1945

Unofficial answers to the examination questions, May 1942 to November 1944 inclusive

H. P. Baumann

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UNOFFICIAL ANSWERS

.....TO THE UNIFORM CERTIFIED PUBLIC ACCOUNTANTS EXAMINATION OF THE AMERICAN INSTITUTE OF ACCOUNTANTS

MAY 1942 TO NOVEMBER 1944

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By

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INTRODUCTORY NOTE

The problems and questions prepared by the American Institute of Accountants and adopted by state boards of accountancy in examinations for the certified public accountant certificate are periodically published in book form. Unofficial answers to these questions, based on material appearing in *The Journal of Accountancy,* have been concurrently published in separate volumes. The first book of answers covered the period May 1927-November 1931, followed by books containing the answers for the periods: May 1932-November 1935; May 1936-November 1938; May 1939-November 1941. These books have been used in accounting courses in schools throughout the country, and have proved valuable to candidates for the CPA certificate.

Responding to a continuing demand, we now present another book of answers which have appeared in *The Journal of Accountancy,* covering the period May 1942-November 1944. The problems and questions of this period appear in a separate volume which is being published simultaneously. It cannot be too strongly emphasized that these answers are not in any sense official. They represent merely the opinions of the two individuals who have prepared them for publication.

JOHN L. CAREY, *Secretary*

March 1945.

Answers to Examinations of May 1942

Auditing

May 14, 1942, 9 a.m. to 12:30 p.m.

No. 1.

The purposes of the examination of the accounts-payable vouchers and entries therefor in the voucher register are to verify that the creditor's claim is valid and correct in amount and that it has been recorded properly in the accounts of the client.

No. 2.

The answer to this question is quoted from the last paragraph on page 6 of "Statements on Accounting Procedure No. 1," issued in October, 1939, by the committee on auditing procedure of the American Institute of Accountants:

"In cases where the concern maintains well kept and controlled perpetual-inventory records supported by (1) a complete physical inventory at a date not coincident with the balance-sheet date, or (2) physical inventories of individual items taken from time to time so that the quantity of each item on hand is compared with the inventory record for that item at least once in each year, it will be satisfactory to undertake the procedure outlined at any interim date or dates selected by the auditor, his purpose being to satisfy himself as to the credibility of the perpetual-inventory records and whether they may be relied upon to support the inventory totals as shown on the balance-sheet."

No. 3.

(a) If the client keeps copies of the deposit slips, those covering the deposits for a week or ten days prior to and subsequent to the balance-sheet date should be verified by the bank. Otherwise, copies of the deposit slips covering those periods should be obtained from the bank. The deposit slips should be compared with the individual items in the cash-receipts book, with particular attention being paid to the reconciliation of the deposited currency with the remaining accounts not verified individually.

The bank account should be reconciled for the first and last months of the period, and the recorded daily deposits should be traced to the bank statements for those two months.

(b) Procedures outlined in paragraph one under (a) should be followed.

A cash cut-off should be made as soon after the balance-sheet date as possible.

In addition, test circularizations of the accounts and notes receivable should be made. If such test circularization is made as of the balance-sheet date, the cash credits made to the tested accounts up to and including the cut-off date should be traced to the accounts.

No. 4.

The following procedure is suggested:

(1) Obtain a copy of the trust indenture and study those provisions covering the sinking fund to see that they are being met.

(2) Check the statements received from the sinking-fund trustee against the records to determine that the transactions have been correctly recorded. These statements should show the purchases and sales of securities, income and expenses arising from the operation of the fund, sinking-fund deposits to the fund, and any cancellation of bonds.

(3) Obtain directly from the trustee a confirmation of the cash and securities held by him at the balance-sheet date.

No. 5.

The following procedures are suggested in the first examination of the capital-stock accounts:

(1) Examine the charter of the company to determine the authorized number of shares, par value, if any, preferences of the different classes of stock, etc.

(2) Examine the minute book for authority to issue the stock and to ascertain the price, if it is to be sold for cash, or the property or services to be received, if issued for other than cash. Note also any authority to reacquire stock and the consideration to be paid therefor.

(3) Examine the capital-stock, cash, and property accounts to determine that the transactions have been properly recorded. The treasury-stock or reacquired-stock accounts should be examined also to determine their correctness.

(4) Survey the system of internal control over the issuance or transfer of the stock certificates.

(5) Check the entries in the shareholders' register with the stock-certificate books.

(6) Account for all certificates surrendered, see that they are properly endorsed, canceled, and attached to their stubs.

(7) Note if tax stamps are affixed to issues and transfers.
(8) List outstanding shares from the stubs of the stock-certificate books and compare the totals with the capital-stock accounts.
(9) Account for all issued and unissued certificate numbers.
(10) Inspect the treasury-stock certificates.
(11) Verify total amount of dividends paid with the stock outstanding and in the hands of the public.

For subsequent examinations, verification may be limited to an examination of the current minutes, transfers, and unissued certificates.

No. 6.

(a) Dividends in arrears on cumulative preferred stock:
  (1) As a footnote to the balance-sheet.
  (2) As a parenthetical note after the description of the particular class of stock outstanding.
  (3) As a reserve, if the directors have authorized an appropriation of surplus.

In all cases the date of the last dividend paid or declared should be stated.

(b) United States Treasury notes purchased for payment of federal income and excess-profits taxes.
  (1) As a current asset, if held as an investment.
  (2) As a deduction, in an amount equal to their tax-payment value at the balance-sheet date, from the accrued tax-liability account in the current liability section of the balance-sheet.

(c) Treasury stock purchased at a premium.
  (1) At cost, as a deduction from the total of capital stock and surplus.
  (2) At cost, as a deduction from earned surplus.
  (3) At par or stated value, as a deduction from capital stock issued, if the premium is charged to earned or paid-in surplus.

NOTE.—In all the above cases, the number of shares reacquired must be shown. It should also be noted that the statutes of the state of incorporation will govern the treatment.

(d) Treasury bonds in sinking fund purchased at a discount.
  (1) As a sinking-fund asset.
  (2) As a deduction from bonds outstanding.

NOTE.—The bonds may be carried at cost or at par. If at cost, the discount should be amortized over the life of the bond. If at par, the adjustment for discount should be made immediately.

No. 7.

(a) Cash receipts

(1) The mail should be opened by an employee not connected with either the cashier's or the accounts-receivable departments.

(2) All cash receipts should be listed before they are turned over to the cashier.

(3) All receipts should be deposited intact each day.

(4) The list prepared under (2) should be checked against the duplicate deposit slip. Under no circumstances should the checks or the currency be handled by anyone in the accounts-receivable department.

(b) Cash disbursements

(1) An imprest system should be used for the petty-cash fund.

(2) Upon reimbursement of this fund for payments made, the supporting vouchers should be canceled and filed where the petty cashier may not have access to them.

(3) The policy should be to make as many payments as possible by check.

(4) Any individual who handles currency should not be authorized to sign or countersign any checks. Those signing or countersigning checks should be required to examine the authority for payment on all vouchers for which they sign checks.

(c) Accounts receivable

(1) The credit or collection departments should not be permitted to have any control over the accounts-receivable ledgers or handle any cash receipts.

(2) Persons handling currency should not be permitted to authorize any write-offs, such as allowances for bad debts.

(3) The authority to grant credits for returned merchandise should not be vested in any person having to do with cash receipts or with the inventory.

(4) Statements mailed to customers should be compared with the ledger accounts by some person other than the accounts-receivable-ledger clerks or anyone handling the cash receipts.

(5) The ledger clerks should be rotated in preparing the monthly statements of the customers' accounts.

No. 8.

(1) Election of directors:

Names of persons elected, and the length of their terms of office.

(2) Directors' fees:

The dates of the meetings; the number of directors attending each meeting.

(3) Election of officers:
Names of persons elected, their titles, and their terms of office.

(4) Compensation of officers and others:
The amount authorized for each, the term, and when payable, if fixed in amount. If any other basis, such as profit-sharing, the basis of computation.

(5) Declaration of dividends:
The amount authorized for each class of stock, record date, and the date payable.

(6) The detail of capital expenditures:
The description of the property to be purchased or constructed, the date to be acquired or completed, the amount appropriated, the terms of payment, etc.

(7) Contracts and other expenditures other than those arising within the usual course of business:
In the case of sale of assets of material value:
 Description of the asset.
 Reason for its sale.
 Persons authorized to negotiate.
 Price and terms of sale.
Other contracts:
 The purpose and other important provisions of the contract, and the persons authorized to sign.
 If already executed, ratification.
Law suits:
 Identification.
 Nature and the amount of the claim.
 Its present status.
 Persons authorized to settle.
 Basis of settlement.

(8) Authorization to open bank accounts:
Designation of the bank and persons authorized to sign or countersign.

(9) Sale of capital stock:
Class of stock, number of shares to be sold, the price, and the treatment in the accounts.

(10) Purchase of treasury stock:
Class of stock, number of shares to be acquired and from whom, price, and treatment in the accounts.

(11) Loans:
The amount of the loan, when payable, collateral, interest rate, and the persons authorized to negotiate, and with whom.

No. 9.

(1) For his use, the accountant should obtain a copy of the will and inventory of the estate, and compare them with the will and inventory admitted to probate.
(2) Review the payments to beneficiaries and other persons interested in the estate to ascertain whether they were properly made under the will.
(3) The valuations placed on the assets should be compared with the federal estate tax and the state inheritance-tax returns.
(4) Payments made on account of debts of the decedent, funeral and administration expenses, executors' commissions, etc., should be verified.
(5) Income-producing assets should be reviewed in order to account for income.
(6) Any purchases or sales of assets should be verified, as well as any income earned during the period of holding.
(7) Any income or expense applicable to specific legacies since the date of death should be reviewed in order to charge or credit the legatees.
(8) The federal estate, state inheritance, and income-tax returns should be examined to determine whether the tax has been correctly computed.
(9) Watch for transactions on which distinction should be made between principal and income.
(10) Ascertain the form of the accounting required by the probate court and prepare the necessary statements under the rules of that court.

No. 10.

(1) The system of internal control should be reviewed, in order to determine the extent of the tests to be made.
(2) Ordinarily, the examination of the pre-numbered duplicate invoices and credit memoranda for one or more months would be sufficient. The transactions for this period should be traced to the sales and return-sales-and-allowances registers.
(3) These registers should be footed for the months being tested, and the postings of the totals should be checked to the general ledger.
(4) The footings and the balances of the sales and return-sales-and-allowances accounts in the general ledger should be verified.
(5) All entries in the sales and return-sales-and-allowances accounts in the general ledger arising from other than the respective registers should be carefully investigated.

(6) All credit memoranda other than for return sales should be checked for authority for the entire period covered by the audit.
(7) All numbers for duplicate invoices and credit memoranda should be accounted for for the months being tested.
(8) Invoices and shipping records for the last week or ten days of the period under review should be checked in order to determine:
    (a) .That the merchandise invoiced to the customer was actually shipped, and
    (b) That the shipments during this period were invoiced to the customers within the period.
(9) A similar test should be made between the credit memoranda for return sales and the receiving records to determine:
    (a) That the customers were credited in their accounts for the merchandise returned prior to the balance-sheet date, and
    (b) That the merchandise was received before the balance-sheet date for credit memoranda issued.
(10) The merchandise inventory should be examined to determine:
    (a) That the merchandise returned by the customers prior to the balance-sheet date was included,
    (b) That it was properly valued, and
    (c) That the inventory included no merchandise for sales invoiced prior to the balance-sheet date.

No. 11.

(a) A confirmation should be obtained from the vice president covering the dates, amounts, and the purposes for which the checks were issued. This confirmation should be verified against the canceled checks when the cash "cut-off" is made. It should be determined that those advances and expenses applicable to the period covered by the audit were entered in that period.

It would be advisable to determine by inquiry and examination of the cash-disbursements record whether the practice was followed during the year with respect to the vice president and other officers or employees. If so, a detailed examination should be made of these transactions to ascertain that the funds so expended are properly recorded on the books and are supported by duly authorized vouchers.

(b) Inasmuch as the directors, in authorizing the countersigning of checks, did so for the purpose of requiring two responsible officers to consider carefully the disbursements, the practice being followed is really in violation of that authority. This point should be tactfully brought to the attention of the president or executive officer of the company.

The following suggestions may also be made:

(1) Credit may be established with the hotels or air lines that are generally patronized.

(2) Travelers' checks may be used.

(3) A separate bank account may be opened, against which only one signature may be required for making withdrawals. Advances and additional funds could be deposited in this account as required.

No. 12.

The accountant who renders an unqualified, standard short-form report implies that his examination was made in general conformity with the auditing procedures recommended in the bulletins, "Examination of Financial Statements" and "Extensions of Auditing Procedure," issued by the American Institute of Accountants.

Accounting Theory and Practice – Part I

May 14, 1942, 1:30 to 7:30 p.m.

No. 1.

THE ROCKFORD RADIO COMPANY AND ITS SUBSIDIARIES
THE ELGIN SUPPLY COMPANY AND THE PEORIA PHONOGRAPH COMPANY

(a) Consolidated balance-sheet — December 31, 1941

Assets

Other assets (net)		$1,538,520

Liabilities and Net Worth

Liabilities:		
Notes receivable discounted	$ 10,000	
Dividends payable	4,400	$ 14,400
Minority interests (b)		119,440
Net worth:		
Capital stock:		
Preferred	$ 400,000	
Common	800,000	
Total capital stock	$1,200,000	
Consolidation surplus (c)	88,920	
Consolidated surplus	115,760	1,404,680
		$1,538,520

(b) Statement of minority interests

	Elgin Supply Company	*Peoria Phonograph Company*	*Together*
Capital stock:			
Common:			
10% of $500,000	$ 50,000		
10% of $200,000		$ 20,000	
Preferred:			
20% of $200,000		40,000	
Total	$ 50,000	$ 60,000	$ 110,000
Earned surplus:			
10% of $26,000, surplus per books	2,600		2,600
10% of $14,400, income from dividends of Peoria	1,440		1,440

Consolidation surplus:			
10% of $54,000 surplus arising from consolidation of Elgin and Peoria........	5,400		5,400
Total	$ 59,440	$ 60,000	$ 119,440

(c) Statement of consolidation surplus and goodwill

Consolidation surplus:			
Proportionate interest in the net assets of the Elgin Supply Company acquired by the Rockford Radio Company on December 31, 1940:			
Par value of capital stock............	$ 500,000		
Less deficit (See (c) 2).............	4,000		
Book value	$ 496,000		
90% thereof		$ 446,400	
Purchase price (See (c) 1)............		370,080	
Consolidation surplus			$ 76,320
Proportionate interest in the net assets of the Peoria Phonograph Company acquired by the Elgin Supply Company on December 31, 1939:			
Par value of common stock...........	$ 200,000		
90% thereof		$ 180,000	
Purchase price		126,000	
Consolidation surplus		$ 54,000	
Minority interest of Elgin stockholders therein—10%		5,400	
Net consolidation surplus.......			48,600
Total consolidation surplus....			$ 124,920
Goodwill:			
Purchase price of 80% of the $200,000 seven per cent preferred stock of the Peoria Phonograph Company purchased by the Rockford Radio Company for..		$ 176,000	
Book value of the stock................	$ 200,000		
80% thereof		160,000	

Goodwill purchased	$ 16,000	
Goodwill on the books of Peoria Phonograph Company	20,000	
Total goodwill		36,000
Net consolidation surplus		$ 88,920

(c) 1

ANALYSIS OF THE INVESTMENT ACCOUNT OF
THE ROCKFORD RADIO COMPANY IN THE ELGIN SUPPLY COMPANY

Balance, December 31, 1941, per balance-sheet...........	$ 397,080	
Add—Dividend received in 1941 (90% of $20,000).......	18,000	$ 415,080
Deduct—Share in 1941 profit (90% of $50,000)..........		45,000
Cost of 90% interest in the outstanding stock of the Elgin Supply Company		$ 370,080

(c) 2

ANALYSIS OF THE EARNED SURPLUS ACCOUNT OF THE
ELGIN SUPPLY COMPANY

Balance, December 31, 1941, per balance-sheet......................	$ 26,000
Add—Dividend paid in 1941......................................	20,000
Total	$ 46,000
Deduct—Profit for the year 1941.................................	50,000
Balance, December 31, 1940..............................(Deficit)	$ 4,000

ADJUSTMENTS AND ELIMINATIONS

(a) To eliminate the intercompany notes receivable and notes payable.
(b) To record the merchandise in transit from Peoria to Rockford and to eliminate the intercompany accounts receivable and payable.
(c) To eliminate the dividend payable on the preferred stock of the Peoria Phonograph Company to the Rockford Radio Company (80% of $14,000).
(d) To take up on Elgin's books the dividend receivable on the common stock of the Peoria Phonograph Company (90% of $16,000), to take up Rockford's share of income to Elgin (90% of $14,400), and to eliminate the dividend accounts.
(e) To eliminate 90% of the capital stock and earned surplus of the Elgin Supply Company.
(f) To eliminate the 80% interest of the Rockford Radio Company in the preferred stock of the Peoria Phonograph Company.
(g) To eliminate the 80% interest of the Elgin Supply Company in the common stock of the Peoria Phonograph Company.

THE ROCKFORD RADIO COMPANY AND ITS SUBSIDIARIES
THE ELGIN SUPPLY COMPANY AND THE PEORIA PHONOGRAPH COMPANY
WORK SHEET—DECEMBER 31, 1941

Assets	Rockford Radio Company	Elgin Supply Company	Peoria Phonograph Company	Adjustments and Eliminations		Other Assets (Net)	Liabilities	Minority Interests	Capital Stock	Consolidation Surplus and Goodwill	Consolidated Surplus
Investments:											
Elgin Co.	$ 397,080			$ 12,960(d)	$486,360(e)					$76,320CS	
Peoria Co.	187,200				160,000(f)						
					11,200(c)					* 16,000GW	
Peoria Co.		$126,000		14,400(d)	180,000(g)			$ 5,400		48,600CS	
					14,400(d)						
Notes receivable—Peoria Co.	20,000	10,000			30,000(a)						
Accounts receivable — Rockford Co.			$ 15,000		15,000(b)						
Other assets (net)	708,520	400,000	425,000	5,000(b)		$1,538,520					
Goodwill			20,000							* 20,000GW	
	$1,312,800	$536,000	$460,000								
Liabilities											
Accounts payable—Peoria Co.	$ 10,000			10,000(b)							
Notes payable:											
Rockford Co.			$20,000	20,000(a)							
Elgin Co.			10,000	10,000(a)							
Notes receivable discounted		$ 10,000					$10,000				
Dividends payable:											
Preferred			14,000	11,200(c)			2,800				
Common			16,000	14,400(d)			1,600				
Capital stock:											
Preferred	400,000								$ 400,000		
Common	800,000								800,000		
Capital stock		500,000		450,000(e)				50,000			
Capital stock:											
7% preferred			200,000	160,000(f)				40,000			
Common			200,000	180,000(g)				20,000			
Earned surplus	102,800	26,000		36,360(e)	14,400(d)			4,040			$115,760
					12,960(d)						
	$1,312,800	$536,000	$460,000	$924,320	$924,320	$1,538,520	$14,400	$119,440	$1,200,000	$88,920	$115,760

*Red

No. 2.

SCHEDULE I

Computation of the estimated value of the inventory on hand on January 31, 1942

Inventory, December 31, 1942	$61,328.20
Purchases during the month of January	14,396.15
Total	$75,724.35
Deduct the cost of January sales:	
(70% of $15,320.50)	10,724.35
Estimated value of inventory on hand, January 31, 1942	$65,000.00

SCHEDULE II

Computation of the recoverable fire loss

Inventory:				
Amount of insurance carried			$45,500	
Co-insurance percentage			80%	
Estimated value of merchandise on hand at time of fire			$65,000	
Amount of insurance which should have been carried:				
(80% of $65,000)			$52,000	
Value of merchandise destroyed by the fire:				
Estimated inventory		$65,000		
Amount of salvage		17,000	$48,000	
Amount of insurance recoverable:				
$\frac{\$45,500}{\$52,000}$ times $48,000 equals				$42,000
Store and office fixtures:				
Amount of insurance carried			$ 9,500	
Co-insurance percentage			80%	
Value of fixtures at time of fire:				
Store and office fixtures		$18,000		
Less—				
Reserve for depreciation	$7,230			
Depreciation for January	120	7,350	$10,650	

Amount of insurance which should have been carried (80% of $10,650)	$ 8,520	
Value of fixtures destroyed by the fire (total loss)	$ 10,650	
Amount of insurance recoverable (face of policy)		9,500
Total insurance recoverable		$ 51,500

Adjustments to working papers

(1)

	Debit	Credit
Expenses	$ 120.00	
Reserve for depreciation		$ 120.00
To record the depreciation for the month of January, 1942. (1/12 of 8% of $18,000)		

(2)

	Debit	Credit
Expenses	35.00	
Unexpired insurance		35.00
To write off the portion of unexpired insurance for the month of January, 1942. (1/8 of $280)		

(3)

	Debit	Credit
Cash	17,500.00	
Inventory		17,000.00
Fire loss		500.00
To record the sale of the salvaged merchandise.		

(4)

	Debit	Credit
Fire loss	48,000.00	
Inventory		48,000.00
To transfer to the fire loss account the amount of the inventory destroyed by fire.		

(5)

	Debit	Credit
Inventory	14,396.15	
Purchases		14,396.15
To transfer the January purchases to the inventory account.		

(6)

	Debit	Credit
Cost of sales	10,724.35	
Inventory		10,724.35
To record the cost of sales (Schedule I).		

(7)

Fire loss	10,650.00	
Reserve for depreciation	7,350.00	
Store and office fixtures		18,000.00
To transfer the net value of the store and office fixtures destroyed by the fire.		

(8)

Fire loss	245.00	
Unexpired insurance		245.00
To transfer the unexpired insurance to the fire loss account.		

(9)

Cash	51,500.00	
Fire loss		51,500.00
To record the settlement of the insurance claim (Schedule II).		

(10)

Cash	10,000.00	
Morton capital (two-thirds)		6,666.67
Norton capital (one-third)		3,333.33
To record the settlement of the life insurance on the life of Mr. Morton.		

(11)

Accounts payable	7,928.75	
Cash		7,928.75
To record the payment of the accounts payable.		

(12)

Profit and loss	509.15	
Morton capital		339.43
Norton capital		169.72
To distribute the profit for the month on the basis of their profit-sharing ratio of two-thirds and one-third.		

(13)

Morton capital	4,596.67	
Norton capital	2,298.33	
Fire loss		6,895.00
To charge the partners with their share of the loss resulting from the fire.		

[See table on following page.]

MORTON AND NORTON (CO-PARTNERSHIP)

Work Sheet—January 1, 1942

	Trial Balance January 1, 1942		Adjustments		Profit and Loss for the Month of January		Balance-sheet	
	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit
Cash	$ 20,256.57		(3)$ 17,500.00	(11)$ 7,928.75				
			(9) 51,500.00					
			(10) 10,000.00				$91,327.82	
Inventory, December 31, 1941	61,328.20		(5) 14,396.15	(3) 17,000.00				
				(4) 48,000.00				
				(6) 10,724.35				
Store and office fixtures	18,000.00			(7) 18,000.00				
Reserve for depreciation		$ 7,230.00	(7) 7,350.00	(1) 120.00				
Unexpired insurance	280.00			(2) 35.00				
				(8) 245.00				
Accounts payable		7,928.75	(11) 7,928.75					
Morton capital		58,475.78	(13) 4,596.67	(10) 6,666.67				
				(12) 339.43				$60,885.21
Norton capital		29,237.89	(13) 2,298.33	(10) 3,333.33				
				(12) 169.72				30,442.61
Sales		15,320.50				$15,320.50		
Purchases	14,396.15			(5) 14,396.15				
Expenses	3,932.00		(1) 120.00					
			(2) 35.00		$ 4,087.00			
Cost of sales			(6) 10,724.35		10,724.35			
Profit and loss			(12) 509.15		509.15			
			$126,958.40	$126,958.40				
Fire loss			(4)$ 48,000.00	(3)$ 500.00				
			(7) 10,650.00	(9) 51,500.00				
			(8) 245.00					
				(13) 6,895.00				
	$118,192.92	$118,192.92	$58,895.00	$58,895.00	$15,320.50	$15,320.50	$91,327.82	$91,327.82

No. 3.

Although the problem does not require a work sheet, it is given in this solution for explanatory purposes.

ADJUSTMENTS TO WORK SHEET

	Debit	Credit
(1)		
Accounts receivable	550,000	
Sales		$ 550,000
To record the sales for the year.		
(2)		
Raw materials	64,000	
Increase of raw materials inventory		64,000
To record the increase in the raw materials inventory.		
(3)		
Purchases of raw materials	347,000	
Accounts payable		347,000
To record the purchases of raw materials.		
(4)		
Labor	60,000	
Cash		60,000
To record the payments for labor payroll.		
(5)		
Manufacturing expenses	35,900	
Cash		35,900
To record the payments for manufacturing expenses.		
(6)		
Depreciation on buildings	2,000	
Reserve for depreciation on buildings		2,000
To record depreciation for the year.		
(7)		
Depreciation on machinery and equipment	3,000	
Reserve for depreciation of machinery and equipment		3,000
To record the depreciation for the year.		
(8)		
Goods in process	20,000	
Increase of materials-in-process inventory		20,000
To record the increase in the goods-in-process inventory.		
(9)		
Decrease in finished-goods inventory	36,000	
Finished goods		36,000
To record the decrease of finished-goods inventory.		

(10)

Selling expenses	35,000	
Cash		35,000
To record the payments for selling expenses.		

(11)

Administrative expenses	26,000	
Cash		26,000
To record the payment for administrative expenses.		

(12)

Cash	520,700	
Accounts receivable		520,700
To record the collections from customers.		

(13)

Accounts payable	347,500	
Cash		347,500
To record the payments to creditors.		

(14)

Notes payable	45,000	
Donated surplus		45,000
To record the donation to the company by the owners on January 31, 1941.		

(15)

Interest paid	$ 9,150	
Cash		$ 6,650
Accrued interest on notes payable		2,500
To record the interest paid and accrued, as shown below:		

Interest for January, 1941, on $270,000	$ 900
Interest for remainder of year on $225,000	8,250
Total	$9,150
Less—interest paid	6,650
Balance—accrued	$2,500

(16)

Deferred charges	400	
Manufacturing expenses		400
To record the increase in the unexpired insurance from $1,100 to $1,500.		

(17)

U. S. savings bonds	5,000	
Cash		5,000
To record the purchase of bonds.		

(18)

Donations to the Red Cross...........................	2,000	
Cash		2,000
To record the donation to the Red Cross.		

(20)

Federal income and surtax...........................	15,250	
Federal income and surtax payable................		15,250
To record the liability for the above taxes, computed below:		

Net income		$78,350
Deduct—loss carryover:		
1939	$15,000	
1940	13,350	28,350
Taxable income		$50,000
Tax:		
Normal (24% of $50,000).............		$12,000
Surtax:		
(6% on first $25,000)................		$ 1,500
(7% on second $25,000)............		1,750
Total surtax		$ 3,250
Total normal and surtax................		$15,250

BRANDON MANUFACTURING COMPANY
Balance-sheet Working Papers
December 31, 1941

	Balance-sheet January 1, 1941		Adjustments		Balance-sheet December 31, 1941	
	Debit	Credit	Debit	Credit	Debit	Credit
Cash	$ 3,000		$ 520,700(12)	$ 60,000(4)		
				35,900(5)		
				35,000(10)		
				26,000(11)		
				347,500(13)		
				6,650(15)		
				5,000(17)		
				2,000(18)	$ 5,650	
Accounts receivable	15,700		550,000(1)	520,700(12)	45,000	
Raw materials	55,000		64,000(2)		119,000	
Goods in process	8,350		20,000(8)		28,350	
Finished goods	154,500			36,000(9)	118,500	
Deferred charges	1,100		400(16)		1,500	
Land	40,000				40,000	
Buildings	94,000				94,000	
Reserve for depreciation of buildings		$ 14,000		2,000(6)		$ 16,000
Machinery and equipment	81,000				81,000	
Reserve for depreciation of machinery and equipment		21,000		3,000(7)		24,000
Four per cent notes payable		270,000	45,000(14)			225,000
Accounts payable		20,500	347,500(13)	347,000(3)		20,000
Five per cent cumulative preferred stock		100,000				100,000
Common stock		80,000				80,000
Deficit	52,850			63,100(x)		10,250
	$505,500	$505,500				
Donated surplus				45,000(14)		45,000
Accrued interest on notes payable				2,500(15)		2,500
U. S. savings bonds			5,000(17)		5,000	
Federal income and surtax payable				15,250(20)		15,250
			$1,552,600	$1,552,600	$538,000	$538,000

BRANDON MANUFACTURING COMPANY
PROFIT AND LOSS WORKING PAPERS

For the year ended December 31, 1941

	Adjustments		Cost of Sales		Profit and Loss	
	Debit	*Credit*	*Debit*	*Credit*	*Debit*	*Credit*
Net sales		$550,000(1)				$550,000
Increase of raw materials inventory		64,000(2)		$ 64,000		
Purchases of raw materials	$347,000(3)		$347,000			
Labor	60,000(4)		60,000			
Manufacturing expenses	35,900(5)		35,900			
Depreciation on buildings	2,000(6)		2,000			
Depreciation—machinery and equipment	3,000(7)		3,000			
Increase of materials in process inventory		20,000(8)		20,000		
Decrease of finished goods inventory	36,000(9)		36,000			
Selling expenses	35,000(10)				$ 35,000	
Administrative expenses (including capital stock tax)	26,000(11)				26,000	
Interest on notes	9,150(15)				9,150	
Unexpired insurance on plant		400(16)		400		
Donated to the Red Cross	2,000(18)				2,000	
Transfer cost of sales				399,500	399,500	
Net profit for year					78,350	
			$483,900	$483,900	$550,000	$550,000
Net profit brought down						$ 78,350
Federal income and surtax	15,250(20)				$ 15,250	
Net profit after taxes	63,100(x)				63,100	
	$634,400	$634,400			$ 78,350	$ 78,350

BRANDON MANUFACTURING COMPANY

Balance-Sheet—December 31, 1941

Assets

Current assets:				
Cash			$ 5,650	
U. S. savings bonds			5,000	
Accounts receivable			45,000	
Inventories:				
Raw materials		$ 119,000		
Goods in process		28,350		
Finished goods		118,500	265,850	$ 321,500
Unexpired insurance				1,500
Fixed assets:				
	Cost	Reserve for Depreciation	Net Book Value	
Land	$ 40,000		$ 40,000	
Buildings	94,000	$ 16,000	78,000	
Machinery and equipment	81,000	24,000	57,000	
Totals	$ 215,000	$ 40,000		175,000
				$ 498,000

Liabilities and Net Worth

Current liabilities:			
Accounts payable		$ 20,000	
Federal income and surtax payable		15,250	
Four per cent notes payable		225,000	
Accrued interest on notes payable		2,500	$ 262,750
Net worth:			
Five per cent cumulative preferred stock		$ 100,000	
Common stock		80,000	
Donated surplus		45,000	
Surplus:			
Profit for the year 1941	$ 63,100		
Less—deficit, January 1, 1941	52,850	10,250	235,250
			$ 498,000

Note.—Preferred stock dividends are in arrears since the organization of the company on January 1, 1934.

