCC as "honesty in fact in the conduct or transaction concerned and the observance of reasonable commercial standards of fair dealing in the trade." Based upon the facts, it appears that a shift in the market that will result in Starr bearing a loss on the sale to Magic will satisfy the requirement of good faith. In addition, the agreement modifying the sales price must meet the requirements of the statute of frauds if the contract, as modified, is within its provisions. Under the facts, the contract as modified by Magic and Starr, falls within the provisions of the statute of frauds and thus the statute of frauds must be satisfied. Magic's oral agreement to the modification is not sufficient to satisfy the statute of frauds. However, the statute of frauds will be satisfied if: both parties are merchants; a writing in confirmation of the agreement which is sufficient against the sender is received; the recipient receives the writing within a reasonable time; the recipient has reason to know the contents of the writing; and, the recipient fails to give written notice of objection to the contents of the writing within ten days after it is received. As the facts clearly indicate, the mailing of the signed letter by Starr to Magic on May 17 satisfied the aforementioned requirements and thus the modification agreement is enforceable.

Magic's third assertion that Starr is not entitled to recover the full sales price for the equipment is incorrect. The UCC provides that a seller may recover the price of goods identified to a contract and in the possession of the seller if the seller is unable after reasonable effort to resell them at a reasonable price or the circumstances reasonably indicate that such effort will be unavailing. Under the facts of the case at hand, Starr is entitled to recover the full sales price of \$20,000 because the equipment could not be resold for any price.

Answer 3 (10 points)

a. Yes. The requirements necessary for the filing of a valid petition in bankruptcy have been met. An involuntary case may be commenced against a person by the filing of a petition where the aggregate amount of unsecured claims is at least \$5,000 and a sufficient number of creditors join in the filing of the petition. Where there are fewer than 12 creditors only one creditor need file the petition. Under the facts, the petition was validly filed against Mix because Able's unsecured claim was more than \$5,000 and because there were fewer than 12 creditors.

b. Lang's action as trustee to appoint Ring as the accountant for the bankruptcy estate was proper if such action was with the bankruptcy court's approval. The trustee, with the court's approval, may engage professional persons such as accountants on any reasonable terms and conditions.

Lang's inclusion of the inheritance in the property of the estate was also correct because property of the estate includes property that the debtor acquires or becomes entitled to acquire by inheritance within 180 days after the filing of the petition. By acquiring the right to inherit the property on December 15, 1986, which was less than 180 days after the filing of the petition on July 1, 1986, Mix's inheritance was properly included in the bankruptcy estate. Thus, Mix's receipt of the inheritance more than 180 days after the filing of the petition does not prevent the inclusion of the inheritance in the property of the estate.

c. The \$60,000 will be distributed to satisfy the claims and expenses of the bankruptcy estate in the following order of priority:

1. Carr's claim to the extent of the sale proceeds of the machinery in which Carr had a valid perfected security interest in bankruptcy. \$20,000
2. Administrative expenses including the expenses to maintain and sell the unsecured property of the estate (\$1,000) and Ring's fee for services rendered (\$3,000). 4,000
3. Unsecured claim for federal income taxes. 6,000

4. The unsecured claims of Able and Baker and the balance of Carr's claim, which have equal priority, will be paid proportionately as follows:

	<u>\$ 20,000</u>				
Able	—	$\frac{\$ 20,000}{\$ 120,000}$	×	\$30,000	5,000
		<u>\$ 40,000</u>			
Baker	—	$\frac{\$ 40,000}{\$ 120,000}$	×	\$30,000	10,000
		<u>\$ 60,000</u>			
Carr	—	$\frac{\$ 60,000}{\$ 120,000}$	×	\$30,000	<u>15,000</u>

Total distributions	<u><u>\$60,000</u></u>
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Answer 4 (10 points)

Stieb's first assertion, that Bold could not validly accept his offer dated April 5 because \$100 was inadequate consideration to hold the offer open, is incorrect. In general, the courts will not question the adequacy of consideration if the consideration has legal sufficiency and there is a bargained-for exchange. Adequacy of consideration has nothing to do with legal sufficiency. Thus the subject matter that the parties have exchanged need not have approximately the same value. Based upon the facts, Bold's payment of the \$100 in exchange for Stieb's promise to keep the offer open was both legally sufficient and bargained for.

Stieb's second assertion, that his offer dated April 5 had terminated since he had revoked his offer prior to Bold's acceptance, is incorrect. An offer may be terminated by the offeror if a revocation is communicated to the offeree before the offeree accepts. In the majority of states revocation is effective upon receipt of the revocation by the offeree or the offeree's agent. On the other hand, acceptance will generally take effect at the time the acceptance is sent (dispatched) by an authorized means of communication. Bold used an authorized means of communication, i.e., the mail, which was the same method used by Stieb in making the offer. Therefore, Bold's acceptance and payment of \$100 on April 18 was effective on that date and formed an option contract. Thus, Stieb's letter of revocation mailed on April 17 was not effective until Bold received the revocation on April 19 by which time an option contract had already been formed and the offer could not be revoked.

Stieb's third assertion, that even if his revocation was not effective, Bold's letter of May 15 was a counteroffer, which automatically terminated Bold's right to accept Stieb's offer of April 1, is incorrect. In general, the power of acceptance under an option contract is not terminated by a rejection or counteroffer made by the offeree, unless the requirements are met for the discharge of a contractual duty or the offeror changes its position to its detriment in reliance on such rejection or counteroffer. Although a rejection and/or counteroffer will terminate an offer when communicated, Bold's letter of May 15 will not terminate its right to exercise its option on the land because there was neither a discharge of a contractual duty nor reliance by Stieb to its detriment on the May 15 letter.

Answer 5 (10 points)

a. The initial capitalization of Creme in 1980 would result in \$20,000 being allocated to stated capital. Stated capital includes the par value of all shares of the corporation having a par value that have been issued. Therefore, the \$20,000 is calculated as follows: 40,000 shares issued \times 50¢ par value = \$20,000.

The \$15,000 of expenses incurred in organizing Creme would not affect stated capital. The Model Business Corporation Act permits payment of organization expenses out of the consideration received by it in payment for its shares if the payment does not render such shares assessable or unpaid. Thus, stated capital remains at \$20,000.

The 5% stock dividend would increase stated capital by \$1,000 calculated as follows: 40,000 shares \times 5% stock dividend = 2,000 shares \times 50¢ par value = \$1,000. The market price of the shares would have no effect on stated capital. Thus, stated capital is \$21,000.

The exercise of the stock option by Creme's president would increase stated capital by \$500 calculated as follows: 1,000 shares \times 50¢ par value = \$500. Neither the price paid by Creme's president nor the market price of the shares on the date the option was exercised would affect stated capital. Thus, stated capital is \$21,500.

The 2-for-1 stock split would not affect stated capital. Instead the par value of 50¢ per share would be reduced to 25¢ per share and the 43,000 shares of stock issued would be increased to 86,000 shares. Thus, stated capital remains at \$21,500.

The acquisition of 5,000 shares as treasury stock at \$30 per share by Creme would have no effect on stated capital under the cost method. Thus, stated capital remains at \$21,500.

The reissuance of the 3,000 shares of treasury stock at \$32 per share would also have no effect on stated capital under the cost method. Thus, stated capital remains at \$21,500.

b. Cash dividends may be declared and paid if the corporation is solvent and payment of the dividends would not render the corporation insolvent. Furthermore, each state imposes additional restrictions on what funds are legally available to pay dividends. One of the more restrictive tests adopted by many states permits the payment of dividends only out of unrestricted and unreserved earned surplus (retained earnings). The Model Business Corporation Act prohibits dividend distributions if, after giving effect to the distribution, the corporation's total assets would be less than its total liabilities.

ANSWERS TO EXAMINATION

ACCOUNTING THEORY

(Theory of Accounts)

November 6, 1987; 1:30 P.M. to 5:00 P.M.