BRANDON MANUFACTURING COMPANY

STATEMENT OF PROFIT AND LOSS
For the Year Ended December 31, 1941

Sales				$ 550,000
Deduct—cost of sales:				
Materials:				
Raw materials purchase		$ 347,000		
Less—increase in inventory		64,000		
Raw materials used			$ 283,000	
Labor			60,000	
Manufacturing expenses		$ 35,900		
Depreciation:				
Buildings	$ 2,000			
Machinery and equipment	3,000	5,000		
Total		$ 40,900		
Less—insurance credit		400	40,500	
Manufacturing cost			$ 383,500	
Add—decrease of finished goods inventory			36,000	
Total			$ 419,500	
Deduct—increase in goods in process inventory			20,000	
Cost of sales				399,500
Gross profit				$ 150,500
Deduct—expenses:				
Selling expenses			$ 35,000	
Administrative expenses			26,000	
Interest on notes payable			9,150	
Donation to Red Cross			2,000	
Total expenses				72,150
Net profit, before taxes				$ 78,350
Federal income and surtax				15,250
Net profit for the year, after taxes				$ 63,100

No. 4.

CITY OF GLENDALE

(a) FUND BALANCE-SHEET
March 31, 1942

Assets	General Fund	Capital Fund	Total
Cash	$ 12,000	$ 5,000	$ 17,000
Uncollected taxes	84,000		84,000
Accounts receivable (net)	7,600		7,600
Deferred charges to future taxation		340,000	340,000
	$ 103,600	$ 345,000	$ 448,600
Liabilities			
Notes payable	$ 50,000		$ 50,000
Accounts payable	8,000		8,000
Bonded indebtedness		$ 345,000	345,000
General fund surplus	45,600		45,600
	$ 103,600	$ 345,000	$ 448,600

NOTE.—The capital fund may be divided into a sinking fund and a bond fund.

CITY OF GLENDALE

(b) STATEMENT OF GENERAL FUND CASH
For the year ended March 31, 1942

Balance, March 31, 1941		$ 14,000
Add:		
Actual revenues	$ 222,200	
Sale of serial bonds at par	150,000	
Decrease in accounts receivable	12,800	
Increase in accounts payable	500	385,500
Total		$ 399,500
Deduct:		
Expenditures	$ 306,000	
Increase in uncollected taxes	11,500	
Decrease in notes payable	70,000	387,500
Balance, March 31, 1942		$ 12,000

CITY OF GLENDALE

(c) Statement of General Fund Surplus
For the year ended March 31, 1942

Deficit, March 31, 1941			$ 20,000
Add:			
Excess of estimated revenues over actual revenues:			
Estimated	$ 250,000		
Actual	222,200	$ 27,800	
Excess of appropriations over estimated revenues:			
Appropriations	$ 260,000		
Estimated revenues	250,000	10,000	
Excess of expenditures over appropriations:			
Expenditures	$ 306,000		
Appropriations	260,000	46,000	
Provision for doubtful accounts		600	84,400
Total			$ 104,400
Deduct—serial bonds issued to fund operating deficit			150,000
Surplus, March 31, 1942			$ 45,600

CITY OF GLENDALE

(d) Statement of Bonded Indebtedness
For the year ended March 31, 1942

	Serial Bonds	Sinking Fund Bonds	Together
Balance outstanding, March 31, 1941	$ 111,000	$ 95,000	$ 206,000
Add—serial bonds issued	150,000		150,000
Totals	$ 261,000	$ 95,000	$ 356,000
Deduct—serial bonds retired	11,000		11,000
Balance outstanding, March 31, 1942	$ 250,000	$ 95,000	$ 345,000

Commercial Law

May 15, 1942, 9 a.m. to 12:30 p.m.

GROUP I

No. 1.

(a) Contracts by drunken men are valid unless the state of intoxication at the time the contract was made was such that it rendered the person intoxicated incapable of understanding the nature of the transaction in which he was engaged. Contracts made under such conditions are voidable at the option of the person who was intoxicated, but the contract must be avoided within reasonable time after becoming sober and after having knowledge of the agreement which was made.

Since intoxication is entered into voluntarily, a return of any consideration which has been received by the intoxicated person is a condition precedent to the avoidance of the bargain. For the same reason, property may not be recovered by the person intoxicated from bona fide purchasers for value.

When a contract has been made with a person who was intoxicated at the time, the agreement is closely scrutinized for evidences of fraud.

(b) By the weight of authority, contracts by persons of unsound mind who at the time had no mental understanding of their acts are merely voidable. Some courts use the words "void" and "voidable" loosely, but it is doubtful whether the courts which have said that the contracts of a lunatic are void would follow that doctrine to its logical conclusion.

Since a lunatic's contracts are voidable, they may be ratified by the lunatic when he recovers his reason. Similarly, the lunatic's representatives or his heirs may ratify after death a bargain made by him while insane.

In some jurisdictions contracts made with lunatics are valid if consideration is given by the other party to the contract in ignorance of the lunacy; that would not apply to this case because the unsoundness of mind is stated to be obvious.

For the same reason which exists with regard to contracts made with infants, lunatics are liable for necessaries furnished them. This liability should be regarded as quasi-contractual rather than contractual, since a lunatic is liable only for the reasonable value of the necessaries, which may be less than the price which he agreed to pay.

(c) Contracts by corporations are valid only when within the corporate powers. Otherwise, an attempt to make a contract is an *ultra vires* act.

A contract which is beyond the corporate powers and which is wholly executory on both sides will not be enforced. If a contract which is beyond the corporate powers has been fully executed on both sides it cannot be set aside on the ground of *ultra vires*.

If a contract not within the corporate powers has been executed wholly or partly on only one side, there is a split of authority regarding the validity of such a contract. The English courts and a minority of American courts treat such a contract as void, but allow a recovery to be maintained on quasi-contractual principles. A majority of American courts hold that a party cannot set up the defense of *ultra vires* after the *ultra vires* contract has been partly executed by the other party to the contract.

(d) Contracts by an infant are voidable, and generally may be avoided or ratified by the infant when he reaches maturity. Public policy prevents an infant from disaffirming some contracts such as a contract to marry.

An infant's conveyance of realty may be avoided only after he has attained his majority, though contracts relating to personal property may be avoided by the infant during his minority. If the infant wishes to disaffirm a contract made during his minority, he must act within a reasonable time after becoming of age.

An infant's contract for necessaries does not bind him strictly as a contract, but he will be held liable for the reasonable value of the necessaries which may be different from the price which he agreed to pay.

No. 2.

Inasmuch as P's instructions to B were not communicated to C there was no limitation on the apparent authority of B as P's agent to contract with C. C may therefore recover damages from P for breach of the warranty. P may recover from B any damages that he has sustained to C and also any damage that he has sustained from B selling below the market price.

No. 3.

(a) No. The sharing of gross income is not strong evidence of a partnership, because partners are associated for the purpose of earning profits and gross income is not a profit. There might be gross income but no net income or even a loss, and one of the parties might be paying all or a disproportionate part of the expenses.

The sharing of net income is stronger evidence, because it reveals the co-owners as bearing proportionate parts of the expenses, which would be consistent with an association for the purpose of earning profits.

(b) In determining whether or not the landlord is a partner, it is necessary to consider the intent of the parties as determined by a consideration of the whole agreement, the nature of the transaction, and the conduct of the parties. The fact that money received for the use of property is declared to be received as "rent" is some evidence that a partnership relation is not intended. If the landlord has no voice in the management of the business and the share of the net profits is merely a measure of the amount of rent to be paid, the landlord cannot be held as a partner.

(c) No. All partners must join in an assignment. No partner has implied authority to do any act which would make it impossible for the firm to carry on its ordinary business. A partner is an agent of the firm only for the purpose of carrying on its business.

No. 4.

(a) The principal or chief function is to determine and maintain the managerial policy of the business. The most important subsidiary function is to elect and supervise officers to manage the business in accordance with that policy. Another important function is to declare dividends, whereby the corporation's profits shall be distributed among its stockholders.

(b) Yes. The directors, acting jointly in board meetings, are responsible for the management of the corporation, but the place at which the board holds its meetings is immaterial, unless prescribed by statute, certificate, or by-laws.

(c) No. An individual director has no authority, because directors act jointly as a board. He is neither an officer nor an agent.

(d) A voting trust is the accumulation in the hands of one or more persons as trustee or trustees of shares of corporate stock belonging to more than one owner, in order thereby to control the corporation's business. Voting trusts usually are formed by the holders of a majority of the voting stock and continue for a stated period of time. The trustee or trustees thus acquire the voting rights of the stockholders and thus vote all of the stock held as a unit. A voting trustee acquires the legal title to the stock which he holds for the benefit of the stockholder who transferred it to him, and voting trustees usually issue certificates of beneficial ownership which are transferable in the same manner as the original stock.

No. 5.

(a) A law fixing a limited period in which a claimant may sue.
(b) To expedite the prosecution of just causes of action and to discourage suits upon old claims.
(c) There are both federal and state laws.
(d) The limitations differ among the states, and differ within states according to the nature of the claims.
(e) The limitation on a suit for breach of contract may be three years in State A and five years in State B. The limitation on a suit in tort may be three years in both states.
(f) In examining accounts and notes receivable, and in considering liability for federal and state taxes.

GROUP II

No. 6.

Yes. There was an implied warranty of fitness for the particular purpose. Where the buyer expressly makes known to the seller the particular purpose for which the goods are required, and it appears that the buyer relies on the seller's skill or judgment, there is an implied warranty that the goods shall be reasonably fit for such purpose. One of the buyer's remedies for breach of warranty is to return the goods or offer to return them to the seller and recover the price which has been paid.

No. 7.

(a) Insolvency exists whenever the aggregate of a debtor's property (exclusive of any property transferred or concealed with intent to defraud, hinder, or delay his creditors) at a fair valuation shall not be sufficient to pay his debts.
(b) Inability to pay debts as they mature, regardless of an excess of total assets over total liabilities.
(c) A referee is appointed by the court to serve for two years as an assistant to the court. His duties in general are to do everything which the court could do except to commit a person to imprisonment and to approve or reject compositions or discharges. His acts are subject to review by the court which appointed him. His principal duties are to declare dividends and instruct trustees when and how to pay them; to review schedules of property and lists of creditors; to give notice to creditors; to receive proof of claims; and to prepare and file all necessary records.

(d) A trustee is elected by the creditors; or is appointed by the court if the creditors fail to elect. His duties in general are to collect, reduce to money, and close the estate as promptly as practicable. He must prepare and file accounts, present statements at the final meeting of creditors, pay dividends declared by the referee, and attend to all details under the direction of the referee.

(e) A discharge releases the bankrupt from all debts except (1) taxes, (2) liabilities for obtaining money by false pretenses, wilful and malicious injuries to the person or property of another, alimony, support of wife or child, seduction, and adultery, (3) provable debts which were not properly scheduled (unless the creditor had notice of the proceedings), (4) liabilities created by the bankrupt's fraud, embezzlement, misappropriation, or defalcation while acting in any fiduciary capacity, (5) wages due to workmen, clerks, salesmen, or servants earned within three months prior to the petition; and (6) liabilities for money of an employee retained by the bankrupt as employer as security for the employee's performance of his duties.

No. 8.

(a) No; because there is no consideration.

(b) It can be made by symbolic or constructive delivery, for example, by transferring a document of title, or by delivering the keys to a place where the goods are stored.

(c) A completed conditional gift of personal property can be revoked if the donee fails to perform the condition. Gifts *causa mortis* may be revoked by the donor at any time before his death. This is an implied condition and need not be expressed. A completed unconditional gift can be revoked if the donor can prove undue influence or fraud.

No. 9.

No. Two of the requirements for negotiability specified in the Negotiable Instruments Law are that the amount payable must be "a sum certain in money," and that the instrument must be payable on demand or at a fixed or determinable future time. Another section of that Law provides that the sum payable is a sum certain although it is to be paid by stated instalments with a provision that upon default in payment of any instalment or of interest, the whole shall become due.

Another section explains what constitutes a determinable future time but makes no mention of the effect of an acceleration clause. Numerous court decisions, however, have held that an acceleration clause does not make the due date uncertain.

No. 10.

(a) Paper arising out of actual commercial transactions.
(b) Paper issued for capital assets of any kind, and paper issued for speculative investments or for renewals of same.
(c) No. The former double liability was removed July 1, 1937, by Act of Congress.
(d) Payment of deposits in insured banks which fail. Acting as receiver for closed banks. Extending loans for mergers to avert bank failures.

No. 11.

(a) The person who owes the money is the mortgagor.
(b) No, by the weight of authority, because this provision in the mortgage is one for the benefit of the mortgagee, and it can be waived by him.

No. 12.

(a) No, because Y lost his insurable interest when the debt was paid and the mortgage canceled. In property insurance insurable interest must exist at the time the policy is issued and also at the time of loss.
(b) Yes, by the weight of authority, because in life insurance, insurable interest need exist only at the time the policy is issued. Y had an insurable interest at that time, and the fact that later he lost it does not invalidate the policy.

Accounting Theory and Practice – Part II

May 15, 1942, 1:30 to 7:30 p.m.

No. 1.

X IRON AND COAL COMPANY

WORK SHEET ENTRIES

	Debit	Credit
(1)		
Y Furnace Company—stock	$ 24,999	
Surplus		$ 24,999
To increase the book value of the investment in the Y Furnace Co. stock (1,000 shares at $25 per share).		
(2)		
Y Furnace Company—stock	140,000	
Inventory		5,000
Plant and equipment, less depreciation		135,000
To record the transfer of the plant, equipment, and inventory to the Y Furnace Company in exchange for 3,000 shares of the new stock of that company.		
(3)		
Surplus	500	
Cash		500
To record the payment for taxes and legal fees.		
(4)		
X Iron and Coal Company—stock	950,000	
Surplus	172,000	
Accounts payable	10,000	
Cash		45,500
Receivables		5,500
Y Furnace Company—stock		165,000
Y Furnace Company—note		35,000
Marketable securities		881,000
To record the transfer of all of the assets and liabilities of the X Iron and Coal Company to the Z Iron and Coal Company.		
(5)		
Capital stock	950,000	
X Iron and Coal Company—stock		950,000
To record the dissolution of the X Iron and Coal Company.		

Y FURNACE COMPANY

	Debit	Credit
(6)		
Capital surplus	$ 251,000	
Surplus (deficit)		$ 251,000
To record the transfer of the deficit to a capital surplus account.		
(7)		
X Iron and Coal Company—note payable	180,000	
Capital surplus		180,000
To record the reduction in the amount payable to the X Iron and Coal Company.		
(8)		
Capital stock	75,000	
Capital surplus		75,000
To record the reduction in the par value of the capital stock from $100 to $25 per share.		
(9)		
Inventory	5,000	
Plant and equipment, less depreciation	135,000	
Capital stock		75,000
Capital surplus		65,000
To record the purchase of the inventory, plant, and equipment from the X Iron and Coal Company for 3,000 shares of capital stock of a par value of $25 per share.		
(10)		
Capital surplus	500	
Accounts payable		500
To record the liability for taxes and legal fees.		

Z IRON AND COAL COMPANY

	Debit	Credit
(11)		
Unissued capital stock	$1,000,000	
Capital stock		$1,000,000
To record the authorized capital stock of the Z Iron and Coal Company (10,000 shares of a par value of $100 each).		
(12)		
X Iron and Coal Company—stock	950,000	
Unissued capital stock		950,000
To record the issuance of 9,500 shares of stock in exchange for 9,500 shares of X Iron and Coal Company stock.		

(13)

Organization expense	2,000	
Accounts payable		2,000
To record the liability for taxes and legal fees.		

(14)

Cash	45,500	
Receivables	5,500	
Y Furnace Company—stock	165,000	
Y Furnace Company—note	35,000	
Marketable securities	881,000	
Accounts payable		10,000
X Iron and Coal Company—stock		950,000
Capital surplus		172,000
To record the acquisition of the assets and the assumption of the liabilities of the X Iron and Coal Company.		

X IRON AND COAL COMPANY
WORK SHEETS

Assets	Balance-sheets, before Reorganization	Entries Debit	Entries Credit	Transfer of Net Assets Debit	Transfer of Net Assets Credit	Dissolution Debit	Dissolution Credit
Cash	$ 46,000		$ 500(3)		$ 45,500(4)		
Receivables	5,500				5,500(4)		
Inventory	5,000		5,000(2)				
Y Furnace Co.:							
Stock	1	$ 24,999(1) 140,000(2)			165,000(4)		
Demand note—face value $215,000	35,000				35,000(4)		
Marketable securities	881,000				881,000(4)		
Plant and equipment, less depreciation	135,000		135,000(2)				
X Iron and Coal Company stock				$ 950,000(4)			$950,000(5)
	$1,107,501						
Liabilities							
Accounts payable	$ 10,000			$ 10,000(4)			
Capital stock—$100 per share	950,000					$950,000(5)	
Surplus	147,501	500(3)	24,999(1)	172,000(4)			
	$1,107,501	$165.499	$165.499	$1,132,000	$1,132,000	$950,000	$950,000

Y FURNACE COMPANY

Assets	Balance-sheets, before Reorganization	Entries Debit	Entries Credit	After Reorganization Debit	After Reorganization Credit
Cash	$ 5,000			$ 5,000	
Receivables	500			500	
Inventory	5,500	$ 5,000(9)		10,500	
Plant and equipment, less depreciation	55,000	135,000(9)		190,000	
	$ 66,000				
Liabilities					
Accounts payable	$ 2,000		$ 500(10)		$ 2,500
X Iron and Coal Co.—note payable	215,000	180,000(7)			35,000
Capital stock—$100 per share	100,000	75,000(8)	75,000(9)		100,000
Surplus or (deficit*)	251,000*		251,000(6)		
Capital surplus		251,000(6) 500(10)	180,000(7) 75,000(8) 65,000(9)		68,500
	$ 66,000	$646,500	$646,500	$ 206,000	$ 206,000

Z IRON AND COAL COMPANY

Work Sheet

	Opening Entries		Acquisition of Net Assets of X Iron and Coal Company		Balance-sheet, after Acquisition of Net Assets of X Iron and Coal Company	
Assets	*Debit*	*Credit*	*Debit*	*Credit*	*Debit*	*Credit*
Cash			$ 45,500(14)		$ 45,500	
Receivables			5,500(14)		5,500	
Y Furnace Co.:						
Stock			165,000(14)		165,000	
Demand note—face value $215,000			35,000(14)		35,000	
Marketable securities			881,000(14)		881,000	
X Iron and Coal Company stock	$ 950,000(12)			$ 950,000(14)		
Organization expense	2,000(13)				2,000	
Liabilities						
Accounts payable		$ 2,000(13)		10,000(14)		$ 12,000
Capital stock—$100 per share—unissued	1,000,000(11)	950,000(12)			50,000	
Capital stock—authorized (10,000 shares)		1,000,000(11)				1,000,000
Capital surplus				172,000(14)		172,000
	$1,952,000	$1,952,000	$1,132,000	$1,132,000	$1,184,000	$1,184,000

No. 2.

THE SANDFORD MANUFACTURING COMPANY

(a) Work sheet summarizing the receiver's transactions for the period April 28, 1941, to November 20, 1941

		Trial Balance, April 28, 1941	Cash Transactions		Adjustments and Setoffs		Operations During Receivership		Loss on Realization	Receiver's Balance-sheet November 20, 1941
			Disbursements	*Receipts*	*Debit*	*Credit*	*Debit*	*Credit*		
Assets:										
Cash—Balance, April 28, 1941	$ 800	$ 800								
Total receipts	303,800									
Total	$304,600									
Less total disbursements	170,400									
Balance, November 20, 1941	$134,200									$134,200
Receivables		1,400		$ 1,000(1)						400
Finished goods		100,000					$ 60,000(3)			
Materials and supplies		15,000								
Sold during period of operations				75,000(1)				$ 75,000(1)		
Materials used during operations							9,000(3)			
Sold after operations were discontinued				25,000(1)					$ 21,000	
Goods on consignment (out)		220,000								
Applied in part payment of advances						$220,000(5)				
Employees' bonds		4,700								
Returned after payment by them of accommodation notes						4,700(6)				
Unexpired insurance		800		100(1)					700	
Machinery and equipment		507,300								
Less reserve for depreciation						7,300(1)				
Returned to lessor						30,000(7)				
Sold				200,000(1)					270,000	
Total assets		$850,000								$134,600

THE SANDFORD MANUFACTURING COMPANY
(Continued)

(a) Work sheet summarizing the receiver's transactions for the period April 28, 1941, to November 20, 1941

	Trial Balance, April 28, 1941	Cash Transactions		Adjustments and Setoffs		Operations During Receivership		Loss on Realization	Receiver's Balance-sheet November 20, 1941
		Disbursements	*Receipts*	*Debit*	*Credit*	*Debit*	*Credit*		
Liabilities:									
Accounts payable	$110,000								
Unrecorded liability					10,000(4)				$120,000
Bank overdraft	1,000								1,000
Bank loans	105,000								105,000
Smith and Co.	250,000								
Consigned goods accepted in part payment				$220,000(5)					30,000
Acceptances	23,000								23,000
Collateral notes payable	4,700								
Paid by employees				4,700(6)					
Lease, machinery	30,000								
Accrued interest on lease	2,000			2,000(7)					
Machinery returned in full settlement				30,000(7)					
City taxes accrued	4,000	$ 4,000(2)							
Interest on city taxes		400(2)				400			
Mortgage on machinery	100,000	100,000(2)							
Accrued interest on mortgage	3,000	5,000(2)							
Accrued during receivership						2,000			
Reserve for depreciation	7,300			7,300(1)					
Cash-surrender value of life insurance			1,000(1)					1,000*	
Rent received			1,000(1)				1,000		
Interest received			200(1)				200		
Unclaimed wages			500(1)				500		
Labor, materials, and other operating and general expenses		61,000(2)				61,000			
Total liabilities	$640,000								$279,000
Net worth:									
Capital stock—preferred	$100,000								$100,000
common	100,000								100,000
Surplus	10,000								
Accrued interest on lease					2,000(7)				2,000
Unrecorded accounts payable				10,000(4)					
Loss on operations							55,700		55,700*
Loss on realization, liquidation, and operations								290,700*	290,700*
Deficiency to creditors									$144,400*
Total net worth	$210,000	$170,400	$303,800	$274,000	$274,000	$132,400	$132,400	$	$134,600

* Red.

The transactions have been numbered to correspond with the information given in the problem.

THE SANFORD MANUFACTURING COMPANY
(In Receivership)

(b) Statement of transactions of the receiver for the period Apr. 28, 1941, to Nov. 20, 1941

Total of assets of the company taken over by the receiver on April 28, 1941			$850,000
Less—adjustments and setoffs			262,000
Net book value of assets taken over			$588,000
Deduct: Operating loss during the receivership		$ 55,700	
Loss on realization of assets		290,700	
Payments to preferred creditors		107,000	453,400
Net book value of assets available for unsecured creditors			$134,600
Consisting of:			
Cash	$134,200		
Account receivable—doubtful value	400		
Total	$134,600		
Unsecured creditors' claims			$279,000
Consisting of: Filed and accepted	$267,000		
Filed and disputed	5,000		
Not filed	7,000		
Total	$279,000		

No. 3.

THE SPECIAL PRODUCT MANUFACTURING COMPANY

(a) Comparative statement showing the present and revised values and costs for the year ended December 31, 1941

	Tons	Present Costs Per Ton	Present Costs Total	Revised Costs Per Ton	Revised Costs Total	Effect on Year's Profits Increase or Decrease*
Raw Materials:						
Inventory, Jan. 1, 1941	2,000	$26.500	$ 53,000	$20.000	$ 40,000	$13,000
Purchases	19,000	21.053	400,000	21.053	400,000	
Totals	21,000	21.571	$453,000	20.952	$440,000	$13,000
Inventory, Dec. 31, 1941	1,000	22.500	22,500	22.500	22,500	
Materials used	20,000	21.525	$430,500	20.875	$417,500	$13,000
Production Costs:						
Shrinkage and waste	5,000	7.175		6.958		
Net	15,000	28.700	$430,500	27.833	$417,500	$13,000
Other costs (see note)		11.300	169,500	11.300	169,500	
Total production cost	15,000	40.000	$600,000	39.133	$587,000	$13,000
Cost of Product Sold:						
Inventory of finished goods, Jan. 1, 1941	750	50.667	38,000	37.967	28,475	9,525
Total	15,750	40.508	$638,000	39.078	$615,475	$22,525
Inventory of finished goods, Dec. 31, 1941	900	40.000	36,000	39.133	35,220	780
Cost of product sold	14,850	40.539	$602,000	39.074	$580,255	$21,745

NOTE—

Other production costs of $11.30 per ton represents the difference between the net cost of $28.70 per ton and $40.00 per ton, which is the cost of the 900 tons on hand at December 31, 1941, as stated in the problem.

The inventory of finished goods at January 1, 1941, is stated at cost which is lower than market in the revised cost computation. The amount of cost was determined as follows:

Raw materials (at market, which was lower than cost) January 1, 1941	$ 20.000
Add—Shrinkage of (1/3 of $20)	6.667
Other costs	11.300
Total cost, per ton	$ 37.967

(b) Entry that would bring the books into agreement with the new plan if adopted

		Debit	*Credit*
Surplus, January 1, 1941		$ 22,525	
Inventory of finished goods, December 31, 1941			$ 780
Profit and loss (1941)			21,745
To adjust the profits for the year ended December 31, 1941, and the inventories, as follows:			
January 1, 1941, inventories:			
Raw materials	$ 13,000		
Finished goods	9,525		
Total	$ 22,525		
December 31, 1941, inventory:			
Finished goods	780		
Increase in profit for year	$ 21,745		

No. 4.

(a) Columnar analysis showing distribution of insurance account

Date		Debits	Credits	Surplus December 31, 1940	Insurance Expense Year 1941	Prepaid Insurance	Building Account	Receivable from Insurance Company	Due to Insurance Brokers	Profit and Loss
	1940									
July 2	Premium on fire-insurance policy (building) covering period from August 1, 1940, to July 31, 1942	$ 2,400		$ 500	$ 1,200	$ 700				
Aug. 15	Premium on fire-insurance policy on stock of goods, period from August 1, 1940, to July 31, 1941	1,800		750	1,050					
Sept. 1	Premiums on employees' fidelity bonds, period from August 1, 1940, to July 31, 1941	3,000		1,250	1,750					
Oct. 25	Shortage of R. Jones to be reimbursed by Fidelity Insurance Company	900						$ 900		
Dec. 1	Refund due to reduction in rate on fire insurance on building, period December 1, 1940, to July 31, 1942		$ 200	10*	120*	70*				
Dec. 31	Transfer to profit and loss to close out account		7,900							$ 7,900*
		$ 8,100	$ 8,100							
	1941									
Feb. 8	Premium on liability insurance on trucks and salesmen's autos, August 1, 1940, to July 31, 1941	$ 4,500		1,875	2,625					
Mar. 31	Fire insurance on new building during construction, March 31, 1941, to July 31, 1941	7,500					$7,500			
Apr. 5	Additional premium on fire insurance (new building), due to increased valuation, April 15, 1941, to July 31, 1941	250					250			
Apr. 15	Payment by Fidelity Insurance Company, reimbursements for loss, R. Jones, October 25, 1940		$ 900					900*		
July 1	Premium on fire-insurance policy (building) August 1, 1941, to July 31, 1942, covering new building and increased valuation of old building	1,500			625	875				
Aug. 1	Premium on fire-insurance policy on stock of goods, period August 1, 1941, to July 31, 1942	1,400			583	817				
Aug. 1	Premiums on employees' fidelity bonds, August 1, 1941, to July 31, 1942	3,000			1,250	1,750				
Dec. 15	Defalcation of P. Smith to be reimbursed by Fidelity Insurance Company in 1942	2,000						2,000		
Dec. 31	Premium on liability insurance on trucks and autos, period August 1, 1941, to July 31, 1942—$4,500 not paid or recorded				1,875	2,625			$4,500*	
Dec. 31	Transfer to profit and loss to close out account		19,250							19,250*
		$20,150	$20,150	$4,365	$10,838	$6,697	$7,750	$2,000	$4,500*	$27,150*

* Red.

(b) Entries to adjust surplus, profit and loss, and other December 31, 1941, balance-sheet headings involved

	Debit	*Credit*
Insurance account	$27,150	
Surplus, December 31, 1941		$ 7,900
Profit and loss, 1941		19,250

To reverse the closing entries for the years ended December 31, 1940, and 1941.

Surplus	4,365	
Profit and loss, 1941 (insurance expense)	10,838	
Prepaid insurance	6,697	
Building (cost)	7,750	
Receivable from insurance company	2,000	
Due to insurance brokers		4,500
Insurance account		27,150

To distribute and close out the balance in the insurance account.

No. 5.

FLINT, DURANT AND NASH (co-partnership)

(a) Computation of partnership's liquidating loss for the year ended December 31, 1941

Net assets of the partnership, January 1, 1941 (as represented by the partners' capital)	$48,000
Operating profit for the year 1941	7,200
Total	$55,200
Less—drawings of partners for the year, 1941	12,000
Balance of partners' capital, December 31, 1941	$43,200
Add—balance due creditors on December 31, 1941	8,400
Total of loss	$51,600

(b) Statement of partnership's liquidation

	Assets	Creditors	Flint	Durant	Nash
Capital, January 1, 1941	$48,000		$10,000	$ 8,000	$30,000
Profit for the year, 1941	7,200		2,400	2,400	2,400
Total	$55,200		$12,400	$10,400	$32,400
Withdrawals during year, 1941	12,000		6,000	4,000	2,000
Balances	$43,200		$ 6,400	$ 6,400	$30,400
Liabilities to creditors	8,400	$ 8,400			
Balances	$51,600	$ 8,400	$ 6,400	$ 6,400	$30,400
Loss charged off	51,600		17,200	17,200	17,200
Balances		$ 8,400	$10,800*	$10,800*	$13,200
Flint deficiency charged to:			10,800		
Durant 50%				5,400*	
Nash 50%					5,400*
Balances		$ 8,400		$16,200*	$ 7,800
Cash paid in by Durant	$16,200			16,200	
Balances	$16,200	$ 8,400			$ 7,800
Cash paid to creditors and Nash	16,200*	8,400*			7,800*

(*) Red.

(c) Profit and loss and partners' accounts, closed out after liquidation

Profit and Loss

Debits		*Credits*	
Flint ⅓	$ 2,400	Operating profit for the year 1941	$ 7,200
Durant ⅓	2,400		
Nash ⅓	2,400		
	$ 7,200		$ 7,200
Liquidating loss per (a)	$51,600	Flint ⅓	$17,200
		Durant ⅓	17,200
		Nash ⅓	17,200
	$51,600		$51,600

Partners' Accounts

Flint

Drawings	$ 6,000	Capital investment	$10,000
Liquidating loss (a)	17,200	Operating profit, 1941	2,400
		Balance charged to:	
		Durant ½	5,400
		Nash ½	5,400
	$23,200		$23,200

Durant

Drawings	$ 4,000	Capital investment	$ 8,000
Liquidating loss (a)	17,200	Operating profit, 1941	2,400
Flint deficiency ½	5,400	Cash paid to cover deficiency	16,200
	$26,600		$26,600

Nash

Drawings	$ 2,000	Capital investment	$30,000
Liquidating loss (a)	17,200	Operating profit, 1941	2,400
Flint deficiency ½	5,400		
Cash (balance of capital)	7,800		
	$32,400		$32,400

Answers to Examinations of November, 1942

Auditing

November 12, 1942, 9 a.m. to 12:30 p.m.

No. 1.

Advantages:

(1) Serves as an outline of the various phases of systems of internal control.

(2) Tends to emphasize weaknesses in the system followed by a particular client.

(3) Serves as a base against which to check in future engagements what changes, if any, had been made in the system.

(4) Tends to greater uniformity, aids in reviewing the work of the various staff members and in writing the reports.

Disadvantages:

(1) Creates a tendency to avoid responsibility and independent thought.

(2) Suggests answers.

(3) Restricts answers to the size of the space allotted.

No. 2.

The following is quoted from "Extensions of Auditing Procedure" issued on October 18, 1939, by the American Institute of Accountants: ". . . if such exceptions are sufficiently material to negative the expression of an opinion, the auditor should refrain from giving any opinion at all, although he may render an informative report in which he states that the limitations or exceptions relating to the examination are such as to make it impossible for him to express an opinion as to the fairness of the financial statements as a whole."

Accordingly, the auditor should qualify his opinion by stating the limitations relating to the examination; to wit, the restriction to an examination of the home-office records only, and to the omission of a direct confirmation of the receivables.

No. 3.

(1) Examine a certified copy of the will, noting any restrictions as to the investments, principal, income, etc.

(2) Prepare a columnar schedule describing the mortgages and bonds

received from the executors and listing the par and market values.

(3) Obtain from the trust company a statement of purchases and sales of securities, and of the income collected. These transactions should be posted to the columnar work sheet.

(4) Compute and enter on the work sheet the gain or loss on the sales of securities. Such gain or loss is an increase or decrease in principal. The purchases and sales should be checked for proper authorization.

(5) Extend into separate columns the par and book values of the securities on hand at the end of the year.

(6) Ascertain the amount of the accrued interest at the date of the bequest, and allocate the collections during the period between principal and income. The premium on the bonds received by bequest does not have to be amortized as does the premium on bonds subsequently purchased.

(7) Account for all income; verify any in default, and determine that any restricted income is properly accounted for.

(8) Check the work sheet against the books to see that the transactions have been properly recorded.

(9) Verify the cash and securities held at the balance-sheet date by direct confirmation from the trust company.

No. 4.

The following form of request may be printed or stamped on the statement of the customer's account:

Please examine this statement at your earliest convenience and report any exceptions thereto directly to our auditors,

X. Y. & Co.
217 South La Salle Street,
Chicago, Illinois.

No. 5.

The auditor should maintain control of all the cash, cash items, and negotiable instruments until he has completed his audit of such items. This may be accomplished by distributing the staff and making cash counts and security verifications simultaneously, or by placing the securities under seal while the cash is being counted. Representatives of the bank should be required to be in attendance with all members of the accountant's staff.

(1) Cash:

All cash should be counted; bundles of bills and rolls of coin should be tested. All cash and clearing items, checks, money orders, etc., should be forwarded for clearing under the control of the auditor and should be followed up to see that the proceeds have been credited to the account of the bank. The amount due from banks should be verified by requesting confirmations from all the banks, together with statements of the client's bank account from the date of the last statement to the date of the audit, so that all transit items may be checked. The statements should then be reconciled with the ledger accounts.

(2) Loans and discounts:
The notes should be examined for formality and negotiability; and confirmed by direct correspondence with the borrowers. The signatures and endorsements on the larger items should be compared with the signatures on record. Notes discounted or out for collection should be confirmed. The registers should be footed and proved to the controls. All the collateral indicated by the registers should be found, examined, and valued. The collateral should be examined to ascertain that it has been endorsed or is accompanied by a power of attorney. Demand loans long outstanding and past-due time loans (even though secured by collateral) should be examined to determine whether a reserve for loss is required. Amounts due from officers and directors should be shown separately.

(3) Due to depositors:
The ledger balances should be proved to the controls. The overdrafts should be listed and the credit standing of these accounts should be reviewed with the officers. Inactive accounts should be carefully examined and reviewed. While the best verification would be by direct confirmation of all the deposits, this practice is uncommon. Hence, particular attention should be paid to the adequacy of the system of internal control and audit procedures used by the client.

No. 6.

(1) The check number, date, payee, and the amount should be compared with the entry in the cash disbursement or check record. The purpose of this comparison is to determine the correctness of the entries and the extent to which the record may be relied upon.

(2) All check numbers should be accounted for in order to ascertain that no blank checks have been removed for possible unauthorized purposes.

(3) The date of issuance of the check should be compared with the date recorded in the register to learn whether the client has been issuing postdated checks.

(4) The payee and the endorsements should be compared to see that the endorsements are proper; if irregular, such fact may indicate a defalcation.

(5) The date of the check should be compared with the date of the bank's cancellation. If an unreasonable lapse of time occurred between the two dates, it may indicate a defalcation or an irregularity in the reconciliation of the bank account.

(6) The date, number, and amount of the checks issued in prior months should be checked against the list of outstanding checks in the preceding month's bank reconciliation, in order to verify that portion of the reconciliation.

(7) The signatures on the checks should be examined in order to learn whether any have been signed by someone without authority.

No. 7.

(a) Inventories:

(1) The detailed stock records should not be kept in either the receiving or shipping departments, as such records control the flow of merchandise in and out.

(2) The general ledger and detailed stock records should be kept by separate persons and, if possible, in separate departments, since the general ledger carries accounts controlling the detailed stock records.

(3) Departmental, or sectional, physical inventories should be taken continuously and checked against the detailed stock records to determine any discrepancies or errors. Adjustments should be made, both in the stock records and in the general ledger controlling accounts for any changes which are noted in such checking.

(4) In addition to the tests under (3), a complete physical inventory should be taken, priced, computed, and summarized at least once a year by persons not responsible for its control during the year.

(5) Sales should be costed in order to ascertain the cost of goods sold, and the cost of goods on hand at any given time.

(b) Payrolls:

(1) The time tickets or record should be approved by the foremen.

(2) The amount of the payroll should be determined by someone not connected with the timekeeper's, or the cashier's department, and should not be the person who distributes the payroll to the employees.

(3) If paid in currency, the same person who fills the envelopes should not be permitted to distribute them to the employees.

(4) If paid by check, the bank account should be reconciled by someone who has no part in the preparation or distribution of the payroll. The endorsements should be checked periodically against the signatures on the employees' records.

(5) Unclaimed wages paid in currency should not be held beyond a reasonable time, before being redeposited.

(c) Petty Cash Fund:

(1) The fund should be fixed in amount and operated on the imprest system.

(2) The petty cashier should not have access to cash receipts.

(3) The petty cashier should not make disbursements unless authorized by designated responsible persons.

(4) The vouchers should be printed and should provide for the spelling out of the amount to be paid.

(5) After reimbursement, the petty cash vouchers should be canceled and filed where they may not be accessible to the petty cashier.

(6) It should be required that the vouchers be made out in ink.

No. 8.

The significant facts should be disclosed in the auditor's report or as footnotes to the financial statements. If the amount of the probable loss is substantial, it would be well to recommend that the directors set aside a surplus reserve. A substantial charge during the year may be set forth as a separate item in the profit-and-loss statement.

No. 9.

(a) Objections to any cost accounting principle applied:

(1) Charging all the overtime to the contract; and

(2) Considering the overtime premium as direct-labor cost upon which burden was distributed.

(b) Incorrect effect in the client's statements:

The total contract cost was overstated because—

(1) The total overtime premium was charged as cost;

(2) The burden cost was overstated in basing it upon the overstated direct labor; and

(3) The burden variance adjustment was predicated upon an inaccurate base.

(c) Procedure to follow in making a revised cost determination:

(1) Determine the total direct labor, exclusive of overtime, charged to the contract and to the regular business of the company.

(2) Determine the amount of the overtime premium.
(3) Add the overtime premium to the rest of the burden.
(4) Determine the percentage of the burden, including the overtime premium, to the total of the direct-labor cost on the contract and the regular business of the company.
(5) Apply the burden rate determined under (4) to the direct-labor cost of the contract.
(6) The total of the cost of materials used, and the revised direct-labor cost and burden will be the correct cost of the contract.

No. 10.

The term "natural business year" is defined by the Natural Business Year Council as "that period of twelve consecutive months which ends when the business activities of the enterprise have reached the lowest point in their annual cycle."

To determine the natural business year of a manufacturing concern, a columnar work sheet showing the balances of the following accounts at each month end should be prepared:

Accounts receivable
Notes receivable
Inventories (by classes)
Accounts payable
Bank loans
Notes payable

In addition, the sales and production for each month should be shown.

The end of the natural business year will be the month end when most of the above balances reach their lowest point. The production and sales will start to fall off in all probability a month or two earlier.

No. 11.

(a) Suggested plan:

The auditor should visit the plant a few weeks prior to the date on which the inventory is to be taken in order to make a survey of the methods used in storing and handling the inventory and to examine he records accounting for it. A meeting should be held with the storekeeper and the personnel who are to make the physical count at which time the plan may be discussed in some detail and questions answered.

The personnel should be paired off—one to do the actual counting—the other to record on duplicate prenumbered inventory sheets. As each sheet is completed, both should sign the sheets after indicating the location, section, or bin.

The storekeeper should not have control over the inventory sheets, nor be permitted to count or record any part of the inventory.

After the inventory has been taken, the sheets should be accounted for by number. The originals should be sent to the accounting department for pricing and computing, and the duplicates given to the auditor.

A check of the physical inventory should then be made against the perpetual-inventory records which should be brought into agreement with the physical inventory. If any large differences appear, the matter should be investigated immediately.

At the close of the day, the work-in-process inventory may be taken by several crews by segregating the parts, sub-assemblies, and main assemblies in order to simplify the count.

(b) Auditing procedure:

(1) Be present at the inventory-taking to ascertain that the employees are following the procedures outlined to them at the earlier meeting.

(2) Test check some of the quantities against the duplicate copy and the perpetual inventory.

(3) Make tests of the computations, quantities, and prices.

(4) Exclude all goods received on consignment and those goods billed and held for the customer.

(5) Compare pricings with recent invoices or quoted prices.

(6) Make inquiries or tests to determine that purchase entries have been made for all goods included in the inventory.

(7) Determine the propriety of the inventory classification.

(8) Make tests to ascertain that damaged or obsolete stock, discontinued lines, or excessive quantities are not carried at greater than realizable values; make tests of the detailed stock records to determine if quantities are reasonable in relation to the average consumption and purchases.

(9) Ascertain if any of the inventory is pledged.

(10) Apply the gross-profit test if the average gross profit has been fairly constant.

(11) Ascertain that the beginning and ending inventories are on the same basis.

(12) Compare the inventory turnover.

(13) Analyze the controlling accounts.

(14) Obtain an inventory certificate.

No. 12.

Bank certificates of deposit should be verified simultaneously with cash and other negotiable instruments. Request direct confirmation from the issuing bank. If on hand, the certificate should be examined. If in the hands of others, direct confirmation should be obtained from the holder.

If the certificate is payable on demand, it may be shown with the cash in banks. If it is a time certificate, it should be shown separately; as a current asset, if short term—as an investment, if long term. If it is hypothecated or encumbered, such fact must be disclosed in the statement.

November 12, 1942, 1:30 to 7:30 p.m.

No. 1.

THE LASKO MINING COMPANY

COMPARATIVE STATEMENT OF MINING AND REDUCING COSTS
COST OF SALES, AND GROSS PROFITS
For the Year Ended December 31, 194–

	Company's Method			Revised Method		
	Units	Per Unit	Amount	Units	Per Unit	Amount
Sales	220,000	$5.31	$1,168,200.00	220,000	$5.31	$1,168,200.00
Cost of sales:						
Raw ore:						
Inventory, January 1	50,000	4.00	$ 200,000.00	50,000	1.0428	$ 52,140.00
Ore produced	200,000	4.345	869,000.00	200,000	—	—
Mining expenses	—	—	—	—	.9945	198,900.00
Total	250,000	4.276	$1,069,000.00	250,000	1.00416	$ 251,040.00
Inventory, December 31	20.000	4.345	86,900.00	20,000	.9945	19,890.00
Ore used	230,000	4.27	$ 982,100.00	230,000	1.005	$ 231,150.00
Processing:						
Inventory, January 1	5,000	4.40	22,000.00	5,000	1.27	6,350.00
Reducing plant expenses	—	—	629,850.00	(a)	2.85	629,850.00
Mining expenses	—	—	198,900.00	—	—	—
Total	235,000	7.7994	$1,832,850.00	235,000	3.6909	$ 867,350.00
Inventory, December 31	15,000	4.7795	71,692.50	15,000	1.290(b)	19,350.00
Total processed	220,000	8.0053	$1,761,157.50	220,000	3.8545	$ 848,000.00
Less ore lost in processing	20,000	—	—	20,000	—	—
Oxylite produced	200,000	8.8058	$1,761,157.50	200,000	4.24	$ 848,000.00
Oxylite:						
Inventory, January 1	25,000	8.39	209,750.00	25,000	4.328	108,200.00
Total available	225,000	8.7596	$1,970,907.50	225,000	4.2498	$ 956,200.00
Inventory, December 31	5,000	8.39	41,950.00	5,000	4.24	21,200.00
Oxylite sold	220,000	8.7679	$1,928,957.50	220,000	4.25	$ 935,000.00
Gross profit (loss*) on sales	220,000	3.4579*	$ 760,757.50*	220,000	1.06	$ 233,200.00
"Earnings" account			869,000.00			
Gross profit	220,000	.4920	$ 108,242.50			

(a) Tons processed

Inventory, January 1, (5,000 tons)—90%	4,500
Ore processed (230,000 tons transferred less 15,000 tons in inventory)	215,000
Inventory, December 31 (15,000 tons)—10%	1,500
	221,000

(b) Tonnage value of closing work-in-process inventory:

Cost of ore used—per ton (as above)	$1.005
Processing cost—per ton ($2.85)—10%	.285
	$1.290

No. 2.

(a) The predecessor probably had some stock which it had reacquired prior to the reorganization. This stock should have been canceled as a part of the reorganization plan and should not have been taken over by the successor corporation. The balance in the account should be charged to the goodwill or surplus arising from the consolidation.

(b) The stock certificates should be examined, the existence of the corporation and its assets and liabilities should be verified, and the basis of the valuation should be ascertained. If the company is still in existence, the investment account should be eliminated and its assets and liabilities should be consolidated with the parent company. If not in existence, the balance should be charged off to surplus arising from consolidation.

(c) The stockholders and directors should have authorized or approved the acquisition of the 140 shares of common stock and the issuance of the bonus shares to the management. The basis of the valuation of the bonus stock should have been authorized or approved by the directors. The 47 shares on hand should be deducted from the capital-stock account in the balance-sheet at a valuation consistent with the statutes of the state of incorporation.

(d) The stockholders and directors should have authorized or approved the repurchase of this stock and the amount paid for it. If it is to be held in the treasury it should be deducted at cost from the total of the capital-stock and surplus accounts in the balance-sheet. If not to be reissued, the par of the stock should be charged against the preferred-stock account, the premium against the premium on preferred-stock account, and the remainder ($12 per share) against the earned surplus acccunt.

(e) The directors' and stockholders' minutes of their meetings, the charter, by-laws, and statutes of the state of incorporation should be checked for the authority to repurchase the common stock in the open market. The treatment in the balance-sheet would be similar to that given under (d) above.

(f) The stockholders' minutes of their meetings, the charter, by-laws and statutes should be checked to ascertain whether the issuance of fractional shares was authorized. If so, the credit balance should have been credited to the stock dividend. To correct at this time, the credit should be made to the earned-surplus account. It is also possible that a stock dividend was paid on the common stock held in the treasury.

(g) The directors' and stockholders' minutes, the charter, by-laws, and state statutes should be checked to ascertain that the sales were properly authorized, and that the price was approved by the directors. The excess of the selling price over the cost should be credited to paid-in surplus, or, if permissible under the state statutes, it may be credited to earned surplus.

No. 3.

Adjusting entries not recorded on the books of Parathon Distributing Company at December 31, 1941

(1)

	Debit	*Credit*
Building and equipment	$ 2,428	
Operating expenses		$ 2,428
To capitalize certain building improvements made during the year, which charges were erroneously made to operating expenses.		

(2)

	Debit	*Credit*
Merchandise sold	22,500	
Inventories		22,500
To reduce the valuation of the closing inventory from cost to market value.		

PARATHON DISTRIBUTING COMPANY

STATEMENT OF PROFIT AND LOSS

For the Year Ended December 31, 1941

Sales		$2,887,000
Merchandise sold		1,907,796
Gross profit on sales		$ 979,204
Deduct:		
Operating expenses	$ 865,890	
Depreciation expense	12,581	
Bad debts	31,040	
Property and income taxes	8,905	
Interest expense	22,500	
Amortized debt discount	2,000	
Total expenses		942,916
Net income for the year		$ 36,288

(a) PARATHON DISTRIBUTING COMPANY

Balance-sheet—December 31, 1941

Assets

Current assets:			
Cash		$183,522	
Customers' accounts	$302,496		
Less reserve for bad debts	36,200	266,296	
Receivable from Paragon Mills, Inc.		173,452	
Inventory (cost $89,434), at market value		66,924	$690,194
Building and equipment:			
Cost		$245,028	
Less reserve for depreciation		23,647	221,381
Unamortized debt expense			23,000
Total			$934,575

Liabilities and Net Worth

Current liabilities:			
Accounts payable for operating expenses		$126,886	
Accrued taxes		12,189	
Accrued interest		22,500	$161,575
4½% income bonds (due July 1, 1953)			500,000
Net worth:			
Capital stock		$ 10,000	
Surplus:			
Balance, January 1, 1941	$ 68,260		
Profit for the year 1941	36,288		
Total	$104,548		
Deduct dividends paid during 1941	15,000		
Remainder	$ 89,548		
Add refund due from Paragon Mills, Inc. (c)	173,452	263,000	273,000
Total			$934,575

(b) PARATHON DISTRIBUTING COMPANY

SUMMARY OF RECEIPTS AND DISBURSEMENTS

For the Year Ended December 31, 1941

Receipts:

Customers accounts collected:		
On sales during 1940:		
Balance at December 31, 1940	$ 246,510	
Less amount charged off	4,600	$ 241,910

On sales during 1941:				
Sales		$2,887,000		
Less amount uncollected at December 31, 1941		302,496	2,584,504	
Total			$2,826,414	
Bad debts recovered during 1941			1,260	
Total receipts				$2,827,674
Disbursements:				
Merchandise purchased from Paragon		$1,885,286		
Add inventory, December 31, 1941 (at cost)		89,434		
Total		$1,974,720		
Deduct inventory, January 1, 1941 (at cost)		22,940	$1,951,780	
Operating expenses:				
Operating expenses per books (as adjusted)		$ 865,890		
Add accounts payable, January 1, 1941		131,000		
Total		$ 996,890		
Deduct:				
Loss on equipment retired	$ 2,528			
Accounts payable, December 31, 1941	126,886	129,414	867,476	
Taxes:				
Property and income tax expense		$ 8,905		
Add accrual at January 1, 1941		37,767		
Total		$ 46,672		
Deduct accrual at December 31, 1941		12,189	34,483	
Interest:				
Interest expense		$ 22,500		
Add accrual at January 1, 1941		11,250		
Total		$ 33,750		
Deduct accrual at December 31, 1941		22,500	11,250	
Additions to buildings and equipment			14,200	
Building improvements			2,428	
Dividends paid			15,000	
Total disbursements				2,896,617
Excess of disbursements over receipts				$ 68,943

Proof

Cash, January 1, 1941	$ 252,465
Cash, December 31, 1941	183,522
Excess of disbursements over receipts	$ 68,943

(c) PARATHON DISTRIBUTING COMPANY

COMPUTATION OF THE AMOUNT TO BE REFUNDED BY PARAGON

December 31, 1941

Under "net earnings" guarantee:		
Excess of disbursements over receipts (b)	$ 68,943	
Deduct interest paid during the year 1941	11,250	
Remainder	$ 57,693	
Add 200% of the interest falling due each year	45,000	
Amount receivable under the "net earnings" guarantee		$ 102,693
Under net tangible assets guarantee:		
Tangible assets:		
Cash	$ 183,522	
Customers accounts (less reserve)	266,296	
Inventory at market value	66,924	
Building and equipment (net)	221,381	
Total	$ 738,123	
Less current liabilities	161,575	
Net tangible assets before "net earnings" guarantee	$ 576,548	
Add amount receivable under Paragon's guarantee of "net earnings"	102,693	
Total	$ 679,241	
150% of Parathon's funded debt	750,000	
Amount receivable under the net tangible assets guarantee		70,759
Total amount receivable from Paragon under the guarantee		$ 173,452

Commercial Law

November 13, 1942, 9 a.m. to 12:30 p.m.

GROUP I

No. 1.

(a) This provision in the contract would be invalid because in effect it would be usurious. Compound interest means interest upon interest; for example, when a sum of money due for interest is added to the principal and then bears interest.

(b) This agreement would be valid because based on a new consideration, namely, the forebearance of the creditor to enforce payment of the interest when it was due.

No. 2.

(a) Executor is a person or corporation to whom the carrying out of the provisions of a will concerning personal property has been confided by the testator in his will and who has been duly appointed by the court.

Administrator is a person appointed by the court to collect and distribute the personal property of a person who has died without leaving a valid will, or of a testator where there is no executor.

Trustee is a person or corporation appointed by will or by deed or by a court to hold property of any kind for the benefit of another.

(b) The duties of an executor, in general, are to collect and distribute the decedent's personal property, taking care, in the distribution, of administration and funeral expenses, claims of creditors, and taxes.

The duties of an administrator, in general, are the same as those of an executor.

The duties of a testamentary trustee, in general, are to conserve the trust fund and administer it in accordance with the terms of the trust.

(c) An executor's account is a formal, written statement of his receipts and payments or distributions of estate assets and income. The purpose of it is to report these facts to the court and to all persons interested in the estate, and thus to disclose the balances of principal and income remaining in the executor's possession.

(d) The executor is primarily responsible. He cannot bind the estate, but if the payment of the fee was a legally proper charge against the estate, the executor will be reimbursed by being allowed credit for it in his account.

No. 3.

(a) Transactions (1) and (2) are bailments because each is a delivery of personal property by one person to another to be held according to the purpose of the delivery and to be returned or delivered to some other person when that purpose has been accomplished. Transaction (3) is not a bailment because custody is exercised by the servant in the name of the master, under whose immediate control the servant at all times acts.

(b) (1) The bailee need exercise only that degree of care which a reasonably prudent person would use with respect to similar property of his own at the same time and in the same circumstances. He is responsible to the bailor for injury or loss which was either intentional or due to his gross negligence.

(2) The bailee must exercise the highest degree of care. He is liable to the bailor for injury or loss resulting from any negligence, even though slight, or from any deviation from the terms of the bailment. He is responsible also for injury or loss which was intentional.

(3) The bailee is held only to such degree of care as would be reasonable in the circumstances, but if he deviates from the terms of the bailment he becomes an insurer and liable for any injury or loss. He is responsible also for injury or loss which was intentional.

No. 4.

The lien of the mortgage covered the machine and its coils. In determining whether personal property attached to real property is a fixture, three factors should be considered: (1) Method of annexation or attachment to the building; (2) the use made of that part of the building to which the property is attached; and, (3) the intention of the person making the annexation to make it permanent. Of these, the most important is the third one. In this case, intended permanency was shown by the fact that the owner of the building installed the machinery which was adapted and essential to the business conducted in the building, and by its size and the manner of attachment. The fact that the machine and coils could be removed without damage to the property is not sufficient to overcome the weight of the other facts.

No. 5.

Marshaling of assets is a purely equitable right, not based in any way upon contract or other legal rights. It is the control of legal claims by creditors in such a way as to assure an equitable distribution of funds when various creditors have liens or other security affecting some but not all of the debtor's properties. For example, if X has a mortgage on two parcels of land belonging to the debtor and Y has a second mortgage on one of the same parcels but no other security, equity will compel X to exhaust his remedy against the parcel not covered by Y's mortgage before he proceeds against the other one. In that way, both X and Y may be fully protected, whereas Y might lose all of his security if X exercised his legal right to foreclose first on the parcel on which Y held a second, and therefore junior, mortgage.

GROUP II

No. 6.

(a) A fiduciary is not controlled by the beneficiaries, but acts independently of them, being accountable to them for any breach of trust. He has control over the subject matter of the trust, and cannot be discharged or relieved from duty by the beneficiaries. An agent is accountable directly to his principal and is subject to his direction and control. The significance of this distinction lies in the fact that a fiduciary is required to make tax returns for the individual, estate, or trust for which he acts; whereas, an agent is merely a representative of his principal and the tax return is made by the principal.

(b) "Basis" is the term used in place of the term "cost" when the law requires that cost must be adjusted (for example, by capital expenditures applicable to property after its acquisition), or when fair market value must be used in lieu of cost, or when the cost to some prior owner must be used in lieu of the cost to the present owner; in order to determine gain or loss on the sale or other disposition of property, or to fix the amount on which allowable depreciation can be computed. The basis itself may require adjustment; for example, A purchased the X building and subsequently gave it to B. B exchanged the X building for the Y building (in a tax-free exchange) and subsequently gave the Y building to C. In determining C's gain from a sale or exchange of the Y building, the basis of the Y building must be reduced by deductions for depreciation on the X building while held by A and B and on the Y building while held by B and C.

(c) Examples: Exclusion—proceeds of life insurance excluded from gross income. Exemption—taxpayer's personal exemption deducted from net income. Deduction—ordinary and necessary expenses deducted from gross income. Credit—foreign income tax deducted from U. S. income tax.

(d) Boot is property or money received on an exchange in addition to property received tax-free on the exchange. Gain is recognized to the extent of the boot but no loss of any kind is recognized.

No. 7.

The restaurant's refusal to pay is legally justifiable. The corporation is not permitted to recover any part of the contract price because the contract was in violation of a state law. The law will not aid either party to an illegal contract to enforce it, will not aid a party who has fulfilled his part to recover money or property from the other, and will not recognize any right of action founded on the illegal contract.

No. 8.

This contract can be terminated at will by either party without notice. Parties to a contract can legally stipulate for performance perpetually, but this must be shown by clear and unequivocal language. There was no such language in this contract.

No. 9.

(a) This endorsement was not a forgery because the endorser was the person intended by the drawer to be the payee.

(b) If it had been a forgery, the bank would have had a right to recover the amount of the check from the endorser, to whom it was paid, and would have been obliged to cancel any charge against the drawer's account for the amount of the check. A drawer's account cannot legally be charged for unauthorized payments made by the bank, and a payment to anyone other than the designated payee would be one unauthorized by the drawer.

No. 10.

(a) The stockbroker has this legal right, in order to facilitate prompt sale if such sale becomes necessary.

(b) Waldron is obliged to accept this offer. The stockbroker is accountable for the number of shares of each kind of stock received by him, but he is not required to return the identical certificates received because a certificate is merely evidence of ownership and all shares of the same kind of stock in the same corporation are of equal value.

No. 11.

(a) Railroads, express companies, sleeping-car companies, telephone companies, pipe-line companies. Others are: telegraph companies, cable companies, motor-bus companies, and certain facilities used by railroads, such as bridges, car floats, lighters, ferries, and tug boats.

(b) Interstate Commerce Commission. The book containing the plan of the uniform system of accounts, records, and memoranda, and all published rulings on that system, should be obtained from the Commission in Washington, or from a local office of the Commission's bureau of accounts.

(c) A bill of lading is a written acknowledgment by a carrier that it has received from a shipper the goods therein described to be transported on the terms and to the place therein specified. It is both a receipt and a contract. It is negotiable when it states that the goods specified in it are consigned to the order of a person named in it.

(d) (1) The carrier is liable as an insurer and thus is absolutely responsible for the safe delivery of goods shipped except as noted below. It is not permitted to relieve itself from responsibility from damage caused by its negligence, but it is permitted to contract that in consideration of reduced freight rates it shall not be responsible for losses not caused by its own negligence. A carrier is not responsible for losses caused by acts of God (e.g., a flood or other event for which no human act was responsible), by seizure by an enemy in wartime or by an officer of law under legal process in peacetime, or losses caused by the shipper (e.g., by improper packing), or for losses due to the inherent nature of the goods (if the carrier uses ordinary care).

(2) The carrier is liable only for death or injury caused by its own negligence, but the negligence may be slight because the carrier must exercise the utmost practicable care. This rule applies to roadbed, cars, stations, all other equipment, the operation of trains, and the control of its employees and passengers.

No. 12.

(a) Any new and useful art, machine, manufacture, composition of matter, or any new and useful improvement thereof, not known or used or patented by any other person prior to invention or discovery by the patentee.

(b) The first person who made the invention or discovery.

(c) Seventeen years.

(d) Generally speaking, either an action at law for damages or an action in equity for an injunction and, as incidental thereto, an accounting for profits and damages.

Accounting Theory and Practice – Part II

November 13, 1942, 1:30 to 7:30 p.m.

No. 1.