Answer 1 (60 points)

- | | | | | | |
|-------|-------|-------|-------|-------|-------|
| 1. a | 11. c | 21. d | 31. c | 41. d | 51. c |
| 2. c | 12. b | 22. b | 32. c | 42. d | 52. b |
| 3. c | 13. b | 23. c | 33. a | 43. d | 53. d |
| 4. b | 14. c | 24. b | 34. d | 44. c | 54. b |
| 5. b | 15. b | 25. a | 35. b | 45. c | 55. a |
| 6. b | 16. d | 26. a | 36. a | 46. d | 56. d |
| 7. c | 17. b | 27. b | 37. d | 47. a | 57. a |
| 8. c | 18. d | 28. d | 38. d | 48. b | 58. d |
| 9. b | 19. a | 29. a | 39. c | 49. d | 59. b |
| 10. d | 20. a | 30. c | 40. c | 50. b | 60. a |

The scores for the multiple choice questions were determined in accordance with the following scales:

Correct	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Score	0	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24	25	26	27

Correct	21	22	23	24	25	26	27	28	29	30	31	32	33	34	35	36	37	38	39	40
Score	28	29	30	31	32	33	34	35	36	37	38	39	40	41	42	43	44	45	46	47

Correct	41	42	43	44	45	46	47	48	49	50	51	52	53	54	55	56	57	58	59	60
Score	48	49	50	51	52	53	54	55	56	57	58	59	60	60	60	60	60	60	60	60

Answer 2 (10 points)

a. Tidal should account for the assignment of trade accounts receivable by debiting trade accounts receivable assigned and crediting trade accounts receivable for the amount of trade accounts receivable assigned. Tidal should account for the note payable to Herb Finance by debiting cash for 70 percent, debiting finance fee expense for 5 percent, and crediting notes payable for 75 percent of the trade accounts receivable assigned.

Tidal should account for the subsequent collections on the trade accounts receivable assigned by debiting cash and crediting trade accounts receivable assigned. Tidal should account for the write off as uncollectible of some specific accounts of the assigned receivables by debiting allowance for doubtful accounts and crediting trade accounts receivable assigned.

Tidal should account for the total payment to Herb Finance by debiting interest expense and notes payable, and crediting cash. The amount of the cash payment consists of both principal (the amount of the note payable) and interest computed at a rate of 12 percent on the balance outstanding.

b. 1. Tidal should determine the amount of the discount for the note receivable as follows:

- Determine the maturity value of the note receivable (the face value of the note receivable plus the 15 percent interest to be earned over the 90-day life of the note receivable).
- Multiply the maturity value of the note receivable by one-sixth (the 60-day life of the discounted note receivable) of the 18 percent discount rate to arrive at the amount of the discount.

2. The discounting transaction should be accounted for by debiting cash and crediting notes receivable discounted. Cash would be debited for the amount received from the bank, and notes receivable discounted, a contra-asset account, generally would be credited for the face value of the note receivable. Also, interest expense should be debited for the difference between the amount received from the bank and the face value of the note receivable at the date of discounting plus interest income earned to the date of discounting and interest revenue should be credited for the interest income earned to the date of discounting. The income and expense, however, are usually netted against each other instead of being recorded separately when the amounts involved are immaterial.

Answer 3 (10 points)

a. 1. Houston should report the cash dividends received during the year as dividend revenue in the income statement.

2. The realized gain or loss on the securities sold during the year should be reported as a part of net income for the current year. The reported realized gains or losses should be measured as the difference(s) between the selling price and the cost of the securities sold.

b. Houston should report the portfolio as a current asset in its balance sheet. The portfolio should be presented at the lower of cost or market. Applying this rule, Houston should report the portfolio at market through the use of a valuation account. The amount by which the aggregate cost of the portfolio exceeded market value at the end of the year should be reported as an unrealized loss in its income statement.

Reporting the portfolio at market value reflects the realizable value of the portfolio at the end of the period. The estimated loss is reported (matched) in the income statement in the period in which the decline in realizable value occurred. Recognition of the lower market value and the anticipated loss is consistent with conservatism.

c. Houston should use the equity method of accounting for its forty percent investment in the outstanding voting stock of Joy. The equity method is appropriate when the company has the ability to exercise significant influence. Houston is presumed to be able to exercise significant influence over Joy because of the size of its investment and the wide dispersion of the remaining shares among unrelated investors.

Answer 4 (10 points)

a. Spackenkill should report the potential costs due to the discovery of a safety hazard as an expense or loss in the income statement and as a liability in the balance sheet because both of the following conditions for accrual are met:

- It is considered probable that a liability has been incurred.
- The amount of loss can be reasonably estimated.