(a) ESTATE OF SAMUEL GIFFORD

JOHN DOE, EXECUTOR

EXECUTOR'S CHARGE AND DISCHARGE STATEMENT

From August 15, 1941, to June 30, 1942

As to principal

I charge myself with:				
Inventory of assets filed with the court on August 15, 1941				$116,687.07
Assets subsequently discovered:				
Cash in Second National Bank			$ 2,500.00	
Cash in the office safe			125.50	
Life insurance collected			58,000.00	
Dividend on A. B. Company preferred stock declared on June 1, 1941			1,250.00	61,875.50
Profits on sales of the following:				
	Selling Price	Inventory Value	Profit	
One-half of A. B. Company preferred stock	$13,500.00	$11,432.50	$ 2,067.50	
Parkhurst Transit Company common stock	200.00	100.00	100.00	
Totals	$13,700.00	$11,532.50	$ 2,167.50	2,167.50
Total				$180,730.07
I credit myself with:				
Property taxes accrued at date of death			$ 1,575.20	
Household debts at date of death			2,111.00	
Specific bequests			20,000.00	
Executor's fee			1,000.00	
Estate tax			18,262.50	
Funeral expenses			750.00	
Court costs			88.50	
Widow's allowance			4,800.00	48,587.20
Balance of principal at June 30, 1942, per schedule (b)				$132,142.87

As to income

I charge myself with:			
Rents received		$ 4,526.00	
Dividends received ($4,025 minus $1,250)		2,775.00	
Interest accrued on U. S. Savings Bonds:			
2.9% on $37,500 for 15 months	$ 1,359.38		
Less—accrued to date of death	326.25	1,033.13	$ 8,334.13
I credit myself with:			
Property taxes ($3,336.95 minus $1,575.20)			1,761.75
Balance of income at June 30, 1942, as below:			
Income cash, per schedule (c)		$ 5,539.25	
Accrued interest on U. S. Savings Bonds, per above		$ 1,033.13	
Total			$ 6,572.38

(b) ESTATE OF SAMUEL GIFFORD

John Doe, Executor

Inventory of Principal, June 30, 1942

Cash, per schedule (c)		$ 33,571.92
Real estate, valued by court appraiser at		38,750.00
Home furnishings		6,824.00
Stocks, at market:		
A. B. Company, preferred	$11,432.50	
A. B. Company, common	3,738.20	15,170.70
U. S. Savings Bonds		37,500.00
Accrued interest on U. S. Savings Bonds		326.25
Total inventory of principal schedule (a)		$132,142.87

(c) ESTATE OF SAMUEL GIFFORD

John Doe, Executor

Statement of Principal and Income Cash

For the Period July 18, 1941, to June 30, 1942

Principal cash

In First National Bank:		
Balance, July 18, 1941		$ 4,533.12
Transferred from other banks:		
From the Second National Bank	$ 2,500.00	
From the closed bank	465.00	2,965.00

Deposit of cash in the office safe			125.50
Receipts:			
Life insurance collected		$58,000.00	
Dividend on A. B. Company, preferred		1,250.00	
Proceeds from the sale of stocks:			
A. B. Company, preferred	$13,500.00		
Parkhurst Transit Company, common	200.00	13,700.00	72,950.00
Total			$ 80,573.62
Deduct:			
Disbursements, per charge and discharge statement, schedule (a)			48,587.20
Balance in the First National Bank, June 30, 1942			$ 31,986.42
In closed bank:			
Balance, July 18, 1941		$ 2,050.50	
Transferred to the First National Bank		465.00	1,585.50
Total principal cash, June 30, 1942, schedule (b)			$ 33,571.92
Income cash			
In First National Bank:			
Rents received		$ 4,526.00	
Dividends received		2,775.00	
Total		$ 7,301.00	
Deduct—disbursements per charge and discharge statement, schedule (a)		1,761.75	
Total income cash, June 30, 1942			5,539.25
Total principal and income cash			$ 39,111.17

No. 2.

BOYLSTON MANUFACTURING COMPANY

STATEMENT SHOWING COMPUTATIONS OF ADJUSTED UNIT COSTS

for the years 1940 and 1941

	Product A			Product B			Product C		
	1941	*1940*	*Increase or Decrease**	*1941*	*1940*	*Increase or Decrease**	*1941*	*1940*	*Increase or Decrease**
Units sold	(600)	(500)	(100)	(1,600)	(2,500)	(900*)	(1,250)	(1,000)	(250)
Net sales	$120,000	$100,000	$20,000	$40,000	$50,000	$10,000*	$25,000	$25,000	$ —
Unit selling price	($200.00)	($200.00)	(—)	($25.00)	($20.00)	($ 5.00*)	($20.00)	($25.00)	($5.00*)
Cost of sales:									
Materials used:									
Per production accounts	$ 60,000	$ 40,000	$20,000	$13,000	$10,000	$ 3,000	$10,000	$16,000	$ 6,000*
Transfer to products A(4/5) and B(1/5), the $8,000 of excessive cost of materials included in the cost of product C for 1940	—	6,400	6,400*	—	1,600	1,600*	—	8,000*	8,000
Materials used, as adjusted	$ 60,000	$ 46,400	$13,600	$13,000	$11,600	$ 1,400	$10,000	$ 8,000	$ 2,000
Per unit	($100.00)	($ 92.80)	($ 7.20)	($ 8.125)	($ 4.64)	($ 3.485)	($ 8.00)	($ 8.00)	($ —)
Labor	15,000	10,000	5,000	10,000	5,000	5,000	15,000	9,000	6,000
Per unit	($ 25.00)	($ 20.00)	($ 5.00)	($ 6.25)	($ 2.00)	($ 4.25)	($12.00)	($ 9.00)	($3.00)
Overhead (redistributed on a direct-labor cost basis):									
1941—15/40-10/40-15/40	9,375			6,250			9,375		
1940—10/24-5/24-9/24		6,250	3,125		3,125	3,125		5,625	3,750
Per unit	($ 15.625)	($ 12.50)	($ 3.125)	($ 3.90625)	($ 1.25)	($ 2.65625)	($ 7.50)	($ 5.625)	($1.875)
Total cost of sales	$ 84,375	$ 62,650	$21,725	$29,250	$19,725	$ 9,525	$34,375	$22,625	$11,750
Per unit	($140.625)	($125.30)	($15.325)	($18.28125)	($ 7.89)	($10.39125)	($27.50)	($22.625)	($4.875)
Gross profit on sales	$ 35,625	$ 37,350	$ 1,725*	$10,750	$30,275	$19,525*	$ 9,375*	$ 2,375	$11,750*
Per unit	($ 59.375)	($ 74.70)	($15.325)	($ 6.71875)	($12.11)	($ 5.39125)	($ 7.50*)	($ 2.375)	($5.125)

BOYLSTON MANUFACTURING COMPANY

Statement Accounting for Decrease in Gross Profit

Years 1941 and 1942

Increase caused by change in sales price:		
Product A—No change in price	$ ——	
Product B—1,600 units at decreased price of $5.00	8,000.00	
Product C—1,250 units at decreased price of $5.00	6,250.00	$ 1,750.00*
Decrease caused by change in sales volume:		
Product B—Decrease of 900 units at $12.11 each	$10,899.00	
Product A—Increase of 100 units at $74.70 each	$ 7,470.00	
Product C—Increase of 250 units at $2,375 each	593.75	
Total reduction	$ 8,063.75	2,835.25

Decrease caused by increase in costs:

	Material	*Labor*	*Overhead*		
Product A:					
Unit costs 1941	$ 100.00	$ 25.00	$ 15.625		
Unit costs 1940	92.80	20.00	12.50		
Increase	$ 7.20	$ 5.00	$ 3.125		
Amount (600 units)	$4,320.00	$3,000.00	$ 1,875.00	$ 9,195.00	
Product B:					
Unit costs 1941	$ 8.125	$ 6.25	$ 3.90625		
Unit costs 1940	4.64	2.00	1.25		
Increase	$ 3.485	$ 4.25	$ 2.65625		
Amount (1,600 units)	$5,576.00	$6,800.00	$ 4,250.00	16,626.00	
Product C:					
Unit costs 1941	$ 8.00	$ 12.00	$ 7.500		
Unit costs 1940	8.00	9.00	5.625		
Increase	$ ——	$ 3.00	$ 1.875		
Amount (1,250 units)	$ ——	$3,750.00	$ 2,343.75	6,093.75	31,914.75
Net decrease in gross profit					$33,000.00

Summary (by products)

	Products			
	A	B	C	Total
Decrease or increase* caused by changes in:				
Sales prices	$ ——	$ 8,000.00*	$ 6,250.00	$ 1,750.00*
Sales volume	7,470.00*	10,899.00	593.75*	2,835.25
Cost of production:				
Materials	$4,320.00	$ 5,576.00	$ ——	$ 9,896.00
Labor	3,000.00	6,800.00	3,750.00	13,550.00
Overhead	1,875.00	4,250.00	2,343.75	8,468.75
Total (production cost)	$9,195.00	$16,626.00	$ 6,093.75	$31,914.75
Total (all causes)	$1,725.00	$19,525.00	$11,750.00	$33,000.00

No. 3.

CITY OF X

(c) General Fund—Work Sheet

April 30, 1941

	Trial Balance April 30, 1940		Transactions for the Year Ended April 30, 1941		Trial Balance, April 30, 1941 (After Closing)	
	Debits	*Credits*	*Debits*	*Credits*	*Debits*	*Credits*
Cash on hand	$ 910		$ 392,450(4) 20,000(5)	$ 412,100(15)	$ 1,260	
Cash in banks	54,670		412,100(15)	5,007(8) 16,000(11) 383,643(12) 100(13) 5,000(14) 1,000(20)	56,020	
Petty cash	100		100(13)		200	
Tax receivable—1938 levy	22,420			22,420(4)	—	
Reserve for taxes not collected —1938 levy		$ 22,420	22,420(4)			$ —
Taxes receivable—1939 levy	260,000			233,580(4)	26,420	
Reserve for taxes not collected 1939 levy		260,000	233,580(4)			26,420
Taxes receivable—1939 levy, pledged on anticipation notes	5,000		20,000(5)	5,000(4)	20,000	
Stores inventory	3,700		5,310(7)	6,760(10)	2,250	
Due from water fund	8,000		1,500(10) 5,000(14)		14,500	
Accounts payable		9,240	383,643(12)	139,033(7) 246,500(9)		11,130
Tax-anticipation notes payable		5,000	5,000(8)	20,000(5)		20,000
Reserve for encumbrances		14,140	133,723(7) 387(16)	138,610(6)		18,640
Special reserve for contingencies		2,000	2,000(19)		—	
Unappropriated surplus		42,000	408,000(3) 18,640(17) 10,000(18) 1,000(20)	405,000(1) 2,000(19) 2,450(22) 20,650(25)		34,460
	$354,800	$354,800				
Estimated revenues			405,000(1) 2,450(22)	407,450(21)		—
Taxes receivable—1940 levy			285,000(2)		285,000	
Reserve for taxes not collected —1940 levy				285,000(2)		285,000
Appropriations			387,350(24) 20,650(25)	408,000(3)	—	
Revenues realized			407,450(21)	131,450(4) 22,420(4) 233,580(4) 20,000(5) 387(16)		–
Encumbrances			138,610(6)	18,640(17) 119,583(23)	—	
Expenditures			7(8) 246,500(9) 5,260(10) 16,000(11) 119,583(23)	387,350(24)	—	
Reserve for stores				10,000(18)		10,000
			$4,108.713	$4,108,713	$405,650	$405,650

EXPLANATIONS OF TRANSACTIONS

For the Year Ended April 30, 1941
Shown on Working Papers

(1) To record the estimated revenues for the year.
(2) To record the city's share of the general property taxes from the 1940 tax levy.
(3) To record the approved operating budget appropriations.
(4) To record the realized revenues, and to write off the applicable reserves.
(5) To record the issuance of tax-anticipation notes and the taxes receivable against them.
(6) To record the purchase orders issued.
(7) To record the invoices received, approved, and vouchered.
(8) To record the payment of tax-anticipation notes and interest thereon.
(9) To record the vouchered payrolls which were approved for payment.
(10) To record the supplies issued, including $1,500 issued to the water fund.
(11) To record the issuance of warrants to cover interest and principal of bonds.
(12) To record the issuance of warrants in payment of approved vouchers.
(13) To record the increase in the petty cash fund.
(14) To record the advance of $5,000 from the general to the water fund.
(15) To record the deposit of cash in the banks.
(16) To adjust for the difference of $387 in the purchase-order encumbrances as shown by the analysis.
(17) To transfer the encumbrances as of April 30, 1941.
(18) To set up a reserve for stores as authorized by the city council.
(19) To transfer the special reserve for contingencies to surplus.
(20) To record the refund of prior years' taxes.
(21) To transfer the balance of revenues realized into the estimated revenues account.
(22) To close out the balance in the estimated revenues account.
(23) To transfer the balance in encumbrances account to the expenditures account.
(24) To close out the balance in the expenditures account into the appropriations account.
(25) To close out the balance in the appropriations account into surplus.

CITY OF X

(a) General Fund Balance-Sheet

April 30, 1941

Assets

Cash:		
On hand	$ 1,260	
In banks	56,020	
Petty cash	200	$ 57,480
Taxes receivable:		
1939 levy	$ 26,420	
Less—reserve for taxes not collected	26,420	
1940 levy	$ 285,000	
Less—reserve for taxes not collected	285,000	
1940 levy (pledged on anticipation notes)		20,000
Stores inventory		2,250
Due from water fund		14,500
		$ 94,230

Liabilities, Reserves, and Surplus

Liabilities:		
Accounts payable	$ 11,130	
Tax-anticipation notes payable	20,000	$ 31,130
Reserves:		
Reserves for encumbrances	$ 18,640	
Reserve for stores	10,000	28,640
Surplus		34,460
		$ 94,230

CITY OF X

(b) Statement of Revenues, Expenditures, and Surplus

For the Year Ended April 30, 1941

Revenues realized:			
Taxes:			
1938 levy	$ 22,420		
1939 levy	233,580		
1940 levy	20,000	$ 276,000	
Miscellaneous		131,450	
Total revenues realized		$ 407,450	
Deduct—expenditures:			
Interest on tax-anticipation notes	$ 7		
Payrolls	246,500		
Stores issued	5,260		
Redemption of bonds	10,000		
Bond interest	6,000		
Purchase orders	119,583	387,350	
Excess of revenues realized over expenditures		$ 20,100	
Add—special reserve closed out		2,000	
Total		$ 22,100	
Balance of surplus, April 30, 1940		42,000	$ 64,100
Deduct:			
Encumbrances at April 30, 1941		$ 18,640	
Reserve for stores		10,000	
Refunds of prior years' taxes		1,000	29,640
Balance of surplus, April 30, 1941			$ 34,460

Answers to Examinations of May, 1943

Accounting Practice – Part I

May 12, 1943, 1:30 to 6:00 p.m.

No. 1.

It would appear that the inventory purchased on January 1, 1943, was charged to the profit-and-loss statement for the quarter at a value of $100,000. Had it been charged at $200,000 the statements would have shown a loss of $5,000 rather than a profit of $95,000.

(1) As the inventory purchased on January 1, 1943, represents an estimated minimum or base stock, the inventory at March 31, 1943, could be valued on the basis of "last-in, first-out." If this method is used, instead of "first-in, first-out" the amount of the inventory at the end of the quarter would be $105,000 and the balance-sheet would show:

Assets

Cash	$ 20,000
Accounts receivable, less reserve	30,000
Raw materials, valued on the basis of "last-in, first-out"	105,000
Plant and equipment, less depreciation	440,000
	$ 595,000

Liabilities and Capital

Liabilities	None
Capital stock	$ 600,000
Deficit (loss for the quarter)	5,000
	$ 595,000

(2) The inventory at January 1, 1943, could be increased to the contract price of $200,000 and the offsetting credit of $100,000 received as a one-time consideration shown as capital surplus. Under this method the balance-sheet would show:

Assets

Cash	$ 20,000
Accounts receivable, less reserve	30,000
Raw materials, at contract price	205,000
Plant and equipment, less depreciation	440,000
	$ 695,000

Liabilities and Capital

Liabilities	None
Capital stock	$ 600,000
Capital surplus	100,000
Deficit (loss for the quarter)	5,000
	$ 695,000

Under either of these methods, the auditor need not modify his report.

(3) If the client insisted upon presenting the balance-sheet as given in the problem, the auditor should qualify his report by fully covering the matter of the contract and concession received, both on the balance-sheet and on the income statement.

No. 2.

THE OPERATING COMPANY

(1) Summary of adjusted property account and reserve for depreciation

Year		Property Account	Salvage, as Estimated	Reserve for Depreciation	Book Value of Property, Less Salvage
1933	Original plant cost	$385,462.55	$20,000.00	....	$365,462.55
1934	Depreciation (1/20 of $365,462.55)	....	....	$ 18,273.13	347,189.42
1935	Depreciation (1/19 of $347,189.42)	....	....	18,273.13	328,916.29
1935	Extension cost	138,875.44	5,000.00	....	462,791.73
	Total	$524,337.99	$25,000.00	$ 36,546.26	$462,791.73
1936	Depreciation (1/18 of $462,791.73)	....	....	25,710.65	437,081.08
1937	Depreciation (1/17 of $437,081.08)	....	....	25,710.65	411,370.43
1938	Depreciation (1/16 of $411,370.43)	....	....	25,710.65	385,659.78
1939	Depreciation (1/15 of $385,659.78)	....	....	25,710.65	359,949.13
1940	Depreciation (1/14 of $359,949.13)	....	....	25,710.65	334,238.48
	Total	$524,337.99	$25,000.00	$165,099.51	$334,238.48
1940	Plant retirement	25,248.30	....	8,836.91	16,411.39
	Remainder	$499,089.69	$25,000.00	$156,262.60	$317,827.09
1940	Replacements	29,541.60	....	....	29,541.60
	Total	$528,631.29	$25,000.00	$156,262.60	$347,368.69
1941	Depreciation (1/13 of $347,368.69)	....	....	26,720.67	320,648.02
December 31, 1941—adjusted balances		$528,631.29	$25,000.00	$182,983.27	$320,648.02
1942	Depreciation (1/12 of $320,648.02)	....	....	26,720.67	293,927.35
December 31, 1942—adjusted balances		$528,631.29	$25,000.00	$209,703.94	$293,927.35

THE OPERATING COMPANY

(2) Entry to adjust balance-sheet prior to consolidation

Reserve for depreciation	$15,314.77	
Surplus (December 31, 1941)	10,906.84	
Property account		$25,248.30
Income (1942)		973.31

To adjust the above accounts as shown below:

	Per books	Per summary	Adjustment
Reserve for depreciation	$225,018.71	$209,703.94	$15,314.77(Dr.)
Property account	$553,879.59	$528,631.29	$25,248.30(Cr.)
Depreciation, 1942	$ 27,693.98	$ 26,720.67	$ 973.31(Cr.)
Surplus, 1941:			
Reserve for depreciation	$197,324.73	$182,983.27	$14,341.46(Cr.)
Cost of plant retired			25,248.30(Dr.)
Remainder			$10,906.84(Dr.)

THE SERVICE COMPANY

(2) Entry to adjust balance-sheet, prior to consolidation

Surplus (December 31, 1941)	$30,543.72	
Reserve for intercompany profit		$27,998.41
Income (1942)		2,545.31

To set up reserve for intercompany profit on construction cost which was charged to the Operating Company.

Explanation of the above adiustment:

	Total	Original Plant (1933)	Extension (1935)	Replacements (1940)
Cost	$553,879.59	$385,462.55	$138,875.44	$29,541.60
Deduct retirement in 1940	25,248.30	25,248.30	....	....
In use during 1942	$528,631.29	$360,214.25	$138,875.44	$29,541.60
Intercompany charge (1/11)	$ 48,057.39	$ 32,746.75	$ 12,625.04	$ 2,685.60
Amount realized annually	$ 2,545.31			
1/20 of $32,746.75		$ 1,637.34		
1/18 of 12,625.04			$ 701.39	
1/13 of 2,685.60				$ 206.58
Amount unrealized (11 years)	$ 27,998.41	$ 18,010.74	$ 7,715.29	$ 2,272.38

The intercompany charges for maintenance have no effect upon the balance-sheets and, therefore, it is not necessary to consider them in solving this problem. The expense and income would be eliminated in consolidating the income statements each year.

No. 3.

Adjusting Entries

		Debits	Credits
	(A)		
Surplus		$2,151,400	
Investment in fixed assets			$2,151,400
To set up the amount invested in fixed assets.			
	(B)		
Deferred charges to future operations		340,000	
Surplus			340,000
To set up the amount of bonds outstanding at the beginning of the year as a deferred charge.			
	(1)		
Expense		12,600	
Investment in fixed assets			12,600
To credit the latter account with the purchase price of equipment acquired during the year.			
	(2)		
Expense		7,290	
Reserve for uncollectible taxes			7,290
To provide a reserve for uncollectible taxes at the rate of 6%, as follows:			

	Total	*General Fund*	*Library Fund*
Tax levy	$ 121,500	$ 117,300	$ 4,200
6% thereof	$ 7,290	$ 7,038	$ 252

		Debits	Credits
	(3)		
Expense		20,000	
Deferred charges to future operations			20,000
To adjust for the bonds paid during the year.			
	(4)		
Expense		5,475	
Stores inventory		4,525	
Reserve for stores			10,000
To set up the stores inventory and the reserve, as follows:			

Stores purchased	$ 9,150
Amount issued	4,625
Inventory on hand	$ 4,525
Amount of reserve provided	10,000
Chargeable to expense	$ 5,475

(5)

	Debits	Credits
Due from state	3,200	
Revenue		3,200
To record city's share of gasoline taxes due from the state.		

(6)

This entry segregates the assets of the library fund, as follows:

Cash collected	$ 3,600
Expenses paid	3,125
Balance on hand	$ 475
Special tax levy	$ 4,200
Cash collected	3,600
Taxes receivable	$ 600
Reserve for uncollectible taxes — 6% of $4,200	$ 252

(7)

	Debits	Credits
Expense	$ 2,180	
Reserve for encumbrances		$ 2,180
To record the orders and contracts outstanding at the close of the year.		

(8)

	Debits	Credits
Surplus	1,869	
Expense		1,869
To credit the expense account for charges on account of previous year.		

(9)

	Debits	Credits
Petty cash	300	
Expense		300
To record the setting up of a petty-cash fund charged to expense in error.		

(10)

	Debits	Credits
Investment in fixed assets	6,800	
City property		6,800
To write off the equipment retired during the year.		

(3) Comments on the Accounting System

1. From the trial balance given in the problem it would appear that the balance-sheets prepared in the past did not follow the generally accepted form of segregating the assets, liabilities, reserves, and surplus according to funds. Such groupings should include the following:
   (a) General fund.
   This fund should include the current assets, current liabilities, and reserves in order to set out the current financial position of the city.
   (b) Library fund.
   This fund should account for the special levy for the city library.
   (c) Property fund.
   This fund should show the fixed assets, the changes therein, and the amount invested in these fixed assets.
   (d) Bond fund.
   This fund should show the bonds payable, additional bonds issued, if any, and those paid during the period.
2. Reserves for uncollectible taxes should be provided for in the general and the library funds.
3. Reserves for encumbrances and for stores should be provided in order to prevent overappropriation of surplus in the general fund.
4. Budgetary control accounts should be a part of the accounting procedure.
5. After grouping the several funds, it becomes apparent that the reason for the city's inability to pay its bills is due to a deficit in its general fund of $22,588. This fact was obscured in the trial balance, which showed a combined surplus of $1,830,580.

(a) CERTAIN CITY
Balance Sheet
Date

General Fund

Assets

Assets:		
Cash		$ 2,985
Petty Cash		300
Accounts receivable		2,420
Taxes receivable, current year's levy	$20,800	
Less reserve for uncollectible taxes	7,038	13,762
Due from state		3,200
Stores inventory		4,525
Total		$ 27,192

Liabilities, Reserves and Surplus

Liabilities:		
Tax auticipation notes payable	$ 15,000	
Accounts payable	22,600	$ 37,600
Reserves:		
Reserve for encumbrance	$ 2,180	
Reserve for stores	10,000	12,180
Total liabilities and reserves		$ 49,780
Deficit:		
Surplus, beginning of year	$ 17,311	
Add revenue	154,600	
Total	$171,911	
Deduct expenses	194,499	22,588
Total		$ 27,192

Library Fund

Assets

Assets:		
Cash		$ 475
Taxes receivable, current year's levy	$ 600	
Less reserve for uncollectible taxes	252	348
Total		$ 823

Liabilities, Reserves and Surplus

Unappropriated surplus:	
Revenue	$ 4,200
Deduct expenses	3,377
Total	$ 823

Property Fund

Assets

City property:	
Balance at beginning of year	$2,151,400
Add equipment purchased	12,600
Total	$2,164,000
Deduct equipment retired	6,800
Total	$2,157,200

Liabilities, Reserves and Surplus

Investment in fixed assets	$2,157,200
Total	$2,157,200

Bond Fund

Assets

Deferred charges to future operations	$ 320,000
Total	$ 320,000

Liabilities, Reserves and Surplus

Bonds payable:	
Balance at beginning of year	$ 340,000
Deduct bonds paid	20,000
Total	$ 320,000

(b) CERTAIN CITY
BALANCE-SHEET—WORK PAPERS
Date

	Trial Balance Per Books		Adjustments		General Fund	Library Fund	Property Fund	Bond Fund
	Debits	*Credits*	*Debits*	*Credits*				
Cash	$ 3,460				$ 2,985	$ 476(6)		
Accounts receivable	2,420				2,420			
Taxes receivable, current year's levy	21,400				20,800	600(6)		
Expense	152,500		$ 12,600(1) 7,290(2) 20,000(3) 5,475(4) 2,180(7)	$ 1,869(8) 300(9)	194,499	3,125(6) 252(6)		
City property	2,164,000			6,800(10)			$2,157,200	
Reserve for uncollectible taxes				7,290(2)	7,038*	252*(6)		
Deferred charges to future operations			340,000(b)	20,000(3)				$320,000
Stores inventory			4,525(4)		4,525			
Due from state			3,200(5)		3,200			
Petty cash			300(9)		300			
Total assets and expenses	$2,343,780				$221,691	$4,200	$2,157,200	$320,000
Tax anticipation notes payable		$ 15,000			$ 15,000			
Accounts payable		22,600			22,600			
Revenue		155,600		3,200(5)	154,600	$4,200(6)		
Bonds payable		320,000						$320,000
Surplus, beginning of year		1,830,580	$2,151,400(a) 1,869(8)	340,000(b)	17,311			
Investment in fixed assets			6,800(10)	2,151,400(a) 12,600(1)			$2,157,200	
Reserve for stores				10,000(4)	10,000			
Reserve for encumbrances				2,180(7)	2,180			
Total liabilities and revenues		$2,343,780	$2,555,639	$2,555,639	$221,691	$4,200	$2,157,200	$320,000

* Deduction.

Theory of Accounts

May 13, 1943, 9 a.m. to 12:30 p.m.

GROUP I

No. 1.

"Consistent," as used in the standard short form of report means that there has been no significant change in the application of generally accepted accounting principles (official pronouncements of accounting and governmental regulatory bodies applied by competent accountants) during the year under review as compared to the preceding period.

No. 2.

The excess of the assets over the liabilities of $1,500,000 represents the capital or net worth of the business. Of this amount, $500,000 should be expressed as the value of the 100,000 shares of issued capital stock at the stated value of $5.00 per share as fixed by the Board of Directors. The remainder ($1,000,000) represents paid-in and/or earned surplus. The capital stock and surplus would be shown in the balance-sheet as follows:

Common stock—no par value; stated value $5.00 per share; issued, 100,000 shares		$ 500,000
Surplus:		
Paid in	$?	
Earned	?	1,000,000
Total, capital stock and surplus		$1,500,000

No. 3.

(1) While property accounts are generally carried at cost, there can be no objection to recording them at appraised values.

(2) The committee on accounting procedure of the American Institute of Accountants in its Accounting Research Bulletin No. 5 recommends "that when such appreciation has been entered in the books, income should be charged with depreciation computed on the new and higher values. . . . A corporation should not at the same time claim larger property values in its statement of assets, and provide for the amortization of only smaller property sums in its statement of income."

(3) The credit should have been made to an account designated as "surplus arising from the revaluation of fixed assets." Only actual operating profits should be credited to "surplus" account.

No. 4.

For the purchase price of $260,000 the corporation acquired the right to receive payments on the principal of the bonds and on the defaulted interest coupons. The $40,000 received for application to the interest in arrears is not income, but is a reduction in the cost of the total investment.

No. 5.

Wear and tear are not the only factors which affect the useful life of equipment. The passage of time, obsolescence, and particularly the policy with respect to maintenance, are also important factors which must be considered.

GROUP II

No. 6.

Services to oneself are not earnings. The costs of such services may be added to the cost of construction, but the credit should be to operating expenses and not to income. As tariff rates would include an element of profit, these rates should not be used.

No. 7.

The delivered sales is generally a sound basis for the recognition of revenue because (1) the last step in the operations (delivery of the product) has been performed; (2) title has passed to the purchaser; and (3) cash or a receivable has been accepted in exchange for the product.

(a) Accrual of revenue on long-term contracts is allowable because the amount is based upon estimates of the profit available when the contract has been completed and upon the stage of completion at the time the accrual of the profit is recorded. The possibilities of loss or failure to deliver are minimized because periodic appraisals are made of the stage of completion and cost to date.

(b) Accrual of revenue on cost-plus-fixed-fee contracts is allowable because the amount is based upon billable costs which, presumably, are accounted for, and upon periodic appraisals by the purchaser's representatives.

No. 8.

Because of the better time correlation between the cost of materials and labor to the sales price of the inventory, the use of the "lifo" method (1) results in a more uniform rate of gross profit and (2) minimizes the fluctuations in inventory values during a period of rising or receding prices. It is also acceptable for use in determining taxable income under certain conditions.

No. 9.

From the instructions of the New York Stock Exchange for the preparation of listing applications (1939)—

"Valuation of Inventories:

"Indicate the practice followed in adjusting inventories to the lower cost or market; i.e., whether on a basis of specific items, groups, or classes, or entire inventory.

"State whether 'market' is considered:

"(a) as replacement market, and whether in that event allowance is made for any decline in price of basic commodities in finished goods and work in process, or,

"(b) as selling market, and whether in that event allowance is made for selling expense and normal margin of profit.

"State the company's practice if (a) and (b) are followed in respect of different parts of the inventory.

"Describe treatment of any intercompany profit on goods included in inventory.

"Method of Computing Cost of Goods Sold:

"State general method of computing cost of goods sold; i.e., whether computed on basis of 'average cost,' 'standard cost,' 'last-in, first-out,' 'first-in, first out,' etc."

From Regulation S-X (Rule 5-02, 6) of the Securities and Exchange Commission.

"(a) State separately in the balance-sheet, or in a note therein referred to, major classes of inventory such as: (1) finished goods; (2) work in process; (3) raw materials; and (4) supplies. Any other classification that is reasonably informative may be used.

"(b) The basis of determining the amounts shown in the balance-sheet shall be stated. If a basis such as 'cost,' 'market,' or 'cost or market, whichever is lower' is given, there shall also be given, to the extent practicable, a general indication of the method of determining the 'cost' or 'market'; e.g., 'average cost' or 'first-in, first-out'."

No. 10.

Comparable costs of production may be obtained by excluding from the manufacturing costs of "X" the interest charge on borrowed money, and of "Y" the excess of the rental charge for the plant over the charges for insurance, taxes, repairs, and depreciation of the plant of "X."

No. 11.

(a) Turnover may be defined as the number of times an asset or a group of assets is converted into other assets during a period which is generally one year. Although the amount of sales is not an asset, it does represent the total of cash and receivables resulting from sales.
(b) Capital is sales divided by capital.
(c) Working capital is sales divided by working capital.
(d) Receivables is sales divided by receivables.
(e) Inventory is cost of sales divided by inventory at cost.
(f) Finished goods is (1) cost of sales divided by finished goods at cost, or (2) sales divided by finished goods at selling price.

No. 12.

Machine tools and other property accounts are generally stated on the books at cost. The question here is what is the cost of the machine tools.

The purchase price includes an instalment obligation payable quarterly during the next two years. This obligation is probably worth less than its face value of $40,000. The amount of the discount (or interest) on these notes should be deducted from the $50,000 shown as machine tools on the books and set up as a deferred charge (prepaid interest) to be amortized over the life of the obligation.

Accounting Practice – Part II

May 13, 1943, 1:30 to 6:00 p.m.

No. 1.

SUMMER RESORT HOTEL

(a) SUMMARY OF CIGAR COUNTER TRANSACTIONS

In Terms of Single Cigars and Packages of Cigarettes for the Period (Date) to (Date)

	Received from Stock Room	Inventory	Sales Units	Sales Unit Price	Sales Amount	Cost of Sales Unit Cost	Cost of Sales Amount	Profit
Cigars:								
	500	175	325	25¢	$ 81.25	18¢	$ 58.50	$ 22.75
	1,000	210	790	2/25¢	98.75	9¢	71.10	27.65
	1,500	340	1,160	10¢	116.00	7½¢	87.00	29.00
Total cigars	3,000	725	2,275		$296.00		$216.60	$ 79.40
Cigarettes:								
	250	46	204	20¢	$ 40.80	15¢	$ 30.60	$ 10.20
	3,000	775	2,225	15¢	333.75	12¢	267.00	66.75
Total cigarettes	3,250	821	2,429		$374.55		$297.60	$ 76.95
Grand total	6,250	1,546	4,704		$670.55		$514.20	$156.35
Receipts—per cashier's record					576.95			
Difference (shortage) not accounted for					$ 93.60			

(b) RECOMMENDATIONS FOR MAINTAINING ADEQUATE INTERNAL CHECK AND GENERAL-LEDGER ACCOUNTING CONTROL

It should not be assumed that the cigar counter alone is responsible for the shortage shown above; part of it may have occurred in the transactions with the stock room and the cashier. If practical, one of the employees working at the cigar counter should be assigned to requisitioning the cigars and cigarettes from the stock room and with making the deposits of the cash with the cashier. Receipts should be obtained from the cashier and given to the stock room clerk. A record should be kept of the different classes of cigars and cirgarettes showing the quantities of each on hand at the beginning of the day, the number received from the stock room, the number sold during the day, and the balance on hand at the close of business. An employee, other than one working at the counter, should be assigned the duty of taking an inventory and comparing it with this running inventory at various times.

The accounting department should keep a record of daily sales, showing the quantities, sales prices, and costs by brands and sizes. The amount of the daily sales should agree with the amount of cash deposited with the cashier; the totals for the month would furnish the amounts to be recorded in the general ledger accounts for the sales and cost of sales.

No. 2.

SCHEDULE I

BROWN ELECTRIC COMPANY

ANALYSIS SHOWING COLLECTIONS OF ACCOUNTS RECEIVABLE

During the Year Ended December 31, 1942

Balance at January 1, 1942	$ 242,736.64	
Less—uncollectible 1941 accounts	7,270.00	$ 235,466.64
Sales during 1942	$ 8,540,672.31	
Less—uncollectible 1942 accounts	1,504.20	8,539,168.11
Total		$ 8,774,634.75
Deduct—balance at December 31, 1942		338,665.34
Remainder		$ 8,435,969.41
Add—collection of 1941 accounts previously written off		2,005.00
Collections of accounts receivable during 1942		$ 8,437,974.41

SCHEDULE II

BROWN ELECTRIC COMPANY

ANALYSIS SHOWING DISBURSEMENTS FOR MERCHANDISE

During the Year Ended December 31, 1942

Inventory at December 31, 1942	$ 328,668.99
Cost of goods sold	6,638,916.40
Total	$ 6,967,585.39
Less—inventory at January 1, 1942	122,463.71
Purchases during 1942	$ 6,845,121.68
Add—liability to merchandise creditors at January 1, 1942	38,740.93
Total	$ 6,883,862.61
Deduct—liability to merchandise creditors at December 31, 1942	82,682.16
Payments to merchandise creditors during 1942	$ 6,801,180.45

Schedule III

BROWN ELECTRIC COMPANY

Analysis Showing Disbursements for Selling and General Expenses
During the Year Ended December 31, 1942

Amount shown in statement of profit and loss			$ 1,441,032.82
Liability on general expense accounts on January 1, 1942			40,531.43
Total			$ 1,481,564.25
Deduct:			
Non-cash charges:			
Provision for bad debts	$ 15,000.00		
Net increase in inventory write-down provision	15,000.00		
Provision for price decline of industrial bonds	3,700.00		
Provision for depreciation	56,740.93	$ 90,440.93	
Cash item shows separately in Statement (a):			
Premium paid on bonds redeemed		$ 5,750.00	
Liability on general expense accounts on December 31, 1942		50,374.88	$ 146,565.81
Payments to general expense creditors during 1942			$ 1,334,998.44

BROWN ELECTRIC COMPANY

(a) Statement of Receipts and Disbursements
For the Year Ended December 31, 1942

Receipts:			
Collections of accounts receivable (Schedule I)			$ 8,437,974.41
Proceeds of additional RFC loan			400,000.00
Industrial bonds sold at par			2,000.00
Total receipts			$ 8,839,974.41
Disbursements:			
For merchandise (Schedule II)		$ 6,801,180.45	
For selling and general expenses (Schedule III)		1,334,998.44	
Property taxes		18,010.12	
Interest:			
On bonds	$ 5,750.00		
On RFC loan	3,500.00	9,250.00	
Federal income and profits taxes		10,568.05	
Industrial bonds purchased		84,200.00	
Additions to plant and equipment		451,023.74	

Redemption of bonds:			
Principal	$115,000.00		
Premium	5,750.00	120,750.00	
Dividend paid:			
June 30, 1942	$ 24,400.00		
December 31, 1942	24,075.00	48,475.00	
Total disbursements			8,878,455.80
Excess of disbursements over receipts			$ 38,481.39
Balance of cash—January 1, 1942			125,453.80
Balance of cash—December 31, 1942			$ 86,972.41

BROWN ELECTRIC COMPANY

(b) Condensed Statement of Application of Funds
For the Year Ended December 31, 1942

Funds provided:			
By profits:			
Per statement of profit and loss		$ 155,454.23	
Add back:			
Provision for depreciation	$ 56,740.93		
Premium paid on bonds redeemed (charge to general expense)	5,750.00	62,490.93	$ 217,945.16
By proceeds of addition RFC loan			$ 400,000.00
By decrease in working capital			52,303.58
Total funds provided			$ 670,248.74
Funds applied:			
Additions to plant and equipment			$ 451,023.74
Instalment on RFC loan			50,000.00
Redemption of bonds ($115,000 at 105)			120,750.00
Dividends paid during year			48,475.00
Total funds applied			$ 670,248.74

No. 3.

THE WEST INDIES MOLASSES COMPANY

(a) STATEMENT SHOWING THE COST OF MOLASSES DELIVERED AT THE PLANT OF THE UNION SOLVENTS COMPANY
During the Year 1942

	Molasses		Sugar Content		Costs	
	1,000 gal.	(12 lbs. to gal.) 1,000 lbs.	Per Cent	1,000 lbs. of 50% Test	Per 1,000 lbs.	Amount
Inventory, December 31, 1941	43,200	518,400	51%	264,384	$6⅔	$ 1,762,560
Receipts of 1941 crop during 1942	2,400	28,800	50	14,400	6⅔	96,000
Receipts of 1942 crop	240,000	2,880,000	52	1,497,600	6⅔	9,984,000
Total	285,600	3,427,200		1,776,384	6⅔	$11,842,560
Add:						
Sundry expenses in West Indies	......	......		......	....	715,406
United States expenses incident to the purchases in West Indies	......	......		......	....	172,786
Total	285,600	3,427,200		1,776,384	7.17	$12,730,752
Deduct:						
Net proceeds from sales of supplies in West Indies	......	......		......	....	$ 96,384
Sales of molasses in West Indies	96,000	1,152,000	52	599,040	7⅓	4,392,960
Total deductions	96,000	1,152,000		599,040	7.49	$ 4,489,344
Cost of purchases of molasses in West Indies	189,600	2,275,200		1,177,344	7.00	$ 8,241,408
Deduct inventory, December 31, 1942	33,600	403,200	52	209,664	7.00	1,467,648
Amount shipped to the United States	156,000	1,872,000		967,680	7.00	$ 6,773,760
Deduct—shrinkage en route (and price adjustment)	6,000	72,000		67,680	....	......
Amount delivered in the United States	150,000	1,800,000	50	900,000	7.53	$ 6,773,760
Add—cost of operating vessels, less revenue from other cargo ($2,221,240 less $220,000)	......	......		......	....	2,001,240
Cost of molasses delivered in the United States during 1942	150,000	1,800,000	50	900,000	9.75	$ 8,775,000

THE UNION SOLVENTS COMPANY

(b) STATEMENT SHOWING THE COST OF MOLASSES USED IN THE PRODUCTION OF ALCOHOL
During the Year 1942

	Molasses		Sugar Content		Costs	
	1,000 gal.	(12 lbs. to gal.) 1,000 lbs.	Per Cent	1,000 lbs. of 50% Test	Per 1,000 lbs.	Amount
Inventory, December 31, 1941	14,400	172,800	49%	84,672	$9.17	$ 776,318
Cost of molasses delivered during the year (a)	150,000	1,800,000	50	900,000	9.75	8,775,000
Total	164,400	1,972,800		984,672	9.70	$ 9,551,318
Inventory, December 31, 1942	4,400	52,800	50	26,400	9.70	256,080
Cost of molasses used in production of alcohol during 1942	160,000	1,920,000		958,272	9.70	$ 9,295,238

Commercial Law

May 14, 1943, 9 a.m. to 12:30 p.m.

GROUP I

No. 1.

(a) The subject matter of the tenancy must be real property in order to create the relationship of landlord and tenant. It may not be personal property.

(b) Five provisions which should be found in a property drawn lease:
   (1) The name of the lessor.
   (2) The name of the lessee.
   (3) A description of the premises.
   (4) The term of the lease.
   (5) The rent.

(c) A covenant in a lease is a specific promise by landlord or tenant; for example, a covenant by the landlord to keep the premises in repair, or a covenant by the tenant to surrender the premises in good condition at the termination of the lease. A condition in a lease is a provision directly affecting the commencement or termination of the tenancy; for example, a condition may require the landlord to make alterations in the premises before the term of the tenancy is to commence, or a condition may provide that upon a certain use by the lessee the landlord may terminate the tenancy.

(d) After mortgaging the property to Y, any lease that X may make to Z is subject to the prior mortgage. If Y thereafter obtains the property through foreclosure, he may terminate the tenancy of Z.

No. 2.

(a) (1) The right to exoneration is the surety's right, when the obligation matures, to bring a suit in equity against the principal to compel him to discharge it, or to compel any cosureties to pay their proportionate share for example, the surety can demand that the principal pay his obligation when it falls due, or, if the principal fails to pay, demand that each cosurety immediately pay the creditor his proportionate amount.

   (2) The right to contribution is the surety's right to recover from cosureties. When the surety has paid more than his proportionate share of the principal's obligation, he is entitled to have his cosureties repay him their proportion of the indebtedness paid; for example, one of three cosureties who

was obliged to pay one-half of the principal's obligation may recover one-sixth from each of his cosureties.

(3) The right to indemnity is the surety's right to recover reimbursement from the principal for payments made or losses incurred in consequence of the principal's default; for example, payment to the creditor on account of default in the principal's obligation, or loss of the surety's property which was pledged as security for the principal's obligation.

(4) The right to subrogation is the surety's right, when he has fully discharged the principal's obligation, to stand in the place of the creditor and to use against the principal and any others liable to the creditor, all remedies which the creditor could have used; for example, to utilize all property of the principal which had been placed with the creditor as security.

(b) The rights of Y, the creditor, against X, the principal, are suspended for the duration of the war. But the rights of Y against Z, the surety, are not affected because both are residents and citizens of the same country. It is true that Z's right to subrogation has been impaired, because Z could not proceed against X during the war, but Y was in no way responsible for this impairment and there is no equitable or legal reason for relieving Z from his obligation as surety.

(c) If an employer, after acquiring knowledge of an employee's dishonesty, retains him in service without the consent of a surety for the employee's fidelity, given after knowledge of the facts, the employer cannot hold the surety liable for subsequent defaults, although the surety remains bound for any defaults up to the discovery of the dishonesty. The surety company, therefore, would not be liable for the second theft, but would be liable for the first theft, unless delay in notifying the surety violated some express provision of the contract of suretyship, or unless the statute of limitations had intervened.

No. 3.

(a) The corporation is not a trustee for the stockholders, since no separate trust fund has been established.

(b) The relationship between the corporation and the stockholders is that of debtor and creditors.

(c) Whether or not the corporation is a trustee would become important in case of bankruptcy. If a trust had been established before insolvency, the stockholders to whom the dividend was declared could obtain payment from the fund in preference to general creditors. If such a trust relationship did not exist, the stockholders would share with other creditors of the corporation.

No. 4.

(a) If a debt has not been duly scheduled and if the creditor does not have notice or actual knowledge of the proceedings, a discharge in bankruptcy will not affect the debt, because in such case the creditor has not had an opportunity to prove his claim and to secure an allowance thereof.

(b) A person is deemed insolvent within the provisions of the Bankruptcy Act when the aggregate of his property, exclusive of any property which he may have conveyed, transferred, concealed, removed, or permitted to be concealed or removed with intent to defraud, hinder, or delay his creditors, is not at a fair valuation sufficient in amount to pay his debts.

(c) No. A secured creditor under the Bankruptcy Act is one who has security for his debt upon the property of a bankrupt of a nature to be assignable under the Act, or who owns such a debt for which some endorser, surety, or other person secondarily liable for the bankrupt has such security upon the bankrupt's assets.

No. 5.

I assume that the sales were the result of orders, and there is no indication that any mention had been made of arbitration. It was not until the stage of delivery that the invoices were stamped "All controversies arising from the sale of goods are to be settled by arbitration." These notices merely constituted separate offers for arbitration, each of which looked back to a single sale and delivery theretofore made. The purchaser was under no duty to speak further, and there was no acceptance of the offers to arbitrate.

X cannot, therefore, compel Y to submit to arbitration.

GROUP II

No. 6.

(a) Arbitration is the extrajudicial determination of a controversy by judges or arbitrators chosen by the parties to the dispute pursuant to an agreement between the parties.

(b) An arbitration is provided by an agreement between the parties.

(c) Arbitrators are appointed in accordance with the agreement of the parties. The arbitration agreement may either name the arbitrators or state a method whereby they shall be chosen. In some states by statute the court will appoint arbitrators or will regulate the method of their selection in the event the parties neglect, fail, or refuse to do so.

(d) The outcome of an arbitration is an award made by the arbitrators. The award is enforceable and may be sued on as any other contract, or may be enforced by equitable remedies, where appropriate.

No. 7.

(a) A limited partnership is one in which the liability of certain special partners, who contribute a specific amount of capital, is limited to the amount so contributed, while the general partners, of whom there must be at least one, are jointly and severally liable as in an ordinary partnership. The object is to give the limited partners immunity from having their individual assets liable for the payment of partnership debts. If, however, the limited partners contribute services, or take any part in the control of the business, or permit their names to appear in the firm name, the statutes usually provide that they become liable as general partners.

(b) A limited partnership is not recognized at common law. It exists under statutes. There is a uniform limited partnership act which has been adopted in many states.

No. 8.

(a) A trust may be an *inter vivos* trust created by a living person, or a trust created by will. An *inter vivos* trust is irrevocable, unless the power to revoke is reserved. A trust created by will does not take effect until the death of the person who makes the will. Prior to that time it may be revoked by a revocation of, or codicil to, the will, or it may be revoked for practical purposes by the testator otherwise disposing of the property before his death.

(b) If an executor of a will is also to be trustee of a trust created thereby, he first acts as executor, in which capacity he collects the assets of the estate, pays the debts and costs of administration, and makes distribution as provided by the will. The trusteeship does not start until the executor has distributed to himself, as trustee, the property devised in trust. Separate books of account should be kept for the executorship and the trusteeship.

(c) A trust can be created for any purpose which is not illegal. A trust may fail for illegality where its performance would involve the commission of a criminal or tortious act by the trustee, or where it would be against public policy, or where the purpose is to defraud creditors or other third persons, or where the consideration is illegal. A trust may also offend the rule against perpetuities or statutes in regard to the restraint of alienation.

(d) Wasting property consists of interests which terminate or necessarily depreciate in course of time. Examples of intangible wasting assets are leaseholds, annuities, and royalties. The trustee is under a duty not to pay the whole of the income from wasting property to a beneficiary who is entitled to income from the trust, but should set aside part of the income as an amortization fund or should sell the property and invest the proceeds.

No. 9.

(a) The term "capital assets" is defined in the U. S. Revenue Code. It includes such items as land, stocks, securities, and the taxpayer's personal residence. A capital gain or loss is a gain or loss from the sale or exchange of a capital asset, while all other gains or losses are ordinary. The distinction is important because special rules of taxation are applied in cases of capital gains and losses.

(b) An example of constructive receipt is an interest coupon which is owned by a taxpayer and which is payable, but which has not been collected. The term is used in connection with the cash receipts and disbursements methods of reporting income.

(c) The use of the instalment basis is optional. Under this method, the seller returns as income in each year that proportion of the instalments collected in that year which the total or gross profit, to be realized when the property is completely paid for, bears to the total contract price. For example, if the total instalment sales in the year amounted to $50,000, on which the gross profit will be $22,000, or 44 per cent, and the total instalment collections on such sales were $15,000, the amount to be returned as income would be 44 per cent of $15,000, or $6,600.

(d) The taxes now imposed on a domestic corporation, which are based wholly or partly on its income, are:

(1) Normal income tax—a percentage on normal-tax net income, ranging from 15 per cent to 24 per cent.

(2) Surtax—a percentage on surtax net income, ranging from 10 per cent to 16 per cent.

(3) Excess-profits tax—90 per cent of adjusted excess-profits net income (subject to a limitation).

(4) Declared value excess-profits tax—6$\frac{6}{10}$ per cent of net income in excess of 10 per cent, but not in excess of 15 per cent of the declared value of the corporation's capital stock (declared for purposes of the capital-stock tax); 13$\frac{2}{10}$ per

cent of such income in excess of 15 per cent of such declared value.

(5) Surtax on improperly accumulating surplus—27½ per cent of undistributed net income (specially defined) not in excess of $100,000, plus 38½ per cent of it in excess of $100,000.

(6) Surtax on personal holding companies—75 per cent of undistributed net income (specially defined) not in excess of $2,000, plus 85 per cent of it in excess of $2,000.

(7) Tax on net income from refunds or reimbursements of certain excise taxes which would result in unjust enrichment—80 per cent.

No. 10.

The statement constitutes neither a sale nor a contract of sale, because an essential element, to wit, the price, has not been agreed upon, nor has any method been agreed upon whereby the price can be determined. It is simply "an agreement to agree."

No. 11.

A negotiable instrument must contain an unconditional promise to pay, but an indication of a particular account to be debited does not render the promise unconditional. The addition of the words "on account of 14,789 bags Cuban centrifugal sugar, as per contract 4-25-39," therefore, does not render the draft non-negotiable.

No. 12.

(a) This will be expert testimony.

(b) The witness must qualify by showing that he has special knowledge from which he is more capable of forming an opinion on the facts than an ordinary person. In this case the qualification would be by showing that he was a certified public accountant.

(c) The accountant would be asked a hypothetical question. Counsel states a set of facts which he claims to have proved and which the testimony on his part tends to prove, and asks the accountant his opinion on this assumed set of facts.

Auditing

May 14, 1943, 1:30 to 6:00 p.m.

No. 1.

The adequacy of the system of internal control and check should be studied with respect to the procedures followed in accounting for both sales and purchase discounts.

(a) Sales discounts:

Determine the policy relative to sales discounts and other allowances.

Scrutinize the items recorded in the cash-receipts book to see that the discounts and other allowances are substantially correct according to the general terms of sale, and investigate any deviations.

Foot the sales discount columns and check the postings to the general ledger.

Investigate any other postings to the general-ledger account.

(b) Purchase discounts:

Determine the policy relative to the payments of current liabilities.

Scrutinize the items recorded in the cash-disbursements book to see that all discounts have been taken, and investigate any deviations from the general policies pertaining to purchases by reference to the invoices if such differences are substantial in amount.

Foot the purchase-discount columns and check the postings to the general ledger.

Investigate any other postings to the general-ledger account.

No. 2.

If the client does not maintain an insurance register, a schedule should be prepared showing:

(1) Policy number
(2) Name of insurance company
(3) Amount of coverage
(4) Period covered
(5) Net premium
(6) Amount of the unexpired premium at the balance-sheet date
(7) Type of insurance
(8) Co-insurance, if any

The insurance policies should be inspected and checked against the register or schedule, noting particularly, in examining the policies, the recorded ownership or liens.

The amount of the unexpired insurance should be checked and compared with the amount shown in the relative account in the general ledger.

The general adequacy of the insurance coverage should be ascertained by comparison with the book values of the property.

No. 3.

(1) Determine that the brokerage firm is a bona fide one.
(2) By direct correspondence with the brokerage firm, determine that the stock certificates are in the name of the corporation and that they are being held in safekeeping for its account.
(3) From the investment account prepare a schedule showing:
    (a) Date of purchase
    (b) Date of sale
    (c) Description of security
    (d) Number of shares
    (e) Cost, per share, and total
    (f) Selling price, per share, and total
    (g) Gain or loss on sale
    (h) Market price of stock owned on the balance-sheet date
    (i) Dividend dates
    (j) Dividends received.
(4) Check the advices received from the broker against the purchases and sales shown in the schedule.
(5) The canceled checks issued for purchases should be examined, and the proceeds of cash from any sales should be traced to the bank account.
(6) Check all the transactions against the authorizations of the board of directors or the finance committee.
(7) The dividends received, as shown by the schedule, should be verified by reference to a published dividend-payment service, and should be checked against the amount shown in the general ledger.

No. 4.

(1) *Physical evidence:*
    Count of cash
    Inspection of:
        Securities
        Inventories
        Fixed assets
(2) *Documentary evidence:*
    Canceled checks
    Banks' statements

Confirmations
Warehouse receipts
Contracts
Invoices
Minute books
Accounts and records of client

(3) *Oral evidence:*
Opinion of officers and employees with respect to:
Collectibility of receivables
Obsolescence and salability of inventories
Contingent liabilities
Explanations of entries

No. 5.

A paragraph should be included in the report commenting upon the change in the method of valuing the inventory and the effect of such change upon the financial statements.

The income statement should bear a footnote explaining the change and its effect upon the net income before and after federal income and excess-profits taxes.

The balance-sheet should bear a footnote explaining the change and the amount of the reduction in the inventory valuation resulting therefrom.

That section of the report having to do with the comment on the consistent application of accounting principles should be qualified.

No. 6.

A. Federal Old Age Benefits Provisions, State Unemployment Compensation Provisions, Wage and Salary Stabilization Act and its executive orders and regulations, and the Federal Wage and Hour Law.

B. The auditor should not presume to pass on any legal questions which may be presented, but should suggest that the client take up such matters with his attorney. Such questions as whether the client or his employees are covered under the laws are for the attorney to decide. If the auditor finds that there is a contingent liability of significant amount he should indicate it on the financial statements, or qualify his report accordingly.

No. 7.

Study the system of internal check and control and test its operation before attempting to outline an audit program.

Tests may be made of cash, footings, postings, and operating accounts. Review the cost system and test its operation. Analyze and verify changes in the property, security, capital stock, and surplus accounts.

If a dependable perpetual-inventory control is in operation, the auditor may make his inspection at some date prior to the balance-sheet date. Accounts receivable may be confirmed at an earlier date under certain circumstances.

Examining agents' reports, and correspondence with the Bureau of Internal Revenue may also be read and noted.

No. 8.

A. Yes.

B. A cut-off of the cash at a later date by reconciling the bank accounts, examining the canceled checks, etc., for the purpose of discovering any irregularities.

A scrutiny of the cash, purchase, sales, and other records for the purpose of determining whether any transactions applicable to the period under review were recorded subsequently to the balance-sheet date.

An examination of the minute books to discover anything which might affect the financial position of the company.

A study of market quotations and subsequent sales of any products constituting a major part of the inventory which might call for an adjustment downward of its valuation.

A scrutiny of bad-debt charge-offs and of allowances in order to determine whether any additional amount should be set up.

C. Transactions or irregularities applicable to the period under review, or to prior periods, should be reflected in the financial statements.

Factors which occurred subsequently to the balance-sheet date which do not apply to the period prior to that date do not affect the financial statements. However, such factors as the destruction of a plant by fire, flood, etc., collapse of market values, etc., which materially affect the financial condition of the company, should be commented upon in the report or shown as a footnote on the statements.

No. 9.

The reserve for bad debts should be analyzed and the provision for the period traced to the expense account. The policy with respect to writing off bad debts to the reserve should be examined, and the items charged off should be inspected or tested for proper authorization. The adequacy of the reserve should be discussed with the credit manager when reviewing the collectibility of the outstanding accounts.

The total of the individual balances in the memorandum accounts should be checked against the balance in the control account. The charges and credits to the control account should be analyzed. The charges for bad debts, the recoveries collected, and the credits representing charges to the bad-debt reserve account should be tested. Any other transactions appearing in the account should be explained by the credit manager. It would be well to circularize some of the accounts.

No. 10.

As the examination of the minute books is essential to the audit, the auditor should refuse to issue an unqualified certificate unless he is allowed access to these records. He should explain that inasmuch as he was engaged to make an examination which would enable him to render an independent opinion of the financial condition of the compay it would be necessary that he, personally, must determine what effect the minutes of the stockholders, directors, and committees may have upon the financial statements.

No. 11.

The answer to this question depends upon the degree and the effect upon the financial statements of the work performed by the auditor. If the extent of his work in writing up the general journal and in posting the transactions is significant, he may be justifiably criticized if he renders an opinion with respect to the statements on the grounds that such opinion was not independent.

No. 12.

A. The finance charge is a charge for the loan of capital and should be taken up as income over the period of the instalment contract.
B. As the omission of a reserve for unearned finance charges from the balance-sheet would constitute a violation of "generally accepted accounting principles," an exception should be noted in the certificate.
C. As the reserve is for deferred income it should be shown on the liability side of the balance-sheet immediately above the net-worth or capital sections.

No. 13.

(1) Send additional requests by registered mail, return receipt requested.
(2) The auditor might telephone to ascertain the balance or the reason for failure to respond to the written request.
(3) Under some circumstances, requests may be made by telegraph.
(4) A very careful study of the changes in the account, subsequent to the balance-sheet date and a check of the sales records, shipping records, signed orders, etc., making up the unpaid balance should be made.

Answers to Examinations of November 1943

Accounting Practice – Part I

November 17, 1943, 1:30 to 6:00 p.m.

No. 1.

ADJUSTMENTS AND ELIMINATIONS

(1)		
Investment in S Co. bonds	$ 1,500	
Surplus—Top Holding Company		$ 1,500
To increase the investment in S Co. bonds to their par value.		
(2)		
Investment in R Co. stock:		
(Top Holding Company)	9,000	
(S Company)	1,000	
Surplus:		
(Top Holding Company)		9,000
(S Company—since acquisition)		1,000
To restate the investment in R Co. stock to cost, by restoring the deficit since acquisition deducted therefrom.		
(3)		
Capital stock—R Co.	30,000	
Investment R Co. stock:		
Top Holding Company (90%)		27,000
S Company (10%)		3,000
To eliminate the par value of R Co. stock.		
(4)		
Surplus at acquisition—R Co.	1,500	
Investment in R Co. stock:		
Top Holding Company (90%)		1,350
S Company (10%)		150
To eliminate the surplus at acquisition of R Company.		
(5)		
Capital stock—S Company	45,000	
Investment in S Co. stock:		
Top Holding Company (75%)		37,500
R Company (15%)		7,500
To eliminate the par value of S Company stock.		

(6)

Surplus at acquisition—S Co.	4,500	
Investment in S Co. stock:		
Top Holding Company (75%)		3,750
R Company (15%)		750

To eliminate the surplus at acquisition of S Company.

As R Company and S Company have an interest of 15% and 10% respectively in each other's surplus or deficit since the date of acquisition, it will be necessary to determine the amount of such interest, somewhat as follows:

R equals $10,000 minus the interest of S, or .15 ($26,610—.10 R)

100 R equals $1,000,000 minus $399,150 plus 1½R

98½ R equals $600,850

R equals $6,100

The interest of R Company is 15% ($26,610—$610) or $3,900

S equals $26,610 minus the interest of R, or .10 ($10,000—.15S)

100 S equals $2,661,000 minus $100,000 plus 1½ S

98½ S equals $2,561,000

S equals $26,000

The interest of S Company is 10% ($10,000—$3,900) or $610

(7)

Surplus at acquisition—S Co.	$ 4,510	
Surplus at acquisition—R Co.		$ 4,510

To transfer to R Co. its share in the surplus of S Co. since date of acquisition ($3,900), and to S Co. its share in the deficit of R Co. since acquisition ($610).

TOP HOLDING COMPANY
AND ITS SUBSIDIARIES, R COMPANY AND S COMPANY

CONSOLIDATED BALANCE-SHEET

Blank Date

Assets

Current assets		$ 298,110
Property, less reserves		182,500
Goodwill		3,500
		$ 484,110

Liabilities and Net Worth

Current liabilities		$ 173,000
Bonds payable	$ 100,000	
Less, bonds held for cancellation	43,000	57,000
Minority interest		8,100
Net worth:		
Capital stock	$ 200,000	
Surplus	46,010	246,010
		$ 484,110

TOP HOLDING COMPANY AND ITS SUBSIDIARIES, R COMPANY AND S COMPANY

Consolidated Balance Sheet—Work Papers

Blank date

Assets	Top Holding Company	R Company	S Company	Adjustments and Eliminations Dr.	Adjustments and Eliminations Cr.	Goodwill	Minority Interest	Consolidated Surplus	Consolidated Balance-sheet
Current assets	$150,000	$30,000	$118,110						$298,110
Property—less reserves	47,000	5,500	130,000						182,500
Investment R Co. stock:									
90%	18,000			(2)$ 9,000	(3)$27,000				
					(4) 1,350	$1,350*			
10%			2,500	(2) 1,000	(3) 3,000				
					(4) 150	350			
Investment S Co. stock:									
75%	45,000				(5) 37,500				
					(6) 3,750	3,750			
15%		9,000			(5) 7,500				
					(6) 750	750			
Investment S Co. bonds	41,500			(1) 1,500					43,000
Goodwill						$3,500			3,500
	$301,500	$44,500	$250,610						$527,110
Liabilities									
Current liabilities	$ 80,000	$23,000	$ 70,000						$173,000
Bonds payable			100,000						100,000
Capital stock:									
Top Company	200,000								200,000
R Company		30,000		(3)$30,000					
S Company			50,000	(5) 45,000			$5,000		
Surplus at acquisition:									
R Company		1,500		(4) 1,500					
S Company			5,000	(6) 4,500			500		
Earned surplus:									
Top Company	21,500				(1)$ 1,500				
					(2) 9,000			$32,000	
R Company		10,000*			(7) 4,510			5,490*	
S Company			25,610	(7) 4,510	(2) 1,000				
Minority interest (10% of $26,000)							2,600	19,500	
Minority interest							$8,100		8,100
Consolidated surplus								$46,010	46,010
	$301,500	$44,500	$250,610	$97,010	$97,010				$527,110

* Asterisk indicates red.