In addition, Spackenkill should disclose the nature of the costs due to the discovery of a safety hazard in the notes to the financial statements.

b. Spackenkill should disclose the nature of the potential costs of warranty costs in the notes to the financial statements. The disclosure should include a statement that an estimate of the possible loss or range of loss cannot be made.

Spackenkill should not report the warranty costs as an expense in the income statement nor as a liability in the balance sheet. Although the warranty costs are probable, they cannot be reasonably estimated.

c. Spackenkill should disclose the nature of the potential costs due to the discovery of a possible product defect in the notes to the financial statements. The disclosure should include an estimate of the possible loss or range of loss.

Spackenkill should not report the costs due to the discovery of a possible product defect as an expense or loss in the income statement nor as a liability in the balance sheet. Although the costs due to the discovery of a possible product defect can be reasonably estimated, they are not probable.

Answer 5 (10 points)

a. 1. The 11% bonds were issued at a premium (more than face value). Although the bonds provide for the payment of interest of 11% of face value, this rate was more than the prevailing or market rate for bonds of similar quality at the time the bonds were issued. Thus, the bonds must sell at a premium to yield 9%.

2. The amount of interest expense would be higher in the first year of the life of the bond issue than in the second year of the life of the bond issue. According to the effective interest method of amortization, the 9% effective interest rate is applied to a declining bond carrying amount, and results in a lower interest expense in each successive year.

b. 1. Gain or loss on early extinguishment of debt should be determined by comparing the net carrying amount of the bonds at the date of extinguishment with the reacquisition price. If the net carrying amount exceeds the reacquisition price, a gain results. If the net carrying amount is less than the reacquisition price, a loss results.

In this case, a gain results. The bonds were issued at a premium, therefore, the carrying amount of the bonds at the date of extinguishment must exceed face value. Thus, the net carrying amount exceeds the reacquisition price.

2. Brewster should report the gain on the early extinguishment in net income for 1986, as an extraordinary item, net of related income tax effect.

c. 1. Net income is not affected by conversion under the book value method. The book value method views the convertible bonds as possessing substantial characteristics of equity capital. The conversion represents the completion of a prior transaction (the issuance of the convertible debt), not the culmination of an earning process.

2. A gain or loss results, and thus net income is affected by conversion under the market value method when market value differs from the carrying amount of the convertible bonds. The market value method views the convertible bonds primarily as debt whose conversion was a significant economic transaction. The conversion represents the culmination of an earning process. The market value method views the market value of the common stock at the date of the conversion to be the proper measurement at which to carry the common stock.

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November 1987

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INDEX — QUESTIONS

HOW TO USE THIS INDEX: This index presents examination question number references for the four sections of the CPA examination — Accounting Practice Parts I and II, Auditing, Business Law, and Accounting Theory. Each examination section has been organized according to its content specification outline, with questions indexed according to the areas and groups tested.

The question references listed in the right hand column are designated as follows: The question numbers are followed by the page number in this book. The letter M following question numbers indicates a multiple choice item. For example, the reference 17M means multiple choice item number 17 on page 4; the reference 5-14 means essay or problem number 5 on page 14. Note that, in the Accounting Practice section, no distinction has been made between parts I and II.

Accounting Practice — Content Specification Outline

- I. Presentation of Financial Statements or Worksheets.
 - A. Balance Sheet
 - B. Income Statement
 - C. Statement of Changes in Financial Position4-11
 - D. Statement of Owners'
 - E. Consolidated Financial Statements or Worksheets5-23

- II. Measurement, Valuation, Realization, and Presentation of Assets in Conformity With Generally Accepted Accounting Principles.
 - A. Cash, Marketable Securities, and Investments1M-2,2M-2,3M-2,6M-3,4-11
 - B. Receivables and Accruals4M-2,7M-3
 - C. Inventories5M-2,9M-3
 - D. Property, Plant, and Equipment Owned or Leased5-13
 - E. Intangibles and Other Assets10M-3,11M-3

- III. Valuation, Recognition, and Presentation of Liabilities in Conformity With Generally Accepted Accounting Principles.
 - A. Payables and Accruals8M-3,12M-3,13M-4,16M-4,17M-4
 - B. Deferred Revenues14M-4,15M-4,18M-4,19M-5
 - C. Deferred Income Tax Liabilities20M-5,22M-5
 - D. Capitalized Lease Liability23M-5,24M-5
 - E. Bonds Payable25M-5,26M-6,27M-6,28M-6,29M-6
 - F. Contingent Liabilities and Commitments31M-6,35M-7

- IV. Ownership Structure, Presentation, and Valuation of Equity Accounts in Conformity With Generally Accepted Accounting Principles.
 - A. Preferred and Common Stock
 - B. Additional Paid-in Capital
 - C. Retained Earnings and Dividends34M-7
 - D. Treasury Stock and Other Contra Accounts
 - E. Stock Options, Warrants, and Rights40M-7
 - F. Reorganization and Change in Entity
 - G. Partnerships4-11

Index

Accounting Practice — Content Specification Outline (cont.)

V. Measurement and Presentation of Income and Expense Items, Their Relationship to Matching and Periodicity, and Their Relationship to Generally Accepted Accounting Principles.

- A. Revenues and Gains21M-5,30M-6,32M-6,33M-6,36M-7,37M-7,38M-7,39M-7,4-11,5-13
- B. Expenses and Losses42M-8,43M-8,44M-8,45M-8,46M-8,47M-8,5-13
- C. Provision for Income Tax49M-9,50M-9
- D. Recurring Versus Nonrecurring Transactions and Events41M-7
- E. Accounting Changes51M-9
- F. Earnings Per Share48M-8,52M-9

VI. Other Financial Topics.

- A. Disclosures in Notes to the Financial Statements
- B. Accounting Policies
- C. Nonmonetary Transactions5-13
- D. Interim Financial Statements53M-9
- E. Historical Cost, Constant Dollar Accounting, and Current Cost54M-9,55M-9
- F. Gain Contingencies
- G. Segments and Lines of Business59M-10
- H. Employee Benefits56M-10,57M-10
- I. Analysis of Financial Statements58M-10,60M-10
- J. Development Stage Enterprises
- K. Personal Financial Statements
- L. Combined Financial Statements

VII. Cost Accumulation, Planning, and Control.

- A. Nature of Cost Elements
- B. Process and Job Order Costing4-22
- C. Standard Costing4-22
- D. Joint and By-Product Costing, Spoilage, Waste, and Scrap
- E. Absorption and Variable Costing
- F. Budgeting and Flexible Budgeting
- G. Breakeven and Cost-Volume-Profit Analysis
- H. Capital Budgeting Techniques
- I. Performance Analysis
- J. Other4-22

Index

Accounting Practice — Content Specification Outline (cont.)

VIII. Not-for-Profit and Governmental Accounting.

- A. Fund Accounting
- B. Types of Funds and Fund Accounts47M-20,48M-20,52M-21,53M-21,54M-21,55M-21,
56M-21,58M-21
- C. Presentation of Financial Statements for Various
Not-for-Profit and Governmental Organizations
- D. Various Types of Not-for-Profit and
Governmental Organizations41M-19,42M-20,43M-20,44M-20,45M-20,46M-20,
49M-20,50M-21,51M-21,57M-22,58M-22,60M-22

IX. Federal Taxation — Individuals, Estates, and Trusts.

- A. Inclusions for Gross Income and Adjusted Gross
Income1M-15,2M-15,3M-15,4M-15,6M-15,7M-16,8M-16,
9M-16,10M-16
- B. Exclusions and Adjustments to Arrive at Adjusted
Gross Income5M-15
- C. Gain or Loss on Property Transactions18M-17,19M-17,20M-17
- D. Deductions from Adjusted Gross Income
- E. Filing Status and Exemptions17M-17
- F. Tax Computations and Credits
- G. Statute of Limitations15M-16,16M-17
- H. Estate and Gift Taxation and Income Taxation of
Estates and Trusts11M-16,12M-16,13M-16,14M-16