No. 2.

EXHIBIT A

ESTATE OF ALEX DUNN, JR., EXECUTOR

STATEMENT OF CHARGE AND DISCHARGE

January 15, 1943, to January 31, 1943

As to Principal:

I charge myself with:		
Assets, per inventory:		
Cash in bank	$ 3,750.00	
6% note receivable, including $50 accrued interest	5,050.00	
Stocks	50,000.00	
Dividends declared on stocks	600.00	
6% mortgage receivable, including $100 accrued interest	20,100.00	
Real estate—apartment house	35,000.00	
Household effects	8,250.00	
Dividend receivable from Alex Dunn, Sr., Trust fund	250,000.00	$372,750.00
Gain on realization of assets (Exhibit C)		100.00
Assets subsequently discovered		250.00
Total		$373.100.00
I credit myself with:		
Funeral expenses	$ 750.00	
Decedent's debts	8,000.00	
Decedent's bequests	10,000.00	
Loss on realization of assets (Schedule C)	7,500.00	26,250.00
Balance of principal		$346,850.00

Made up, as follows:	
Cash in bank (Exhibit B)	$ 61,100.00
Stocks	27,500.00
Household effects	8,250.00
Dividend receivable from Alex Dunn, Sr., trust fund (see note)	250,000.00
Total assets remaining	$346,850.00

As to Income:		
I charge myself with:		
Dividends received	$ 900.00	
Interest received	41.66	$ 941.66
I credit myself with:		
Advances to widow (see note)		500.00
Balance of income		$ 441.66

NOTES.—In this solution, the dividend receivable from the Alex Dunn, Sr., trust fund is considered as income to the trust because the dividend was declared payable to stockholders of record as of January 12, 1943, which date is prior to the date of death of Alex Dunn, Jr. However, under certain state laws, and possibly under special provisions of the trust agreement the dividend may be considered as a liquidating dividend in whole or in part. Hence, a solution treating the dividend as a liquidating dividend, or a partial liquidating dividend (considering the increase in the value of the stock as of December 31, 1942) may be acceptable.

The advances to the widow, in certain states, is considered as a deduction from principal.

EXHIBIT B

ESTATE OF ALEX DUNN, JR., EXECUTOR

STATEMENT OF CASH RECEIPTS AND DISBURSEMENTS

January 15, 1943, to January 31, 1943

Date	*Receipts*	Principal	Income
Jan. 15	Cash in bank, per inventory	$ 3,750.00	
20	Dividends	600.00	$ 900.00
	6% note receivable	5,000.00	
	Interest accrued on note	50.00	8.33
	Stocks sold (inventoried at $22,500)	20,000.00	
	6% mortgage sold	20,100.00	
	Interest accrued on mortgage	100.00	33.33
28	Sale of assets not inventoried	250.00	
29	Real estate sold (inventoried at $35,000)	30,000.00	
	Total cash receipts	$79,850.00	$ 941.66
	Disbursements		
Jan. 20	Funeral expenses	$ 750.00	
23	Decedent's debts	8,000.00	
25	Decedent's bequests	10,000.00	
31	Advances to widow		$ 500.00
	Total cash disbursements	$18,750.00	$ 500.00
	Cash balances, January 31, 1943	$61,100.00	$ 441.66

EXHIBIT C

ESTATE OF ALEX DUNN, JR., EXECUTOR

STATEMENT OF GAIN OR LOSS ON REALIZATION

January 15, 1943 to January 31, 1943

Asset	Inventory Value	Gain	Loss	Realization
Stocks	$22,500.00	—	$2,500.00	$20,000.00
6% mortgage	20,000.00	$ 100.00	—	20,100.00
Real estate	35,000.00	—	5,000.00	30,000.00
Totals	$77,500.00	$ 100.00	$7,500.00	$70,100.00

No. 3.

A & B CO-PARTNERSHIP

(A) STATEMENT SHOWING THE CASH SETTLEMENT BETWEEN THE PARTNERS

December 31, 1942

Acquired by A:		
Unit number	Amount	
1	$ 14,500	
3	700	
4	2,500	
7	3,200	
Total	$ 20,900	
One-half thereof		$ 10,450
Acquired by B:		
Unit number		
2	$ 13,000	
5	8,000	
6	6,200	
8	8,200	
Total	$ 35,400	
One-half thereof		17,700
Amount payable by B to A		$ 7,250

A & B CO-PARTNERSHIP

(B) Statement Showing the Taxable Profit or Deductible Loss of Partners

December 31, 1942

Partner A:

Value of his one-half interest in assets sold to B. ½ of $36.900 (Column 1 of Schedule C)	$ 18,450
Amount realized by B for his one-half interest in assets bought by A (Schedule A)	17,700
Deductible loss	$ 750

Partner B:

Amount realized by A for his one-half interest in assets bought by B (Schedule A)	$ 10,450
Value of his one-half interest in assets sold to A. ½ of $10,284 (Column 1 of Schedule C)	5,142
Taxable profit	$ 5,308

Note:

The profit to the partnership is:

Price paid by partners (Column 2 of Schedule C)	$ 56,300
Net cost to partnership (Column 1 of Schedule C) ...	47,184
Profit	$ 9,116

The unrealized profit or loss in the unsold one-half interest in assets held by the partners is:

	A	*B*
Share of profit, per above	$ 4,558	$ 4,558
Per Schedule B:		
Deductible loss	750	—
Taxable profit	—	5,308
Unrealized profit (loss*)	$ 5,308	$ 750*

A & B CO-PARTNERSHIP

(c) Statement Showing Cost to Purchasers of Assets Bought

December 31, 1942

Unit	Item			Net Cost to Partnership (1)	Price Paid (2)	Total Columns (1) and (2) (3)	½ Interest of Partner (4)	Obligations Assumed (5)	Cost to Purchasers (6)
	Assets Bought by A:								
	Column Number			(1)	(2)	(3)	(4)	(5)	(6)
1	Accounts receivable		$104,000						
	Less, reserve for uncollectible accounts		104,000	$ —	$14,500	$ 14,500	$ 7,250	$ —	$ 7,250
3	Mortgage receivable, including interest			2,014	700	2,714	1,357	—	1,357
4	Grand Block		$ 6,000						
	Less, accrued taxes		1,480	4,520	2,500	7,020	3,510	1,480	4,990
7	Millard Building		$ 5,700						
	Less, accrued taxes		1,950	3,750	3,200	6,950	3,475	1,950	5,425
	Total purchased by A			$10,284	$20,900	$ 31,184	$15,592	$ 3,430	$19,022
	Assets Bought by B:								
2	Notes receivable		$ 14,000						
	Less, reserve for unearned discounts		1,400	$12,600	$13,000	$ 25,600	$12,800	$ —	$12,800
5	Park Building		$ 14,000						
	Less, accrued taxes		3,200	10,800	8,000	18,800	9,400	3,200	12,600
6	Artesian Square Building		$ 8,900						
	Less, accrued taxes		800	8,100	6,200	14,300	7,150	800	7,950
8	Ponce Subdivision		$ 24,000						
	Less, accrued taxes	$ 8,000							
	Mortgage payable	10,000							
	Accrued interest	600	18,600	5,400	8,200	13,600	6,800	18,600	25,400
	Total purchased by B			$36,900	$35,400	$ 72,300	$36,150	$22,600	$58,750
	Total purchased by A and B			$47,184	$56,300	$103,484	$51,742	$26,030	$77,772

Theory of Accounts

November 18, 1943, 9 a.m. to 12:30 p.m.

GROUP I

No. 1.

Standard cost systems recognize variations from standards, and it is not generally necessary to adjust them except in cases of major changes of a permanent nature. These variations are determined periodically and the amounts due to cost, or volume changes, are computed. These amounts are then applied to the gross profit as determined under the standards to ascertain the actual gross profit for purposes of the profit-and-loss statement. Under the circumstances stated in the question, it does not appear necessary to adjust the standards which are affected by volume increase only.

No. 2.

The liability is usually recorded on the books:

(1) When the merchandise has been received and the invoice has been approved by the receiving and purchasing departments.

(2) When title has been passed, even though the merchandise has not been received.

Permissible exceptions are:

(1) The liability for goods purchased f.o.b. shipping point should be recorded when the seller delivers them to the carrier.

(2) The liability for goods set aside and held by the seller at the buyer's risk should be recorded when so set aside.

(3) No liability is incurred by a consignee until sales are made from the consigned goods in his possession.

No. 3.

(1) Experimental and development expenses applicable to the technological improvement of the present products and their manufacture should be charged to current income because the source of this income is the current sale or manufacture of the products.

(2) (a) If the company has incurred such expenses regularly and has consistently written them off to income each year as incurred, the practice should be continued.

(b) If the expenses were incurred for an experiment which led to obtaining a basic patent, the cost should be charged to patents account and amortized over the life of the patent.

(c) If the expenses were incurred in the development of a new product the costs may be deferred and charged against the income produced by the sale of such new product, or a reasonable period during which this product is sold.

(d) If the experiment or development is abandoned, the cost should be charged to income in the year the decision to abandon was made.

No. 4.

The term "cost," as used in the valuation of inventories, may be the actual cost of a purchased or manufactured product, or it may be a cost based upon some consistent basis of pricing; i.e., "first-in, first-out," "last-in, first-out," "average."

"Market" is the bid price, or replacement value at the date of the inventory for the same merchandise for quantities usually purchased. In the case of a manufactured product, the selling price less the cost of selling, or less the percentage of usual gross profit is deducted to ascertain "market."

"Cost or market whichever is lower" is the lower of cost or market of each unit in the inventory.

No. 5.

(1) Property held temporarily idle should be earmarked in the property ledger, although it is not necessary to segregate in the property account or on the balance-sheet. However, the depreciation charge on such property should be shown as a separate item in the income statement.

(2) The property account and the reserve-for-depreciation account should be relieved of the amounts applicable to the idle property with no future utility and the salvage value should be expressed on the books and in the statements. No depreciation should be provided for in the future.

GROUP II

No. 6.

(a) The change in methods may require a restatement of the inventory at January 1st to cost by adding back the write-downs to market value if any such adjustments had been made. This change will probably increase the taxable income for the preceding year, and require a tax to be paid on such increase at the rates in effect for the prior year.

(b) The excess of the quantities in the December 31st inventory over the January 1st inventory may be valued at (1) earliest costs, (2) latest costs, or (3) average costs during the year. Whichever one of the three is adopted must be consistently used in the future.

(c) A disclosure of the fact that market value is lower than "lifo" cost at the balance-sheet date should be made in the financial statements, although it is not necessary to record the adjustment on the books of the company.

No. 7.

(a) Adjusting entries to correct property accounts:

(1)

Earned surplus		$15,000	
Appreciation of building			$15,000
To reverse entry on books.			

(2)

Earned surplus		3,000	
Reserve for depreciation			3,000
To provide for underdepreciation, as follows:			
Ratio of appraised depreciation is ($60,000 ÷ $150,000) 40%.			
40% of $120,000 (cost)	$ 48,000		
Already provided	45,000		
Underdepreciation	$ 3,000		

(3)

Appreciation of building		30,000	
Reserve for depreciation on appreciation			12,000
Reserve for revaluation of fixed assets			18,000
To record the following:			
Appraised value	$150,000		
Cost	120,000		
Appreciation	$ 30,000		
Depreciation on appreciation: 40% of $30,000	12,000		
Appraisal surplus	$ 18,000		

(b) Schedule showing application of adjustments under (a) to the accounts of the company as on December 31, 1942

	Company's Books before Adjustments		Adjustments		Accounts after Adjustments	
	Debits	*Credits*	*Debits*	*Credits*	*Debits*	*Credits*
Cost of building	$120,000				$120,000	
Reserve for depreciation		$ 45,000		(2)$ 3,000		$ 48,000
Appreciation of building	15,000		(3)$30,000	(1) 15,000	30,000	
Earned surplus			(1) 15,000 (2) 3,000		18,000	
Reserve for depreciation on appreciation				(3) 12,000		12,000
Reserve for revaluation of fixed assets (appraisal surplus)				(3) 18,000		18,000
Balance		90,000				90,000
Total	$135,000	$135,000	$48,000	$48,000	$168,000	$168,000

No. 8.

(a) The proper basis of valuation of treasury no-par common stock issued to an employee for services rendered is the market value of the stock on the date it is transferred to him, or the average market prices for the period in which the services were rendered.

(b) The fair market price of the stock at the date of subscription or at the date of transfer should be used in valuing the treasury stock. The difference, if any, between the subscription price and the value so determined should be charged or credited to capital or paid-in surplus.

No. 9.

(a) There seems to be no reasonable basis upon which the charge was allocated between surplus and current income. From the information given in the question, it would appear more desirable to charge the entire amount as a special item against current income indicating that it is being provided for estimated war costs and losses rather than as a "contingency."

(b) Illustrations of such costs and losses:

(1) Reconversion to peacetime operations
(2) Loss on termination of contracts
(3) Loss on inventories
(4) Acceleration of depreciation on plant
(5) Extraordinary depreciation due to inadquate repairs and maintenance
(6) Obsolescence of wartime equipment

No. 10.

(1), (2), and (3) should be charged to earned surplus at the par value of the stock issued as a stock dividend.

(4) Earned surplus should be charged with the par value of the stock issued, and the paid-in surplus applicable should be charged to paid-in surplus account. If there is no paid-in surplus account, the total amount of the par value and the premium should be charged to earned surplus.

(5) and (6) Earned surplus should be charged with the stated value, and paid-in surplus applicable should be charged to paid-in surplus account. If there is no paid-in surplus account, the total amount should be charged to earned surplus.

No. 11.

(1) Taxes on unimproved property or on property under construction.
(2) Insurance on property under construction.
(3) Interest (during the period of construction) on money borrowed to finance such construction.
(4) Legal expenses incurred for title search, acquiring patents, or organizing the company.
(5) Cost of repairs which extend the life of the property.
(6) Advertising costs of the "institutional" type which benefit subsequent periods.

No. 12.

(a) The unit basis is depreciation provided on individual units of property (1) at rates applied to each unit of production, or (2) at rates based upon the useful life of each unit.

When the property is retired, the cost of the unit and the accrued depreciation thereon are eliminated from the asset and the depreciation-reserve account.

(b) The composite basis is depreciation provided on a group of assets which may or may not be similar. The groupings may include all the assets at a given plant or branch, or all the buildings, all the machinery, etc. The rates are based upon the approximate average life of all the assets within the group and are generally applied on the straight-line method.

When an asset is retired, the cost of the property is credited to the asset account, and charged to the relative depreciation reserve.

(c) The group basis is depreciation provided on aggregates of like kind of properties, such as automobiles, trucks, machinery, furniture, etc. The rates are determined and the retirements of property are dealt with as outlined under (b).

Accounting Practice – Part II

November 18, 1943, 1:30 to 6 p.m.

No. 1.

CITY OF M

COLUMNAR WORK SCHEDULE, SHOWING THE FINANCIAL TRANSACTIONS

Year Ended December 31, 1942

General Fund	Balance-sheet, January 1, 1942 — Assets	Balance-sheet, January 1, 1942 — Liabilities	Budget for Year — Estimated Revenues	Budget for Year — Appropriations	Cash Transactions — Debit	Cash Transactions — Credit	Journal Entries — Debit	Journal Entries — Credit	Balance-sheet, December 31, 1942 — Assets	Balance-sheet, December 31, 1942 — Liabilities
Cash	$ 2,000				(4) $353,900	(4) $346,700			$ 9,200	
Taxes receivable—arrears	15,000					(4) 223,000	(3) $236,250		22,250	
						(4) 6,000				
Reserve for uncollectible taxes—arrears		$ 10,000					(6) 1,000	(3) $ 11,250		$ 20,250
Accounts payable		3,000			(4) 3,000			(5) 2,600		2,600
Unappropriated surplus		4,000					(5) 2,600	(6) 1,000		8,600
								(x) 6,200		
Total	$ 17,000	$ 17,000								
Estimated revenues:										
Taxes receivable—1942 levy			(2) $225,000					(3) 225,000		
Court fines			(2) 10,000			(4) 10,600	(x) 600			
Licenses			(2) 6,000			(4) 6,100	(x) 100			
Permits			(2) 10,000			(4) 9,800		(x) 200		
Interest and penalties			(2) 8,000			(4) 8,400	(x) 400			
Current appropriations:										
General government				(2) $ 68,000	(4) 67,000		(x) 1,000			
Police department				(2) 61,000	(4) 59,250		(x) 1,750			
Fire department				(2) 12,000	(4) 10,750		(x) 1,250			
Highway department				(2) 44,000	(4) 42,000		(x) 2,000			
Sanitation department				(2) 39,000	(4) 40,000			(x) 1,000		
Retirement of serial bonds				(2) 15,000	(4) 15,000					
Interest on bonds				(2) 17,000	(4) 17,000					
Interest on tax notes				(2) 3,000	(4) 2,700		(x) 300			
Total			$259,000	$259,000						
Tax anticipation notes					(4) 90,000	(4) 90,000				
					$700,600	$700,600	$247,250	$247,250	$ 31,450	$ 31,450

City of M
(*Continued*)

Columnar Work Schedule, Showing the Financial Transactions
Year Ended December 31, 1942

Bond Fund	Balance-sheet, January 1, 1942		Budget for Year		Cash Transactions		Journal Entries		Balance-sheet, December 31, 1942	
	Assets	*Liabilities*	*Estimated Revenues*	*Appropriations*	*Debit*	*Credit*	*Debit*	*Credit*	*Assets*	*Liabilities*
Bonds authorized—unissued..	$	$					(7a)$100,000	(7b)$100,000		
Reserve for authorized expenditures							(7e) 80,000	(7a) 100,000		$ 20,000
Cash							(7b) 100,000	(7d) 60,000	$ 40,000	
Construction in progress.....							(7c) 95,000	(7e) 80,000	15,000	
Contracts payable							(7d) 60,000	(7c) 95,000		35,000
	$	$					$435,000	$435,000	$ 55,000	$ 55,000
Statement of Bonded Debt										
Deferred charges to future taxation	$285,000					(4) $ 15,000	(7b)$100,000		$370,000	
Bonds payable		$285,000			(4) $ 15,000			(7b)$100,000		$370,000
	$285,000	$285,000			$ 15,000	$ 15,000	$100,000	$100,000	$370,000	$370,000

Explanation of entries: Transactions numbered (2) to (7e) inclusive correspond with the numbered paragraphs in the problem. Entry (x) closes the balances in the budgetary accounts to Unappropriated Surplus Account.

No. 2.

NATIONAL INDUSTRIES, INC.

(a) Work Schedule Showing the June 30, 1943, Balance-sheet before and after the Proposed Reorganization

Assets	Balance sheet, Per Books	*Explanation of Adjustments*	Paragraph Reference	Adjustments *Debits*	Adjustments *Credits*	Balance-sheet, after Adjustments
Cash	$ 1,130,000	Sale of 4% bonds at 105	(1)	$ 3,150,000		
		Accrued interest for June, 1943 on 4% bonds sold	(1)	10,000		
		Sinking fund cash transferred	(2)	500,000		
		Redemption of Series A and B bonds at par	(2)		$ 3,500,000	
		Interest coupons (July 1, 1943) paid	(2)		97,500	
		Interest for July on 6% Series A bonds redeemed	(2)		10,000	
		Interest for July on 5% Series B bonds redeemed	(2)		6,250	
		Call premium of $15 per $1,000 Series A bond called	(3)		30,000	
		Extra cash dividend on preferred stock A (7,500 shares at $1.25)	(6)		9,375	
		Commissions and expenses on new bonds sold	(8)		45,000	
		Preferred dividends paid July 1, 1943	(9)		39,375	$1,052,500
Other current assets	1,450,000					1,450,000
Property, less depreciation	6,800,000					6,800,000
Sinking fund cash	500,000	Transferred to general cash	(2)		500,000	
Unamortized discount, Series A bonds	30,000	Charged to surplus	(2)		30,000	
Unamortized discount, Series B bonds	90,000	Charged to surplus	(2)		90,000	
Total	$10,000,000					$9,302,500
Liabilities						
Preferred dividends payable July 1, 1943	$ 39,375	Paid July 1, 1943	(9)	39,375		
Bond interest accrued	97,500	Interest accrued for June, 1943 on 4% bonds sold	(1)		10,000	$ 10,000
		Interest paid	(2)	97,500		
Other current liabilities	63,125					63,125
Series A 6% bonds due July 1, 1948	2,000,000	Bonds redeemed	(2)	2,000,000		
Series B 5% bonds due July 1, 1953	1,500,000	Bonds redeemed	(2)	1,500,000		
$5 Preferred Stock A, 7,500 shares, stated value	675,000	Value increased to $100 par	(4)		75,000	
		Increased from 7,500 to 10,000 shares	(5)		250,000	1,000,000
$6 Preferred Stock B, 20,000 shares, stated value	1,700,000	Exchanged for 200,000 shares of new common stock	(7)	1,700,000		
Common stock, no-par, 50,000 shares, stated value	625,000	Exchanged for 5,000 shares of new common stock	(7)	625,000		
Appraisal surplus	1,750,000					1,750,000
Earned surplus	1,550,000	Interest for July on Series A and B bonds redeemed	(2)	16,250		
		Unamortized discount on Series A and B bonds written off	(2)	120,000		
		Call premium on Series A bonds	(3)	30,000		
		Preferred stock A changed to $100 par value	(4)	75,000		
		Stock dividend of 1/3 share to holders of preferred stock A.	(5)	250,000		
		Extra cash dividend on preferred stock A (7,500 shares at $1.25)	(6)	9,375		1,049,375
Total	$10,000,000					
Consolidated 1st mortgage 4% bonds		Sale of new bonds at par	(1)		3,000,000	3,000,000
		plus premium of $5 per bond	(1)		150,000	
Unamortized bond premium		Expenses paid on new bond issue	(8)	45,000		105,000
Common stock (new)		205,000 shares ($10 each) issued in exchange for preferred stock B and old common	(7)		2,050,000	2,050,000
Paid in surplus		Arising from exchange of old stock for new common stock.	(7)		275,000	275,000
Total				$10,167,500	$10,167,500	$9,302,500

NATIONAL INDUSTRIES, INC.

(b) Statement showing the effect of the proposed reorganization upon annual bond interest and amortization charges and dividend requirements

BOND-INTEREST AND AMORTIZATION CHARGES

Annual requirements before reorganization:			
Bond interest:			
$2,000,000 Series A, 6% bonds............	$ 120,000		
$1,500,000 Series B, 5% bonds............	75,000	$ 195,000	
Bond discount amortization:			
Series A bonds..........................	$ 6,000		
Series B bonds..........................	9,000	15,000	
Total		$ 210,000	
Annual requirements after reorganization:			
Bond interest on $3,000,000 4% bonds.......	$ 120,000		
Less amortization of premium.............	2,100	117,900	
Annual saving on bond interest and amortization charges			$ 92,100

PREFERRED DIVIDENDS

Annual requirements before reorganization:			
7,500 shares $5 preferred AA	$ 37,500		
20,000 shares $6 preferred B	120,000	$ 157,500	
Annual requirements after reorganization:			
10,000 shares 5% preferred A.........................		50,000	
Annual saving on preferred stock dividend requirements..			107,500
Total annual savings on bond interest, amoritzation charges and dividend requirements			$ 199,600

No. 3.

Q. R. COMPANY

(a) Computation of the Book Value of the Preferred and Common Stock

of the Company Held by Q on March 31, 1943
and the Amount of the Non-Interest-Bearing Note

Preferred stock:		
Book value of 3,200 shares, per work sheet (b)	$314,400	
Book value per share	$98.25	
Book value of Q's holding—2,100 shares		$206,325
Common stock:		
Book value of 1,000 shares, per work sheet (b)	$904,600	
Book value, per share	$904.60	
Book value of Q's holding—600 shares		542,760
Amount of non-interest-bearing note to be issued by the company		$749,085

Q. R. COMPANY
(b) Work Sheet Showing Adjustments to the Bookkeeper's Statements
March 31, 1943

Assets	Before Adjustments	Adjustments: Explanations	Paragraph Reference	Debits	Credits	After Adjustments
Net Assets (December 31, 1942)	$1,482,740	Transfer from appreciation reserve account to credit of plant account	(1)		$ 53,475	
		To record the actual liability on renegotiation at March 31, 1943	(2)		127,500	
Increase due to net profit for three months ended March 31, 1943	26,250	Transfer of balance from reserve account to plant account	(3)		85,440	
		Additional amount to correctly state 1942 income tax liability	(5)		25,100	
		Sinking fund interest received	(9)	$ 1,525		
Total assets	$1,508,990			$ 1,525	$291,515	$1,219,000
Capital						
Preferred stock (no-par value):						
Issued—3,500 shares at $92 per share	$ 322,000	Accrued dividend paid on treasury stock	(8)		$ 750	$ 294,400
Treasury stock—300 shares at $100 plus accrued dividend	(30,750)	Premium paid on treasury stock ($8 per share)	(8)		2,400	
		Dividend paid on treasury stock (June 30, 1942)	(8)	$ 750		
		Accrued dividend on preferred stock:				
Dividends accrued on preferred stock		June 30, 1942 on 3,500 shares	(10)		8,750	20,000
		December 31, 1942 on 3,200 shares	(10)		8,000	
		March 31, 1943 on 3,200 shares	(10)		4,000	
Total—preferred stock	$ 291,250			$ 750	$ 23,900	$ 314,400
Common stock (no-par value) 1,000 shares	$ 75,000					$ 75,000
Reserves:						
Appreciation	55,800	Transfer of balance at March 31, 1943 to plant account	(1)	$ 53,475		
		Depreciation of appreciation for three months ended March 31, 1943	(11a)	2,325		
Renegotiation of war contracts	250,000	To reduce reserve by the amount of the actual liability at March 31, 1943	(2)	127,500		114,000
		To reduce reserve by the amount of payment made during March	(11b)	8,500		
War plant amortization	85,440	Transfer of balance at March 31, 1943 to plant account	(3)	85,440		
Loss of inventory realization	105,000					105,000
Income taxes, 1942	100,000	Transfer to liability for 1942 income taxes payable	(5)	25,100		74,900
Sinking fund	179,350	Interest on sinking fund investments received March 31, 1943	(9)		$ 1,525	180,875
Earned surplus	340,900	Premium paid on treasury stock ($8 per share on 300 shares)	(8)	2,400		
Profit (for three months ended March 31, 1943)	26,250	Accrued dividends on preferred stock to March 31, 1943	(10)	20,750		
		Depreciation of appreciation transferred to reserve account	(11a)		2,325	354,825
		Payment made on renegotiation during March charged to reserves	(11b)		8,500	
Total—value of common stock	$1,217,740			$325,490	$ 12,350	$ 904,600
Total capital	$1,508,990			$327,765	$327,765	$1,219,000

Commercial Law

November 19, 1943, 9 a.m. to 12:30 p.m.

GROUP I

No. 1.

(a) A principal is liable upon a contract duly made by his agent with a third person when:

(1) The agent acts within the scope of his actual authority.

(2) The contract, although unauthorized, has been ratified.

(3) The agent acts within the scope of his apparent authority, unless the third person has notice that the agent is exceeding his actual authority.

(b) A broker is a person employed to make bargains and contracts between other persons in matters of trade, commerce, and navigation. He differs from a factor in that he does not have possession of the property.

A factor is a person who is employed by another to sell property for him and is vested with the possession or control of the property.

(c) An attorney at law is a person whose profession it is to give advice and assistance in legal matters, and to prosecute and defend proceedings in court; while the term "attorney in fact" is applied to agents whose authority is conferred by a written instrument.

(d) An agent should execute negotiable paper in the name of the principal, so that it will clearly appear upon the face of the instrument that it is the paper of the principal, and not that of the agent. When the fact of the agency appears only in the signature, it should be signed "A.B., by C.D., Agent," or "C.D., for A.B.," or some equivalent expression. If it clearly appears in the body of the instrument that it is the paper of the principal, it is held sufficient if the agent signs his name and adds his character as agent, trustee, treasurer, etc., but an omission to add such character will make it the paper of the agent.

No. 2.

(a) Five of the ways in which a contract may be discharged are:

(1) By mutual agreement.

(2) By performance according to its terms.

(3) By breach.

(4) By impossibility of performance.

(5) By operation of law.

(b) A tender is an unconditional offer or attempt to perform a contract. If the offer is to do something promised, its refusal discharges the promisor from the contract; but, if the offer is to pay something promised, its refusal does not discharge the promisor from the debt, but it does stop the interest, and entitle the promisor to recover the costs of his defense in case he is sued thereon.

(c) The promise to pay A a fair share of the profits of the business is too indefinite as to price to be enforceable in an action on the promise unless it can be made certain by showing extrinsic facts, such as the existence of custom or usage in the particular kind of business in which B is engaged to pay an employee of A's type a standard percentage of profit.

If A has performed services under the contract in reliance upon the promise to receive $40 and a fair share of the profits, if the promise is held unenforceable, he can recover to the extent he has performed under the contract in a quantum meruit action for the reasonable value of his services.

No. 3.

(a) A *de facto* corporation is a corporation so defectively organized as not to be a *de jure* corporation, but nevertheless the result of a bona fide attempt to incorporate under existing statutory authority, coupled with the exercise of corporate powers.

A corporation *de jure* is a corporation created in strict or substantial conformity to the governing corporation statutes.

(b) A stockholder has no legal right to a share of the profits of the corporate business until a dividend is made or declared. It is within the discretion of the directors whether or not dividends shall be declared and paid. A court of equity, in a suit by a stockholder, will compel directors to pay dividends if they have abused their discretion and fraudulently or arbitrarily refused to pay a dividend when the condition of the corporation makes it their duty to do so. When a dividend is lawfully and fully declared out of surplus profits the corporation becomes indebted to the stockholder for the amount of his share and the stockholder may recover it in an action against the corporation.

(c) As a general rule the new company succeeds to all the rights, franchises, privileges, and immunities, and becomes subject to all the debts and liabilities, of the constituent companies.

No. 4.

(a) The indorsee may recover $1,000 from the maker if there are no defenses against the payee available to the maker. However, if the maker has a defense good against the payee, the indorsee can recover only $700 since by the negotiable instruments law he is deemed a holder for value only to the extent of his lien.

(b) No, P is not liable. An indorsement "without recourse" is a qualified indorsement which passes title to the instrument but exempts the transferor from the liability of an indorser. Therefore, P is not liable to A when M, the maker, fails to honor the instrument.

No. 5.

(1) Accountant's fees paid for preparing the taxpayer's personal income-tax return are personal expenses and not deductible from gross income.

(2) An assessment to support a trade association is deductible as a business expense if the membership in the trade association is used as a means of advancing the business interests of the taxpayer.

(3) Attorney's fees paid in connection with suit to protect title to property is a capital expenditure and not deductible from gross income.