**X. Federal Taxation — Corporations, Partnerships, and
Exempt Organizations.**

- A. Determination of Taxable Income or Loss21M-17,22M-18,23M-18,24M-18,25M-18,26M-18,
28M-18,29M-18
- B. Tax Computations and Credits30M-18
- C. S Corporations27M-18
- D. Personal Holding Companies34M-19
- E. Accumulated Earnings Tax35M-19
- F. Distributions
- G. Tax-Free Incorporation
- H. Reorganizations36M-19
- I. Liquidations and Dissolutions
- J. Formation of Partnership
- K. Basis of Partner's Interest
- L. Determination of Partner's Taxable Income and
Partner's Elections
- M. Accounting Periods of Partnership and Partners
- N. Partner Dealing With Own Partnership48M-19
- O. Treatment of Liabilities
- P. Distribution of Partnership Assets38M-19,39M-19
- Q. Termination of Partnership37M-19
- R. Types of Organizations33M-19
- S. Requirements for Exemption32M-19
- T. Unrelated Business Income31M-18

Index

Auditing — Content Specification Outline

I. Professional Responsibilities.

- A. General Standards and Rules of Conduct17M-28,18M-28,19M-28,21M-28,22M-28
- B. Control of the Audit20M-28,23M-28,26M-29,27M-29,49M-31
- C. Other Responsibilities10M-27,24M-28,25M-28,28M-29,29M-29

II. Internal Control.

- A. Definitions and Basic Concepts42M-30,43M-30
- B. Study and Evaluation of the System39M-30,44M-30,45M-31,46M-31,2-32
- C. Cycles47M-31,48M-31,50M-31,53M-32,54M-32,55M-32,
56M-32
- D. Other Considerations14M-27,16M-28,51M-31,52M-31,57M-32,58M-32,
59M-32

III. Evidence and Procedures.

- A. Audit Evidence32M-29,33M-29,34M-29,35M-29,36M-29
- B. Specific Audit Objectives and Procedures31M-29,37M-30,3-32
- C. Other Specific Audit Topics6M-26,38M-30,4-33
- D. Review and Compilation Procedures41M-30

IV. Reporting.

- A. Reporting Standards and Types of Reports1M-26,2M-26,3M-26,4M-26,5M-26,7M-27,8M-27,
9M-27,11M-27,12M-27,13M-27,40M-30,5-33
- B. Other Reporting Considerations15M-27,30M-29,60M-32

Index

Business Law — Content Specification Outline

- I. The CPA and the Law.
 - A. Common Law Liability to Clients and Third Persons26M-38,27M-38,28M-38,29M-38,30M-38
 - B. Federal Statutory Liability31M-38,32M-38,33M-39,34M-39
 - C. Workpapers, Privileged Communication, and Confidentiality.....35M-39

- II. Business Organizations.
 - A. Agency23M-37,24M-37,25M-38
 - B. Partnerships and Joint Ventures19M-37,20M-37,21M-37,22M-37
 - C. Corporations5-44
 - D. Estates and Trusts16M-36,17M-37,18M-37

- III. Contracts.
 - A. Offer and Acceptance4-43
 - B. Consideration2M-35
 - C. Capacity, Legality, and Public Policy3M-35
 - D. Statute of Frauds
 - E. Statute of Limitations
 - F. Fraud, Duress, and Undue Influence4M-35
 - G. Mistake and Misrepresentation5M-35
 - H. Parol Evidence Rule
 - I. Third Party Rights
 - J. Assignments
 - K. Discharge, Breach, and Remedies1M-35

- IV. Debtor-Creditor Relationships.
 - A. Suretyship
 - B. Bankruptcy3-43

- V. Government Regulation of Business.
 - A. Regulation of Employment13M-36,14M-36,15M-36
 - B. Federal Securities Acts6M-35,7M-36,8M-36,9M-36,10M-36,11M-36,12M-36

- VI. Uniform Commercial Code.
 - A. Commercial Paper45M-40,46M-40,47M-40,48M-40,49M-41,50M-41
 - B. Documents of Title and Investment Securities36M-39
 - C. Sales37M-39,38M-39,39M-39,40M-39,2-42
 - D. Secured Transactions41M-39,42M-40,43M-40,44M-40

- VII. Property.
 - A. Real and Personal Property53M-41,54M-41,55M-41,56M-41,57M-42
 - B. Mortgages51M-41,52M-41
 - C. Fire and Casualty Insurance58M-42,59M-42,60M-42

Accounting Theory — Content Specification Outline

- I. **General Concepts, Principles, Terminology, Environment, and Other Professional Standards.**
 - A. Authority of Pronouncements
 - B. Conceptual Framework8M-46
 - C. Basic Concepts and Accounting Principles2-51,3-52,4-52,5-52
 - D. Nature and Purpose of Basic Financial Statements2-51,3-52,4-52,5-52
 - E. Consolidated Financial Statements
 - F. Historical Cost, Constant Dollar, Current Cost, and Other Accounting Concepts

- II. **Measurement, Valuation, Realization, and Presentation of Assets in Conformity With GAAP.**
 - A. Cash, Marketable Securities, and Investments3-52
 - B. Receivables and Accruals2-51
 - C. Inventories1M-46,2M-46,3M-46
 - D. Property, Plant, and Equipment Owned or Leased4M-46,5M-46,6M-46,7M-46
 - E. Intangibles and Other Assets9M-47

- III. **Valuation, Recognition, and Presentation of Liabilities in Conformity With GAAP.**
 - A. Payables and Accruals2-51
 - B. Deferred Revenues10M-47
 - C. Deferred Income Tax Liabilities
 - D. Capitalized Lease Liability11M-47
 - E. Bonds Payable5-52
 - F. Contingent Liabilities and Commitments4-52

- IV. **Ownership Structure, Presentation, and Valuation of Equity Accounts in Conformity With GAAP.**
 - A. Preferred and Common Stock
 - B. Additional Paid-in Capital
 - C. Retained Earnings and Dividends14M-47,15M-47
 - D. Treasury Stock and Other Contra Accounts12M-47
 - E. Stock Options, Warrants, and Rights19M-48
 - F. Reorganization and Change in Entity
 - G. Partnerships13M-47

Index

Accounting Theory — Content Specification Outline (cont.)

- V. Measurement and Presentation of Income and Expense Items, Their Relationship to Matching and Periodicity, and Their Relationship to GAAP.
 - A. Revenues and Gains16M-47,17M-47,18M-47,2-51,3-52,5-52
 - B. Expenses and Losses20M-48,21M-48,2-51,3-52,4-52,5-52
 - C. Provision for Income Tax22M-48
 - D. Recurring Versus Nonrecurring Transactions24M-48,5-52
 - E. Accounting Changes23M-48
 - F. Earnings Per Share33M-49

- VI. Other Financial Topics.
 - A. Statement of Changes in Financial Position34M-49,35M-49
 - B. Accounting Policies25M-48
 - C. Accounting Changes26M-48
 - D. Nonmonetary Transactions27M-48
 - E. Business Combinations28M-48,29M-49
 - F. Interim Financial Statements30M-49
 - G. Gain Contingencies31M-49
 - H. Segments and Lines of Business32M-49
 - I. Employee Benefits36M-49,37M-49
 - J. Analysis of Financial Statements38M-49
 - K. Development Stage Enterprises
 - L. Personal Financial Statements39M-49
 - M. Combined Financial Statements40M-50

- VII. Cost Accumulation, Planning, and Control.
 - A. Nature of Cost Elements45M-50
 - B. Process and Job Order Costing41M-50
 - C. Standard Costing42M-50
 - D. Joint and By-Product Costing, Spoilage, Waste, and Scrap43M-50
 - E. Absorption and Variable Costing46M-50
 - F. Budgeting and Flexible Budgeting47M-50
 - G. Breakeven and Cost-Volume-Profit Analysis48M-50
 - H. Capital Budgeting Techniques49M-50
 - I. Performance Analysis44M-50
 - J. Other50M-50

- VIII. Not-for-Profit and Governmental Accounting.
 - A. Conceptual Framework51M-51
 - B. Fund Accounting52M-51,53M-51
 - C. Types of Funds and Fund Accounts54M-51,55M-51,56M-51,57M-51
 - D. Presentation of Financial Statements for Various Not-for-Profit and Governmental Organizations58M-51
 - E. Various Types of Not-for-Profit and Governmental Organizations59M-51,60M-51

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