(4) The cost of private detectives to protect the taxpayer's farm trucks while en route is a business expense and is deductible from gross income.

(5) The cost to attorney of law books is a capital expenditure and not deductible from gross income.

(6) The payment by wife to husband in consideration that he give up the seafaring profession is a personal expense and not deductible.

(7) The cost of mechanic to install printing press is a capital expenditure and is not deductible from gross income.

(8) The cost of uniforms of city firemen is a capital expenditure and is not deductible from gross income.

(9) Custodian fees are deductible from gross income as a non-business expense if they are paid or incurred by the taxpayer for the production or collection of income, or for the management, conservation, or maintenance of investments held by him for the production of income and they are ordinary and necessary under all the circumstances.

(10) Investment advisory fees are deductible as a non-business expense if they are paid or incurred by the taxpayer for the production or collection of income, or for the management, conservation, or maintenance of investments held by him for the production of income and they are ordinary and necessary under all the circumstances.

GROUP II

No. 6.

(a) Any patent or any interest in a patent is assignable by an instrument in writing, and either the patentee or his assignee may convey an exclusive right under the patent to the whole or any specified part of the United States. But an assignment, grant, or conveyance must be recorded in the patent office in order to be valid against a subsequent purchaser or mortgagee who pays value and has no notice of the prior instrument.

A common-law trade-mark may be assigned by any writing or act of the parties from which the intention to assign can be ascertained. It cannot be assigned except in connection with an assignment of the particular business in which it has been used, with its goodwill, and for continued use upon the same article or class of articles which it was first applied to, and used upon, by its original adopter.

Every trade-mark registered in accordance with the federal statutes, and every mark for the registration of which application has been made, together with the application for registration of the same, are assignable in connection with the goodwill of the business in which the mark is used. The assignment must be in writing and duly acknowledged according to the laws of the country or state in which the assignment is executed. An assignment is void as against a subsequent purchaser for value, without notice, unless it is recorded in the Patent Office within three months from the date thereof.

A copyright can be assigned, transferred, or mortgaged by a written instrument and it can be bequeathed by will. A transferee should immediately record the assignment in the copyright office in order to make it valid against a subsequent purchaser or mortgagee for value without notice whose assignment was duly reported.

(b) (1) Except for provisions allowing longer periods to certain classes of persons, the life of a patent is seventeen years from the date of issuance and is not renewable.

(2) The right in a common-law trade-mark exists as long as the trade-mark is used and ceases only with its abandonment. A certificate of registration of a trade-mark issued under the Federal Trade-mark Act of 1905, except in the case of marks registered in foreign countries, remains in force for twenty years with privilege of renewal on timely application and payment of fees, for successive like terms. Certificates issued for trade-marks previously registered in a foreign country cease to be in force when trade-mark protection ceases in foreign country, and in no case remain in force more than twenty years, unless renewed. The life of certificates of reg-

istration of trade-marks issued by states is prescribed by the statutes of the various states.

(3) The life of a statutory copyright is twenty-eight years from date of first publication or from the date of deposit in case of a copyrighted work of which copies are not produced for sale, renewable for a like period by the author, his surviving spouse or children, his executor, or his next of kin, in that order. In the case of any posthumous work or any periodical, cyclopedic, or composite work copyrighted by the proprietor or work copyrighted by a corporate body or by an employer for whom such work is made for hire, the proprietor of the copyright can secure the renewal of the copyright for a further term of twenty-eight years. A copyright is not renewable by an assignee or licensee of the copyright.

(c) This knowledge is of value to accountants in part for the purpose of using it in amortization, valuation, and verification of the patents, trade-marks, and copyrights as assets in balance-sheets.

No. 7.

(a) A trust is a fiduciary relationship with respect to property, subjecting the person by whom the property is held to equitable duties to deal with the property for the benefit of another person which arises as a result of a manifestation of an intention to create it.

The settlor of a trust is the person who intentionally causes the trust to come into existence.

The trustee is the person who holds the title for the benefit of another.

The trust property is the thing, real or personal, the title to which the trustee holds, subject to the rights of another.

The beneficiary is the person for whose benefit the trust property is held or used by the trustee.

(b) The duties of trustees with respect to accounts are:

(1) To keep accurate and complete records of the trust business;

(2) To furnish the beneficiary with all necessary information regarding the trust;

(3) To render in a court of competent jurisdiction a full account of the administration of the trust.

(c) The trustee will be charged on the accounting with all the principal and income which he has actually received, and in some cases of breach of trust with such further amounts as he would have received if he had performed his duty.

(d) The trustee will be credited on the accounting with all trust moneys necessarily expended for the expenses of administration and for all trust property rightly delivered to the cestui que trust. If trust funds are lacking to pay necessary expenses or to make proper payment to the beneficiaries, the trustee may advance his own funds for such purposes and will be reimbursed therefor upon the accounting.

No. 8.

(a) The difference between a sale and a contract to sell is that a sale is a present transfer of title while a contract to sell is an agreement to transfer the title in the future. The Uniform Sales Act gives the following definitions. A sale of goods is an agreement whereby the seller transfers the property in goods for a consideration called the price. A contract to sell goods is a contract whereby the seller agrees to transfer the property in goods to the buyer for a consideration called the price.

(b) When goods are delivered to the buyer "on sale or return" or on other terms indicating an intention to make a present sale, but to give the buyer an option to return the goods instead of paying the price, unless a different intention appears, the property in the goods passes to the buyer on delivery. The buyer may revest the property interest in the seller by returning or tendering the goods within the time fixed in the contract, or, if no time has been fixed, within a reasonable time.

(c) The loss must be sustained by A. This transaction represents goods delivered to the buyer "on sale or return," and title vested in A on delivery. The person who has title to property bears the loss when the property is destroyed.

No. 9.

(a) A person has an insurable interest in property when he sustains such relations with respect to it that he has a reasonable expectation, resting upon a basis of legal right, of benefit to be derived from its continued existence, or of loss or liability from its destruction. More specifically, an insurable interest exists in the following cases:

(1) When the insured possesses a legal title to the property insured, whether vested or contingent, defeasible or indefeasible.

(2) When he has an equitable title, of whatever character and in whatever manner acquired.

(3) When he possesses a qualified property or possessory right in the subject of the insurance, such as that of a bailee.

(4) When he has mere possession or right of possession.

(5) Whether he has neither possession of the property nor any other legal interest in, but stands in such relation with respect to it that he may suffer, from its destruction, loss of a legal right dependent upon its continued existence.

(b) Credit insurance is a contract whereby the insurer promises, in consideration of a premium paid, and subject to specified conditions as to the persons to whom credit is to be extended, to indemnify the insured, wholly or in part, against loss that may result from the insolvency of persons to whom he may extend credit within the terms of the insurance.

(c) The policy is valid. A creditor has an insurable interest in the life of his debtor and the existence of an insurable interest at the time when the policy is issued is sufficient. The subsequent termination of such interest before the maturity of the policy does not affect its validity.

No. 10.

(a) A bailment is the relation created through the transfer of the possession of goods or chattels, by a person called the bailor to a person called the bailee, without a transfer of ownership, for the accomplishment of a certain purpose, whereupon the goods or chattels are to be dealt with according to the instructions of the bailor.

(b) In a sale the ownership or title passes, although possession need not pass; in a gift title passes only upon the delivery of the goods; while in a bailment possession passes, but title does not.

(c) A warehouseman is one who, as a business, and for hire, keeps or stores the goods of another. This is a bailment for the benefit of both parties, and the bailee is liable for ordinary neglect.

No. 11.

Yes. It seems clear that the note, although signed by A, B, and C individually, was intended to be an obligation of the A, B, C partnership, and that firm received the consideration. Under the Uniform Partnership Act, when the A & B partnership took over and continued the business, D became a creditor of that partnership, and can prove his claim against the firm estate as a firm creditor. However, the creditors of the original partnership of A, B, C, D have an equitable lien on D's claim against the firm estate.

No. 12.

(a) The X Company may deduct from gross income in computing its net income for federal income-tax purposes the premium of $100 paid on the $10,000 policy if it can show that it was an ordinary and necessary business expense. To show that it was an ordinary and necessary business expense, the X Company must establish that the premiums were paid in consideration of personal services actually rendered by Y and that the total amount of compensation paid to Y, including the $100 premium, was not unreasonable compensation for Y's services. The corporation may not deduct the $200 premium paid on the $20,000 policy of which it is a beneficiary because the Internal Revenue Code provides that premiums paid by a taxpayer on a life-insurance policy covering the life of an employee or officer are not deductible when the taxpayer-employer is directly or indirectly a beneficiary under such policy.

(b) Neither the X Company nor the widow are required to include in gross income any part of the amount received upon the maturity of the policies by the death of Y.

Auditing

November 19, 1943, 1:30 to 5:00 p.m.

No. 1.

"Independence" as applied to independence of accountants means the absence of conditions or of types of relationships between an accountant and his clients which might influence the accountant in his viewpoint, judgment, or the conduct of his professional activities with respect to such clients.

Rule 13 of the rules of professional conduct of the American Institute of Accountants is as follows:

"A member or an associate shall not express his opinion on financial statements of any enterprise financed in whole or in part by public distribution of securities, if he owns or is committed to acquire a financial interest in the enterprise which is substantial either in relation to its capital or to his own personal fortune, or if a member of his immediate family owns or is committed to acquire a substantial interest in the enterprise. A member or an associate shall not express his opinion on financial statements which are used as a basis of credit if he owns or is committed to acquire a financial interest in the enterprise which is substantial either in relation to its capital or to his own personal fortune, or if a member of his immediate family owns or is committed to acquire a substantial interest in the enterprise, unless in his report he discloses such interest."

The Securities and Exchange Commission has raised the question of independence of accountants in some of its rules and releases issued in the past. A few of these follow:

"An accountant will not be considered independent with respect to any person in whom he has any substantial interest, direct or indirect, or with whom he is, or was during the period of report, connected as a promoter, underwriter, voting trustee, director, officer, or employee.

"An accountant would not be considered to be independent if the company whose financial statements he certified had indemnified him against all losses, claims, and damages arising out of such certification other than as a result of the accountant's wilful misstatements or omissions.

"An accountant who consistently submerges his preferences or convictions as to accounting principles to the wishes of his client is not in fact independent."

As a matter of interest the student should read the editorial starting on page 179 of the March, 1944, issue of THE JOURNAL OF ACCOUNTANCY and the Accounting Series Release No. 47 issued by the Securities and Exchange Commission, starting on page 258 of the same issue.

No. 2.

The accountant should examine the abstracts of title, deeds, title guarantees, tax bills, appraisals, assessments, insurance policies, etc., but as the title and validity can be established only by reference to the public records, this work should be performed by attorneys.

No. 3.

The auditor would not be warranted in giving a certificate on the basis of the program outlined in the question, as it does not include procedures necessary for the rendering of a certificate.

No provision is made for:

(1) The supervising or the taking of physical tests of the inventory.
(2) The confirmation of accounts receivable by correspondence.
(3) The determination of the adequacy of reserves; such as bad debts, depreciation, renegotiation.
(4) The distinction between capital charges and expenses.
(5) The determination of undisclosed liabilities, either direct or contingent.

No. 4.

(1) The net cost ($14,800) of removing the old building should not be capitalized, but should be written off.
(2) Only that portion of the tax on the building applicable to the construction period within the year 1942 (January and February) should be capitalized. The amount is ⅙ of $3,000, or $500. The remainder of $4,000 should be charged to expense.
(3) The legal and title search expense on property not acquired should be written off to expense. It does not add to the value of the property owned.
(4) The cost of removing used machines replaced by the two new ones is not a capital charge and should be charged to expense.
(5) In theory, and under some circumstances a case may be made for capitalizing the cost of removing the two machines to the third floor to effect more economical operation. However, the amount involved is relatively small, and it would be more desirable to charge it off as an expense.

If the company refused the suggestions, the certificate should indicate the exceptions, unless the items are relatively minor.

No. 5.

(1) Examine the receiving records for some time prior to the balance-sheet date to determine that the merchandise received before that

date has been recorded in the inventory and that the liability therefor has been entered in the accounts.

(2) Review the purchase and disbursement record subsequent to the balance-sheet date to ascertain whether any of the entries were for merchandise received prior to the balance-sheet date.

(3) Examine the available creditors' statements in verification of the accounts payable and reconcile any differences.

No. 6.

Reserve accounts should be adequate (but not excessive) for the purposes for which they are provided. They should be clearly described, correctly stated, and should be provided according to accounting principles consistently followed. The auditor should determine that all necessary and appropriate reserves are set up, and that no charges are made thereto which should be written off to expense.

No. 7.

(1) The cashbook is footed for the purpose of detecting errors which may indicate cash shortages which are being covered up by understating the actual cash receipts or overstating the actual cash disbursements.

(2) The bank deposits as indicated on the bank's statement are reconciled with the receipts per the cashbook in order to detect any possible "kiting" of funds.

(3) The check date, check number, payee, and the amount are compared with the corresponding data in the cashbook for the purpose of determining the correctness of the entries and the extent to which the record may be relied upon.

(4) The procedure of proving agreement between the paid checks and the bank withdrawals is followed for the purpose of determining that the checks verified during the audit are all of the checks that cleared through the bank during the period.

(5) All of the check numbers covering the period to be tested must be accounted for in order to ascertain that all checks have been inspected by the auditor or accounted for as having been issued and outstanding or as having been voided.

No. 8.

None of the auditing procedures followed in the examination of the partnership accounts would be eliminated. The following would be added:

(1) Examine the partnership agreement and determine that the closing entries on the partnership books were correctly made and that

they conform to the provisions of the agreement. Particular attention should be paid to the partnership accounts to see that the annual settlements were in accord with the agreement.

(2) The opening entries on the corporation's books should be checked to see if they were correctly stated. Special inquiry should be made if there has been any change in the opening balance-sheet of the corporation and the closing balance-sheet of the partnership other than in the capital section; particularly so if there is any change in any valuations.

(3) The articles of incorporation, by-laws, and minutes should be examined and particular note made of salaries, bonuses, and commission agreements with officers and employees and of any other contracts.

No. 9.

(a) The auditor should have the trustee or registrar confirm by direct correspondence the amount of the bonds outstanding at December 31, 1942. He should also inspect the bonds on hand, or obtain a cremation certificate, if those repurchased have been destroyed.

(b) He should analyze the bonds payable, and the unamortized bond discount or premium accounts to ascertain if they are properly stated. If the bonds reacquired have not been canceled, the basis upon which they are carried on the books should be checked.

(c) He should study the trust indenture or agreement to ascertain the description, dates of issue and maturity, interest rate, etc., and that all provisions have been met in order to qualify his statements or certificate, if necessary.

No. 10.

(1) If there is a limitation on the scope of the examination such restriction should be stated in the opening paragraph of the report.

(2) If there is an incorrect application of accounting principles the exception should be stated in the "opinion" paragraph. If the matter is very serious, no opinion or certificate should be issued.

(3) If there is an inconsistency of procedures between the current and prior periods it should be stated in the "opinion" paragraph.

No. 11.

(1) The tuition income of private schools should be checked against a computation of fees receivable based upon the enrolment and scholarship records maintained by the registrar, scholarship committee, or the board of trustees.

(2) The rental income of office buildings should be checked against the records of tenants' leases and vacancies. An inspection should be made of the premises to verify the record of vacancies.
(3) The annual dues of golf clubs should be checked against the membership list and records of new members, withdrawals, and arrearages. The minutes of the meetings of the board of directors should be examined in connection with new memberships, resignations, transfers to other classes of memberships, etc.
(4) Donations to charity organizations should be checked against pledge cards, copies of receipts or acknowledgments, and published lists of contributors.
(5) Plate collections at church services should be checked against the record of the count by the ushers or wardens after each service.

No. 12.

(1) A requisition to purchase the materials signed by the storekeeper or the department head.
(2) A purchase order signed by the purchasing department.
(3) A receipt signed by the receiving clerk.
(4) An invoice from the vendor, checked as to price, quantities, terms, clerical accuracy, and approved by the purchasing department.
(5) A copy of the voucher check showing the statement of the invoices paid, the deductions made, the amount of the check issued, the account charged, evidence of the entry of the voucher in the records, and the approval of the controller.

Answers to Examinations of May, 1944

Accounting Practice – Part I

May 17, 1944, 1:30 to 6:00 p.m.

No. 1.

THE STAR MANUFACTURING COMPANY

BALANCE-SHEET

December 31, 1943

Assets

Current assets:			
Cash on hand and in banks		$123,500	
U. S. Treasury bonds, 2%, face value $42,000, at cost plus accrued interest (market value and accrued interest, $45,120)		42,350	
Notes receivable, less discounted notes, $20,000		60,000	
Accounts receivable	$232,900		
Less reserve for bad debts	8,500	224,400	
Inventories (at lower of cost or market):			
Raw materials and supplies	$101,440		
Work in process	110,700		
Finished goods (finished goods valued at $140,000 are pledged against instalment notes payable to bank, per contra)	179,350	391,490	
Advances to suppliers (note)		15,000	
Advances to employees		8,400	
Receivable on common stock—subscription contracts		18,000	$ 883,140
Investments (at cost):			
Capital stock of subsidiary companies		$ 95,000	
Capital stock of other companies (market value, $21,800)		25,000	120,000
Capital assets:			
Land		$ 75,000	
Buildings, as at January 1, 1938, established by revenue agent's report, adjusted for subsequent additions and retirements	$669,500		
Less reserve for depreciation since January 1, 1938	304,500	365,000	
Machinery and equipment	$494,800		
Less reserve for depreciation	162,800	332,000	
Furniture and fixtures	$ 19,100		
Less reserve for depreciation	3,200	15,900	787,900

Sinking fund cash for retirement of First Mortgage 5% Bonds		19,700
Employees' pension fund		14,000
Treasury stock, 100 shares preferred, acquired for resale to employees		10,000
Postwar refund of excess profits tax		8,000
Prepaid expenses and deferred charges:		
Unexpired insurance	$ 3,300	
Prepaid advertising	4,600	
Prepaid interest on notes discounted	1,800	9,700
		$1,852,440

NOTE: The company has non-cancellable commitments to purchase raw materials in the amount of $15,000. The replacement cost of the materials had declined to $10,500 at December 31, 1943.

Liabilities

Current liabilities:		
Accounts payable, trade	$ 282,000	
Accrued payroll and interest	20,120	
Accrued federal income and excess-profits taxes	80,000	
Accrued other taxes	14,300	
Instalment notes payable to bank due $12,000 on first of each month beginning January 1, 1944 (secured by finished goods, per contra)	120,000	
Dividends payable, January 6, 1944	6,000	$ 522,420
First mortgage 5% bonds due January 1, 1960	$ 350,000	
Less bonds held in sinking fund	50,000	300,000
Reserve for employees' pension fund		14,000
Capital stock and surplus:		
Capital stock:		
Preferred, 6% cumulative of a par value of $100 per share (callable after July 1, 1945, at $105 plus accumulated and unpaid dividends); authorized 2,000 shares; issued, 1,800 shares	$ 180,000	
Common, of a par value of $100 per share; authorized, 3,000 shares; issued, 2,500 shares	250,000	
Subscriptions to common capital stock—400 shares	40,000	
Total capital stock	$ 470,000	
Capital surplus	388,000	
Earned surplus, since July 1, 1934	158,020	1,016,020
		$1,852,440

THE STAR MANUFACTURING COMPANY BALANCE SHEET —DECEMBER 31, 1943—WORKING PAPERS

Assets	Debits	Credits	Ref.	Explanation of Adjustments	Adjustments Debits	Adjustments Credits	Balance-Sheet After Adjustments Debits	Balance-Sheet After Adjustments Credits
Cash on hand and in banks	$ 137,500		(1)	To segregate employees' pension fund		$ 14,000	$ 123,500	
Notes receivable, less discounted notes, $20,000	60,000						60,000	
			(3)	To segregate advances to employees		8,400		
Accounts receivable, less reserve, $8,500	247,800		(4)	To segregate advances to suppliers		15,000	232,900	
			(A)	To set up reserve for bad debts....$	8,500			
U. S. Government bonds and accrued interest, $420	42,350						42,350	
Raw materials and supplies	92,440		(5)	To record merchandise not inventoried	9,000		101,440	
Work in process	110,700						110,700	
Finished goods, including consigned merchandise, $21,670	181,320		(7)	To reduce valuation of consigned goods to cost		1,970	179,350	
Investments in the capital stock of other companies	120,000		(8)	To segregate investment in subsidiary		95,000	25,000	
Land and buildings, at cost, less depreciation	440,000		(10)	To segregate land and buildings		440,000		
Machinery and equipment, less depreciation, $162,800	332,000		(B)	To set up reserve for depreciation	162,800		494,800	
Furniture and fixtures, less depreciation, $3,200	15,900		(C)	To set up reserve for depreciation	3,200		19,100	
Sinking fund for retirement of first mortgage bonds	69,700		(11)	To segregate treasury bonds		50,000	19,700	
Treasury stock	10,000						10,000	
Unexpired insurance	3,300						3,300	
Discount on capital stock	15,000		(D)	To write off stock discount		15,000		
Prepaid advertising	4,600						4,600	
Prepaid interest on notes discounted	1,800						1,800	
	$1,884,410							
Employees' pension fund			(1)	Transferred from general cash	14,000		14,000	
Advances to employees			(2)	Transferred from accounts receivable	8,400		8,400	
Advances to suppliers			(4)	Transferred from accounts receivable	15,000		15,000	
Investment in the capital stock of subsidiary			(8)	Transferred from investment account	95,000		95,000	
Land			(10)	Transferred from land and buildings	75,000		75,000	
Buildings			(10)	Transferred from land and buildings	669,500		669,500	
Reserve for depreciation of buildings			(10)	Transferred from land and buildings		304,500		$ 304,500
Bonds held in sinking fund			(11)	Transferred from sinking fund	50,000		50,000	
Receivable on common stock—subscription contracts			(14)	To set up uncollected balances	18,000		18,000	
Reserve for bad debts			(A)	To set up reserve for bad debts		8,500		8,500
Reserve for depreciation on machinery and equipment			(B)	To set up depreciation reserve		162,800		162,800
Reserve for depreciation on furniture and fixtures			(C)	To set up depreciation reserve		3,200		3,200
Postwar refund of excess-profits tax			(E)	To set up postwar refund	8,000		8,000	

THE STAR MANUFACTURING COMPANY BALANCE SHEET—DECEMBER 31, 1943—WORKING PAPERS

(Continued)

Liabilities, Capital Stock, and Surplus						
Accounts payable, trade	$ 273,000	(5) To record liability for merchandise not inventoried		9,000		282,000
Accrued payrolls and interest (exclusive of interest on instalment notes payable to bank)	15,620	(F) Interest on instalment notes transferred		4,500		20,120
Reserve for federal income and excess-profits taxes (net of postwar refund of $8,000)	72,000	(E) To transfer postwar refund		8,000		80,000
Reserve for other taxes	14,300					14,300
Instalment notes payable to bank due $12,000 on first of each month beginning January 1, 1944, and accrued interest, $4,500.	124,500	(F) To transfer interest to accrued interest	4,500			120,000
Dividends payable, January 16, 1944	6,000					6,000
5% first mortgage bonds due January 1, 1960	350,000					350,000
Capital stock:						
Preferred, 2,000 shares authorized; 1,800 shares issued	180,000					180,000
Common, 3,000 shares authorized; 2,500 shares issued	250,000					250,000
Subscriptions to common stock, 400 shares	22,000	(14) To set up uncollected balances		18,000		40,000
Reserve for employees' pensions	14,000					14,000
Free (surplus) available for dividends	159,990	(7) Value of consigned goods reduced to cost	1,970			158,020
Capital surplus	403,000	(D) To write off stock discount	15,000			388,000
	$1,884,410		$1,157,870	$1,157,870	$2,381,440	$2,381,440

Working papers are not required by the examiners. They are included here for explanatory purposes.

No. 2.

CITY OF DOEVILLE—WORKING TRIAL BALANCE—(NOT REQUIRED BY EXAMINERS)—DECEMBER 31, 1943

	Trial Balance, January 1, 1943				Transactions		Trial Balance December 31, 1943	
	Debits	*Credits*		*Explanation*	*Debits*	*Credits*	*Debits*	*Credits*
			3	Collections on prior years' taxes receivable	$ 3,427			
			4	Collections in 1942 tax liens and miscellaneous receivables	3,914			
Cash	$37,452		5	Collections on current taxes receivable	236,421		$32,168	
			7	Receipts from licenses and permits, fines and miscellaneous	21,607			
			11	Payment of audited vouchers		$ 270,653		
Taxes receivable—prior years	3,729		3	Cash received, $3,427; tax liens on balance		3,729	—	
Taxes receivable—1943			5	Taxes levied for 1943 and collections thereon	245,025	236,421	8,604	
			4	Collections made on balances at January 1, 1943		1,868		
Miscellaneous accounts receivable	1,868		7	Miscellaneous income	2,100		2,100	
			3	Tax liens obtained on balance of unpaid taxes receivable	302			
Tax liens	2,046		4	Collections made on balance at January 1, 1943		2,046	302	
			1	To record revenues per adopted budget	269,570			
Estimated revenues			A	To close revenue accounts		269,570	—	
			2	Encumbrances were reinstated from unappropriated surplus	8,010			
			6	Contracts on open market orders were placed	126,382			
Encumbrances			8	Claims presented on open orders		124,955	—	
			B	To close expenditure accounts		9,437		
			8	Claims presented	125,955			
			9	Payroll vouchers approved	116,450			
Expenditures			10	Approved vouchers for sinking fund	20,000		—	
			10	Approved vouchers for state and county taxes	10,370			
			B	To close expenditure accounts		272,775		
			8	Claims presented and approved		125,955		
			9	Payroll vouchers approved		116,450		
Audited vouchers		$20,370	10	Approved vouchers—due to other funds		30,370		$22,492
			11	Payment on audited vouchers	270,653			
			6	To provide for contracts and orders placed		126,382		
Reserves for encumbrances		8,010	8	Claims were presented against open orders	124,955			9,437
			1	To record adopted budget for 1943	269,570	269,570		
Unappropriated surplus		16,715	A	To close revenue accounts	838			11,245
			B	To close expenditure accounts	4,632			
			1-A	To provide for estimated appropriations		269,570		
Appropriations			2	Appropriations made for January 1, 1943 encumbrances		8,010	—	
			B	To close expenditure accounts	277,580			
			5	Taxes levied for 1943		245,025		
			7	Licenses and permits		5,276		
Revenues			7	Fines and penalties		6,956	—	
			7	Miscellaneous		11,475		
			A	To close revenue accounts	268,732			
	$45,095	$45,095			$2,406,493	$2,406,493	$43,174	$43,174

CITY OF DOEVILLE—WORKING PAPERS—ENCUMBRANCES AND UNENCUMBERED BALANCES OF GENERAL FUND FOR THE YEAR ENDED DECEMBER 31, 1943

	State and County Taxes	Addition to Sinking Fund	General Administration	Protection of Life and Property	Protection of Health	Streets and Roads	Education	Total
Appropriations:								
Reserve for encumbrances, January 1, 1943	$ —	$ —	$ 110	$ 2,450	$ 750	$ 2,500	$ 2,200	$ 8,010
Budget for 1943	10,370	20,000	28,200	30,000	21,000	40,000	120,000	269,570
Totals	$10,370	$20,000	$28,310	$32,450	$21,750	$42,500	$122,200	$277,580
Encumbrances:								
Outstanding, January 1, 1943	$ —	$ —	$ 110	$ 2,450	$ 750	$ 2,500	$ 2,200	$ 8,010
Contracts and open market orders	—	—	10,824	15,933	8,422	25,727	65,476	126,382
Adjustment of claim	—	—	—	—	—	1,000	—	1,000
Payroll vouchers	—	—	16,621	17,500	11,850	13,479	57,000	116,450
Vouchers approved	10,370	20,000	—	—	—	—	—	30,370
Total encumbrances	$10,370	$20,000	$27,555	$35,883	$21,022	$42,706	$124,676	$282,212
Unencumbered balances	$ —	$ —	$ 755	$ 3,433*	$ 728	$ 206*	$ 2,476*	$ 4,632*
Encumbrances (above)	$10,370	$20,000	$27,555	$35,883	$21,022	$42,706	$124,676	$282,212
Deduct:								
Audited vouchers:								
Claims	$ —	$ —	$10,853	$13,877	$ 8,887	$28,951	$ 63,387	$125,955
Payrolls	—	—	16,621	17,500	11,850	13,479	57,000	116,450
Sinking fund	—	20,000	—	—	—	—	—	20,000
State and county taxes	10,370	—	—	—	—	—	—	10,370
Totals	$10,370	$20,000	$27,474	$31,377	$20,737	$42,430	$120,387	$272,775
Balances, December 31, 1940	$ —	$ —	$ 81	$ 4,506	$ 285	$ 276	$ 4,289	$ 9,437

Schedule I

CITY OF DOEVILLE—STATEMENT OF REVENUES, EXPENDITURES AND SURPLUS OF THE GENERAL ACCOUNTS FOR THE YEAR ENDED 1943

Unappropriated surplus, January 1, 1943			$16,715
Deduct:			
Revenues (Schedule III)		$268,732	
Less—expenditures (Schedule IV)		272,775	
Excess of expenditures over revenue		$ 4,043	
Increase in reserve for encumbrances:			
December 31, 1943	$9,437		
January 1, 1943	8,010	1,427	5,470
Unappropriated surplus, December 31, 1943			$11,245

* Red figure.

Schedule II

CITY OF DOEVILLE—BALANCE SHEET—GENERAL FUND—DECEMBER 31, 1943

Cash	$32,168	Audited vouchers	$22,492
Taxes receivable—1943	8,604	Reserve for encumbrances	9,437
Miscellaneous accounts receivable	2,100	Unappropriated surplus	11,245
Tax liens	302		
	$43,174		$43,174

Schedule III

CITY OF DOEVILLE—COMPARATIVE STATEMENT OF REVENUE OF THE GENERAL FUND FOR THE YEAR ENDED DECEMBER 31, 1943

	Estimated	Actual	Collected	Uncollected	Excess or Deficiency*
Licenses and permits	$ 6,250	$ 5,276	$ 5,276	$ —	$974*
Fines and penalties	6,715	6,956	6,956	—	241
Miscellaneous	11,580	11,475	9,375	2,100	105*
Taxes	245,025	245,025	236,421	8,604	—
Totals	$269,570	$268,732	$258,028	$10,704	$838*

Schedule IV

CITY OF DOEVILLE—COMPARATIVE STATEMENT OF EXPENDITURES AND ENCUMBRANCES OF THE GENERAL FUND FOR THE YEAR ENDED DECEMBER 31, 1943

	Appropriations	Expenditures	Unexpended Balance	Encumbrances	Unencumbered Balances
State and county taxes	$ 10,370	$ 10,370	$ —	$ —	$ —
Addition to sinking fund	20,000	20,000	—	—	—
General administration	28,310	27,474	836	81	755
Protection of life and property	32,450	31,377	1,073	4,506	3,433*
Protection of health	21,750	20,737	1,013	285	728
Streets and roads	42,500	42,430	70	276	206*
Education	122,200	120,387	1,813	4,289	2,476*
Totals	$277,580	$272,775	$4,805	$9,437	$4,632*

Schedule V

CITY OF DOEVILLE—CLOSING ENTRIES—DECEMBER 31, 1943

(A)

	Debits	Credits
Revenues	$268,732	
Unappropriated surplus	838	
Estimated revenues		$269,570

(B)

	Debits	Credits
Appropriations	$277,580	
Unappropriated surplus	4,632	
Encumbrances		$ 9,437
Expenditures		272,775

No. 3.

A, SOLE PROPRIETOR—WORK SHEET—(NOT REQUIRED BY EXAMINERS)—FOR PERIOD FROM DECEMBER 1, 1943 TO DECEMBER 10, 1943

	Entries to Establish Starting Point at December 1, 1943		Net Assets December 1, 1943		Transactions During Period		Profit and Loss		Net Assets December 10, 1943	
			Debits	*Credits*	*Debits*	*Credits*	*Debits*	*Credits*	*Debits*	*Credits*
Cash	(1)$ 2,455		$2,455		(2c)$2,645	(2d)$1,390			$3,710	
Furniture and fixtures	(1) 2,200		2,200						2,200	
Accounts receivable	(1) 1,900	(2e)$ 80	1,820		(2a) 390	(2c) 1,300			910	
Accounts payable	(2e) 120	(1) 1,890		$1,770	(2d) 1,000	(2b) 892				$1,662
Inventory	(3) 3,340		3,340		(2b) 892	(2a) 272				
						(2c) 960			3,000	
Capital account	(2e) 80	(1) 4,665			(2d) 200					
		(2e) 120								
		(3) 3,340		8,045						7,845
Sales						(2a) 390				
						(2c) 1,345		$1,735		
Cost of sales					(2a) 272					
					(2c) 960		$1,232			
Discount earned						(2d) 10		10		
Supplies					(2d) 25		25			
Rent					(2d) 175		175			
Profit for the period							313			313
	$10,095	$10,095	$9,815	$9,815	$6,559	$6,559	$1,745	$1,745	$9,820	$9,820

NOTE.—The transactions and adjustments are keyed to data paragraphs of the problem.

A, SOLE PROPRIETOR—STATEMENT OF NET ASSETS AS AT DECEMBER 1, 1943 AND DECEMBER 10, 1943

	December 1, 1943	December 10, 1943	Increase or Decrease*
Assets			
Cash	$2,455	$3,710	$1,255
Accounts receivable	1,820	910	910*
Inventory	3,340	3,000	340*
Furniture and fixtures	2,200	2,200	—
Total assets	$9,815	$9,820	$ 5
Liabilities			
Accounts payable	$1,770	$1,662	$ 108*
Net assets	$8,045	$8,158	$ 113

A, SOLE PROPRIETOR—STATEMENT OF PROFIT AND LOSS FOR THE PERIOD DECEMBER 1, 1943 TO DECEMBER 10, 1943

	December 1, 1943	December 10, 1943	Increase or Decrease*
Sales		$1,735	
Cost of sales		1,232	
Gross profits		$ 503	
Less expenses:			
Supplies	$ 25		
Rent	175	200	
Profit from operations		$ 303	
Discount earned		10	
Total profit and income		$ 313	
Less drawings		200	
Increase in capital account		$ 113	

Theory of Accounts

May 18, 1944, 9 a.m. to 12:30 p.m.

GROUP I

No. 1.

(a) A footnote should be made on the financial statements disclosing that a government contract is subject to renegotiation and that the result of such renegotiation may have a material effect on the income and the financial position of the company.

(b) The amount agreed upon between the Price Adjustment Board and the company should be set up as a liability in the balance-sheet and deducted from the sales in the profit-and-loss statement.

(c) If the company does not agree to the amount fixed by the Price Adjustment Board, the statements should fully disclose the amount of the contingent liability, and the fact that the company was contesting the claim.

(d) As the refund applies to the current year, the amount should be recorded as under (b) above.

(e) As the refund applies to the preceding fiscal year, the charge could be shown as an extraordinary deduction in the profit-and-loss statement or as a charge against the surplus account and as a current liability in the balance-sheet.

No. 2.

(a) If the company's experience shows that a large number of C.O.D. sales are not accepted, the income from such sales should not be recorded until the collections are received. If, on the other hand, the records show that the percentage of returns is relatively small, the income may be taken up on the books at the time of shipment.

(b) Income (gross profit) on instalment sales is generally taken up on a basis of—

$$\frac{\text{collections}}{\text{selling price}} \times \text{gross profit}$$

However, it is not incorrect to take up the income at the time of shipment if adequate reserves for collection and repossession expenses and bad debts are provided for.

(c) The income on sales for future delivery is not taken up until title has passed to the vendee.

(d) Income on merchandise shipped on consignment should not be recorded until the consignee returns an "account sale" reporting the sale of the merchandise.

(e) and (f) Income on (e) by-products sales and (f) scrap sales is recorded at the time of sale.

(g) Profit on incomplete construction contracts is often taken up on the books under the percentage of completion method:

$$\frac{\text{cost to date}}{\text{estimated total cost}} \times \text{estimated gross profit}$$

Another method postpones the recording of any profit until the contract is completed.

(h) The income from subscriptions to publications is generally recorded during the period in which the publications are issued.

No. 3.

(a) (1) The interest on the bonds accrued up to and including the date of death (November 16, 1943) is corpus; that accruing thereafter is income.

(2) and (3) Dividends on stock declared prior to the date of death are corpus. In some states the record date controls. In this example, the dividends on the common stock declared on November 1st and the dividends on the preferred stock payable on September 15th are corpus.

(b) The bonds should be recorded by the trustees by a debit to investments of bond account with a corresponding credit to a trust principal account. The valuation of the bonds may be the fair market value or the appraised value. If the bonds are recorded at their appraised value, the "premium" should not be amortized or charged against the income. The important factor is that the bonds or the proceeds from their sale or call are kept intact and that only the income therefrom is credited or distributed to the income beneficiary.

No. 4.

(a) The cost of the property including all charges incurred for the installation of the gas holder at the point of use should be capitalized. In this case:

Cost of holder	$1,000,000
Dismantling charge	100,000
Freight	40,000
Assembling cost	75,000
Total	$1,215,000

(b) As the acquisition and operation of the dredge was necessary to the development of the pulpwood regions, the original cost

($250,000), incidental costs ($55,000), and the monthly operating costs ($35,000) should be capitalized and charged as an improvement of the pulpwood regions.

No. 5.

An analysis and study should be made of the following:

(1) Date of acquisition, cost, estimated life and salvage value of each unit of property.

(2) The past performance of each unit, giving consideration to conditions under which it has been operated.

(3) Estimating the effect of present and probable future conditions upon the property, including obsolescence.

(4) The repair, maintenance and replacement policies of the past.

GROUP II

No. 6.

Subsidiary ledgers of customers' accounts are not necessary under so-called "accounting stub plan."

The billing form is composed of four parts, as follows:

(1) and (2) are attached, and this form is sent to the customer who returns the stub (2) with his remittance.

(3) is sent to the collection department, and

(4) is retained by the accounting department as a record of the account of the customer.

No. 7.

(1) Upon the income statement of the current fiscal year, the cost of goods sold would be overstated with a resulting understatement of the income tax payable and the net income.

(2) Upon the income statement of the subsequent period, the cost of goods sold would be understated with a resulting overstatement of the income tax payable and the net income.

(3) Upon the balance-sheet at the inventory date, the inventory, income-tax liability and earned surplus would all be understated.

(4) There will be no effect upon subsequent balance-sheets if the inventories are correctly stated.

No. 8.

The 100,000 drums are capital assets of the company and should be stated at cost ($2,000,000), less accumulated depreciation ($625,873) in the financial statement. The charge for repairs should be made against income when the expense is incurred. The deposit of $25 on each of the 60,000 drums ($1,500,000) in the possession of customers should be expressed as a current liability. However, the amount of any deposit charges not collected may be shown as a reserve and deducted from the customers' accounts receivable account in the financial statement.

No. 9.

"Original cost" is the cost of the property when it was first placed in use. "Adjustment account" represents the difference between the original cost and the actual cost or book value stated by the current owner.

No. 10.

The accounting treatment for by-products requires the determination of the cost of production to the point where the by-product is "split-off," the additional costs of production of both products from that point, the amount of sales income from both products, and the marketing and other expenses of the products.

(1) Under circumstances where the amount of the by-product sales is inconsequential in relation to the amount of the total sales, the income from the by-product sales may be treated as a reduction of the cost of sales of the principal product or as other income.

(2) Under circumstances where, after the split-off point, the additional cost to complete both products is nominal, the cost to the split-off point is allocated between the principal and by-product on the basis of the selling prices of both products.

(3) Under circumstances where, after the split-off point, marketing and other expenses are attributable to each product, the net profit to the split-off point is allocated between the principal and the by-product on the basis of the net profit of both products.

No. 11.

(1) The special parts purchased for the machines, assuming that they cannot be used for other purposes, should be charged as a part of the cost of the contract.

(2) The price should be adjusted upward to cover the proportionately higher amount of overhead per machine resulting from the decrease in the number to be manufactured.

No. 12.

The definition of encumbrances given by the National Committee on Municipal Accounting is:

"Obligations in the form of purchase orders or contracts which are to be met from an appropriation and for which part of the appropriation is reserved. They cease to be encumbrances when paid or approved for payment."

When an order is placed or a contract entered into, the encumbrance is recorded on the books by a charge to "appropriations" and a credit to "reserve for encumbrances." The order or contract is the supporting document to the entry. When the goods are received or the contracted services are rendered, the liability is recorded and the entry for the encumbrance is reversed.

The principal advantage of this method of accounting is the restricting of the expenditures to the limits set in the budget.

Accounting Practice – Part II

May 18, 1944, 1:30 to 6:00 p.m.

THE MORAN REALTY COMPANY

BALANCE-SHEET

December 31, 1943

Assets

Current assets:		
Cash	$ 28,218.50	
Contracts receivable	33,600.00	
Mortgages receivable	113,050.00	
Accrued interest on mortgages receivable	2,593.50	
Inventory of lots unsold—at cost	20,913.20	$198,375.20
Mortgage receivable—due April 1, 1945		59,850.00
		$258,225.20

Liabilities

Current liabilities:		
Earned commissions payable	$ 2,990.00	
Estimated accrued commissions payable	4,200.00	
Accrued interest on bonds	1,666.67	$ 8,856.67
Bonds payable (5%) due March 1, 1945		100,000.00
Unrealized profit on contract sales	$ 8,504.16	
Less commissions thereon	1,680.00	6,824.16
Net worth:		
Capital stock—800 shares of $100 par value	$ 80,000.00	
Earned surplus	62,544.37	142,544.37
		$258,225.20

THE MORAN REALTY COMPANY

INCOME ACCOUNT

For the Year Ended December 31, 1943

Collections on contract sales:	
80% ($126,000) 1942 sales	$100,800
60% ($ 84,000) 1943 sales	50,400
Total	$151,200
Mortgage sales (1943)	85,000
Total	$236,700

Profit thereon—25.31%			$ 59,908.77
Commissions thereon—5%		$ 11,835.00	
Interest on bonds (5%):			
On $180,000 for 8 months	$6,000.00		
On $100,000 for 4 months	1,666.67	7,666.67	
Taxes (12/15 of $7,300)		5,840.00	
Administrative and general expenses:			
(⅓ of $17,400)		5,800.00	
Interest on mortgages receivable			9,476.25
Income for the year 1943		38,243.35	
		$ 69,385.02	$ 69,385.02

Analysis of Contracts Receivable
For Period October 1, 1942 to December 31, 1943

	Sales				
	Number of Lots	*Price*	*Total*	Cash Collections	Receivable
October 1, 1942 Subdivision:					
A	100	$ 400.00	$ 40,000.00	$ 40,000.00	$ —
B	120	300.00	36,000.00	36,000.00	—
C	200	250.00	50,000.00	50,000.00	—
April 1, 1943 Subdivision:					
A	125	$ 400.00	$ 50,000.00	$ 30,000.00	$ 20,000.00
B	80	300.00	24,000.00	14,400.00	9,600.00
C	40	250.00	10,000.00	6,000.00	4,000.00
	665		$210,000.00	$176,400.00	$ 33,600.00

Analysis of Mortgages Receivable and Accrued Interest
For the Period October 1, 1942 to December 31, 1943

	Sales					Interest	
October 1, 1942 Subdivision:	Number of Lots	Price	Total	Cash Collections (30%)	Receivable	Collected (6%)	Accrued (1½%)
A	250	$400.00	$100,000.00	$30,000.00	$ 70,000.00	$4,200.00	$1,050.00
B	80	300.00	24,000.00	7,200.00	16,800.00	1,008.00	252.00
C	150	250.00	37,500.00	11,250.00	26,250.00	1,575.00	393.75
April 1, 1943 Subdivision:						(3%)	
A	125	$400.00	$ 50,000.00	$15,000.00	$ 35,000.00	$1,050.00	$ 525.00
B	60	300.00	18,000.00	5,400.00	12,600.00	378.00	189.00
C	70	250.00	17,500.00	5,250.00	12,250.00	367.50	183.75
	735		$247,000.00	$74,100.00	$172,900.00	$8,578.50	$2,593.50

THE MORAN REALTY COMPANY

Analysis of Commissions

For the Period January 1, 1941, to December 31, 1943

Earned:	
On mortgage sales (5% of $247,000.00)	$12,350.00
On contract sales collected (5% of $126,000.00)	6,300.00
Commissions earned	$18,650.00
Commissions paid (per problem)	15,660.00
Earned commissions payable	$ 2,990.00
Accrued commissions on contract sales not collected in full (5% of $84,000)	4,200.00
Total	$ 7,190.00

Computation of Inventory Cost of Unsold Lots

Subdivision:	Number of Lots	Price	Amount
A	600	$ 400.00	$240,000.00
B	400	300.00	120,000.00
C	500	250.00	125,000.00
Total	1,500		$485,000.00

Selling price of lots unsold:			
Subdivision:			
B	60	$ 300.00	$ 18,000.00
C	40	250.00	10,000.00
Total	100		$ 28,000.00

Estimated gross profit:

	Amount	Per Cent	
Selling price of all lots	$485,000.00	100.00	
Cost of all lots	362,250.00	74.69	
Estimated gross profit	$122,750.00	25.31	
Cost of lots unsold (74.69% of $28,000)			$ 20,913.00

Analysis of Cash Account

	Debit	*Credit*
Proceeds of sale of common stock	$ 80,000.00	
Proceeds of sale of bonds	300,000.00	
Collections on contract sales	176,400.00	
Collections on mortgage sales		
Principal	74,100.00	
Interest	8,578.50	
Cost of unimproved land		$180,000.00
Cost of railroad sidings		12,800.00
Plots and surveying		39,000.00
Cutting down trees		4,500.00
Sidewalks, gradings, etc.		80,000.00
Redemption of bonds		200,000.00
Legal and other fees		7,500.00
Interest on bonds to September 1, 1943		32,000.00
Sales commissions		15,660.00
Special assessments and municipal taxes		22,000.00
General and administrative expenses		17,400.00
Balance, December 31, 1943		28,218.50
	$639,078.50	$639,078.50

No. 2.

THE TAYLOR MANUFACTURING COMPANY

Fabricating Department Account

For the Month of Blank

	Units	Material	Labor	Overhead	Total
Beginning inventory	200	$ 720	$ 126	$ 84	$ 930
Production	2,266	9,100	3,810	3,180	16,090
Total	2,460	$ 9,820	$ 3,936	$ 3,264	$ 17,020
Trasferred to finishing department at standard costs	2,160	7,776	3,888	2,592	14,256
Balances	300	$ 2,044	$ 48	$ 672	$ 2,764
Work in process inventory at standard costs:	300				1,620
Material—300 at $3.60		1,080			
Labor—60% of 300 at $1.80			324		
Overhead—60% of 300 at $1.20				216	
Variances	—	$ 964	($ 276)	$ 456	$ 1,144

THE TAYLOR MANUFACTURING COMPANY

Finishing Department Account

For the Month of Blank

	Units	Material	Labor	Overhead	Total
Beginning inventory	80	$ 528	$ 66	$ 33	$ 627
Production transferred from fabricating department	2,160	14,256	3,860	2,105	20,221
Total	2,240	$14,784	$3,926	$2,138	$20,848
Transferred to finished goods at standard costs	2,000	13,200	3,000	1,500	17,700
Balances	240	$ 1,584	$ 926	$ 638	$ 3,148
Work in process inventory at standard costs:	240				1,962
Material		1,584			
Labor—70% of 240 at $1.50			252		
Overhead—70% of 240 at $.75				126	
Variances	—	—	$ 674	$ 512	$ 1,186

THE TAYLOR MANUFACTURING COMPANY

Finished Goods Inventory Account

For the Month of Blank

	Units	Amount
Transferred from finishing department	2,000	$ 17,700
Cost of units sold	1,800	15,930
Inventory at end of month	200	$ 1,770

THE TAYLOR MANUFACTURING COMPANY

Variance Account

For the Month of Blank

	Debits	Credits
Fabricating department:		
Material	$ 964	
Labor		$ 276
Overhead	456	
Finishing department:		
Labor	674	
Overhead	512	
Transferred to profit and loss account		2,330
	$ 2,606	$ 2,606

No. 3.

THE BALTIC CORPORATION

Computation of Taxable Net Income and Reconciliation with Net Income Per Books

For the Year Ended December 31, 1943

Net income per books		$15,800
Add—unallowable deductions and additional taxable income:		
Provision for federal taxes on income	$ 4,000	
Net profit derived from trading in own capital stock	2,500	
Cost of approval sales	3,500	
Anticipated cash discounts	150	
Provision for pensions	1,000	
Insurance premiums on life of president	225	
Total additions		11,375
Total		$27,175
Deduct—non-taxable income and additional deductions:		
Refund of 1936 surtax on undistributed profits	$ 1,500	
Loss on lawsuit settled in 1943	3,200	
Sale on approval	5,000	
Payments to superannuated employees	750	
Total deductions		10,450
Taxable net income for year 1943		$16,725

Commercial Law

May 19, 1944, 9 a.m. to 12:30 p.m.

GROUP I

No. 1.

(a) Assuming that A was indebted to B before giving B the power in question, B's authority would be revoked by A's death if B gave no consideration for the power, but B's authority would not be revoked if consideration had been given, such as a definite extension of time. The agent would then have a power given as security, sometimes called a power coupled with an interest, which is not terminated by death, according to the modern authority.

(b) If agent B had a power given as security, A's executor cannot recover the goods from B until B is paid the debt due him from A.

(c) The general rule is that an agent cannot appoint a subagent unless he is expressly or impliedly authorized by the principal to do so. Authority may be implied if a trade custom or local usage permits the appointment of subagents. Authority to perform acts which involve discretion or the agent's special skill can never be delegated, unless otherwise agreed.

(d) The exceptions to the rule that an agent cannot delegate his authority are:

1. Where an act is to be performed which is of a purely mechanical or ministerial nature and does not involve the exercise of judgment, discretion, or personal skill;
2. When the circumstances are such as to render it necessary in order to protect the interest of the principal, such as the employment of an attorney by the agent authorized to collect money or demand by a lawsuit.
3. When the usage of the trade permits the appointment of subagents.
4. When the agent is an association or has an organization, the employees of which normally perform such transactions; e.g., brokers, attorneys, or a corporation.
5. When the business is of such a nature or is to be conducted in such a place that it is impracticable for the agent to perform it in person.

(e) When an unauthorized delegation of authority has been made by an agent, the legal relations between the principal and the third parties cannot be affected by the subagent unless the principal elects to accept the benefits of the subagent's acts. The agent is responsible to the principal for the conduct of the subagent and to the subagent for his compensation.

No. 2.

(a) If a debtor owes several debts he has a right to pay any of the items he sees fit and may show his intention by expression, conduct, or by inference from the circumstances which debt he intends to pay. The debtor's intention must be manifested at or before the time of payment.

When the debtor makes his payment and does not direct its application at that time, the creditor may apply it to any debt which is due or distribute it among all or several of such debts.

If neither debtor nor creditor seasonably applies the payment, the law will apply the payment according to the justice in each case. Usually, payments will be applied against the oldest matured debt.

(b) If interest on the debts is owing, the law usually applies part payment first to extinguish the accrued interest before applying it on any of the principal debts.

(c) After application of payments have once been rightfully made by either debtor or creditor, it is final and cannot be changed without the consent of both parties.

(d) No. In a case where the amount is in dispute if the check bears the words "in full payment" or similar words or the check is accompanied by correspondence stating check is in full payment, creditor cannot accept the check and ignore the condition.

No. 3.

(a) B cannot recover against C, D, and E. B's rights against them as last indorsers are merged in his liability as first indorser to them. His only remedy is against A. This rule prevents circuity of action, and is stated in the Uniform Negotiable Instruments Law as follows:

"Where an instrument is negotiated back to a prior party, such party may, subject to the provisions of this act, reissue and further negotiate the same. But he is not entitled to enforce payment thereof against any intervening party to whom he was personally liable."

(b) Section 17 of the Uniform Negotiable Instruments Law states:

1. Where the sum payable is expressed in words and also in figures and there is a discrepancy between the two, the sum denoted by the words is the sum payable; but if the words are ambiguous or uncertain, reference may be had to the figures to fix the amount.
2. Where the instrument provides for the payment of interest, without specifying the date from which interest is to run, the interest runs from the date of the instrument, and if the instrument is undated, from the issue thereof.

3. Where the instrument is not dated, it will be considered to be dated as of the time it was issued.
4. Where there is a conflict between the written and printed provisions of the instrument, the written provisions prevail.
5. Where an instrument containing the words, "I promise to pay," is signed by two or more persons, they are deemed to be jointly and severally liable thereon.

No. 4.

(a) Taxpayer on a cash basis reports the salary in 1943. If on an accrual basis, reports salary for 1942.

(b) Taxpayer on a cash basis reports the interest received during 1943, $100. If on an accrual basis, taxpayer reports $50 in 1942 and $50 in 1943.

(c) The life tenant is entitled to the depreciation deduction.

(d) B is entitled to the $2,000 deduction for depreciation. The statute provides that in the case of property held by one person with the remainder to another, the deduction for depreciation shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to him.

No. 5.

(a) 1. No. Set-off cannot be permitted.
2. In general a demand to be subject of a set-off or counterclaim must be between the same parties.

The B corporation and A, the sole stockholder, are separate legal entries. Corporate titles and claims must be kept free from complication with the individual affairs of the stockholder.

Allowance of a set-off to A would give him an unfair advantage over the other creditors of the insolvent bank.

(b) Yes, the corporation can recover from the bank. In general, a person who receives checks drawn by or payable to a corporation, signed or indorsed for it by one of its officers, with knowledge that they are being used by the person who signed or indorsed them for his individual benefit, is liable to the corporation if in fact the officer was not authorized to appropriate the checks to his own benefit.

The checks in this case upon their face told the bank that they were the corporation's property and not the personal property of its president.

GROUP II

No. 6.

(a) Section 40 (b) of the Uniform Partnership Act provides that partnership obligations are to be discharged in the following order:

"I. Those owing to creditors other than partners;

II. Those owing to partners other than for capital and profits;
III. Those owing to partners in respect of capital;
IV. Those owing to partners in respect of profits."

(b) First, the proceeds of $50,000 realized of partnership's assets are used to the extent of $20,000 to pay creditors leaving balance of $30,000.

Second, the advance of $5,000 to be paid to the partner A leaving a balance of $25,000.

Third, the capital contribution to be paid to the partners A, $10,000; B, $5,000; and C, $5,000, leaving a balance of $5,000.

Fourth, to be distributed on basis of profit-sharing arrangement, A (50%) $2,500; B (25%) $1,250; and C (25%) $1,250.

No. 7.

(a) The relation between a general depositor and the bank is that of creditor and debtor. There is no trust relation and in case of failure of the bank the depositor has no preference and must share pro rata with general creditors.

(b) General deposits are not the property of the depositors but of the bank receiving them. The relation of the bank and its depositors being that of debtor and creditor, deposits are assets of the bank.

On the other hand, a bank must pay out the deposits on proper orders of the depositor, of balances standing in the name of a depositor and the bank cannot question a depositor's right thereto.

(c) The general rule is that the bank and depositor have mutual rights of set-off in their accounts.

A bank may look to the depositor's credit balance in its hands for repayment of any matured indebtedness to it by the depositor.

(d) A bank ordinarily has no right of set-off or to apply a debt against the depositor's credit balance until such debt matures and becomes due in absence of express authority from depositor.

Where a depositor becomes insolvent, however, the weight of authority is that the bank is entitled to apply his deposit on an unmatured debt to the bank, although some jurisdictions do not accept this rule.

No. 8.

(a) The term "sales in bulk" refers to a sale of all or substantially all of a merchant's stock of goods, out of the usual or ordinary course of the merchant's business.

(b) The purpose of the Bulk Sales Act is to prevent the defrauding of creditors by the secret selling in bulk of all or substantially all of a merchant's stock of goods. These statutes provide that such sales are fraudulent or void as to creditors, or presumptively so, unless specified formalities are observed, such as the making of an inventory, the demanding and the giving of a list of creditors, and the giving of actual or constructive notice to such creditors.

(c) Passing of title—Refers to the transaction whereby one person ceases to be the owner and the other succeeds to his ownership. From the moment title passes, the risk, gain, or increase is on the buyer.

(d) The price must be unpaid at least in part. The title to the goods must have passed to vendee. The vendee must be insolvent. The goods must be in possession of a carrier or other bailee in transit from vendor to vendee. The bill of lading, if there be one, must not have been transferred to a purchaser for value in good faith.

(e) The right of stoppage in transitu is based upon the injustice of allowing the buyer to have property when he has not paid and, owing to his insolvency, cannot pay.

No. 9.

(a) A can recover only $250 provided: (1) A's agreement to limit the carrier's liability was supported by a valid consideration, ordinarily a reduction in shipping rates; (2) A had the option of shipping at a higher rate without any restriction on the carrier's common-law liability; and (3) the limitation on the carrier's liability was reasonable and just—that is, that it bore a fair relation to the carrier's reduced charges and responsibilities. If any one of these three facts did not exist, A's agreement to limit the carrier's liability was inoperative, and A can recover the value of his goods. In a few states, A would not be bound by his agreement if the loss was caused by the negligence of the carrier.

(b) A common carrier must deliver the goods to the person to whom they are consigned or to his agent authorized to receive them, on a reasonable day and at a reasonable hour, at a proper place and in a proper manner.

(c) A common carrier is excused for failure to deliver goods to the consignee:

1. When the goods are demanded by one having paramount title to them;
2. When the consignor, owing to insolvency of the buyer, has exercised the right of stoppage in transitu.
3. When the goods, in the absence of negligence on the part of the carrier, have been lost owing to one of the excepted perils such as:

   A. an act of God

   B. act of the public enemy

C. the fault of the shipper
D. the inherent nature or vice of the thing shipped
E. public authority.

No. 10.

(a) The creditor's unconditional release of the principal debtor discharges the surety. The reason most often given is that the release impairs the surety's right of subrogation and would prevent the surety, if he paid, from suing the principal in the creditor's name. But the function of a surety is to protect the creditor against loss caused by the principal's nonperformance under ordinary circumstances. When the creditor releases the principal, he thereby makes his nonperformance inevitable.

(b) The discharge of the principal in bankruptcy does not discharge the surety's obligation to the creditor. The surety's inability to obtain reimbursement from his principal after he pays the creditor is said to result from the operation of law rather than from the voluntary act of the creditor, and, for this reason, the creditor's right against the surety is unimpaired.

(c) If a creditor enters into a composition agreement with the principal debtor without expressly reserving his rights against the surety, the surety is discharged. Such a proceeding on the creditor's part is voluntary, and, since it operates to release the principal and would prevent his surety, upon payment, from proceeding against him to obtain reimbursement in the creditor's name, the surety's discharge is said to be the necessary consequence. If the creditor reserves his rights against the surety the purported discharge of the debtor operates only as a covenant that the creditor will not sue the debtor, and the debtor is held to have made the composition with the understanding that the surety may still sue him.

No. 11.

(a) In each bankruptcy, the trustee is to be elected by the creditors, exclusive of the bankrupt person's relatives or a bankrupt corporation's stockholders, officers, and directors, by a majority vote in number and amount of claims. If the creditors do not elect a trustee or if the trustee elected by them fails to qualify, the court will appoint a trustee.

(b) The act provides that "the net proceeds of the partnership property shall be appropriated to the payment of the partnership debts and the net proceeds of the individual estate of each general partner to the payment of his individual debts. Should any surplus remain of the property of any general partner after paying his individual debts, such surplus shall be added to the partnership assets and be applied to the payment of the partnership debts. Should any surplus of the partnership property remain after paying the partnership debts, such surplus shall be distributed among the individual partners, general or limited, or added to the estates of the general partners, as the case may be, in the proportion of their respective interests in the partnership and in the order of distribution provided by the laws of the state applicable thereto."

(c) 1. Stockholders are liable for unpaid balances on stock subscriptions, up to the par value of their stock. This liability is an asset of the corporation enforceable by the trustee in bankruptcy.

2. Directors' or officers' liability for a breach of their fiduciary duty, such as mismanagement, fraud, etc., is a corporate asset and may be enforced by the trustee in bankruptcy.

3. Statutory added or double liability of stockholders, in addition to the par value of the stock, is not a corporate asset enforceable by the trustee, but a collateral liability enforceable by creditors, under the majority of state statutes. In other states, it is an asset of the corporation enforceable by the trustee.

(d) Unless a state exemption applies all rights possessed by the insured when adjudged a bankrupt in policies which are payable to his estate and which have a present value to the bankrupt or a cash surrender value pass at once as assets to his trustee in bankruptcy. The bankrupt has the privilege of retaining the policies free from the claims of the creditors upon paying or securing to the trustee the cash value thereof.

When a policy possessed by the bankrupt is payable to a third party beneficiary with power reserved to change the beneficiary, it is generally held that the power possessed by the bankrupt to extinguish the right of the beneficiary passes to the trustee in bankruptcy, subject, however, to all of the limitations imposed by the terms of the policy or otherwise existing upon it in the hands of the bankrupt.

No. 12.

(a) An estate for life is an estate the duration of which is limited by the life or lives of specified persons; and it may be for the life of the tenant, for the life of another, for the joint lives of the tenant and others, or for an uncertain period which cannot last longer than a life or lives.

(b) 1. The life tenant is entitled to the possession and use of the property during the life or lives by which his estate is measured and to receive the issues and profits or rents and income.

2. He must pay the interest on incumbrances.
3. The tenant must not commit waste; that is, any permanent and material injury to the inheritance.
4. The life tenant must, as a rule, pay the taxes which accrue from year to year during the continuance of his estate.
5. The life tenant, unless expressly restrained, may sell, give away, or mortgage his estate.

(c) A joint tenancy is an estate held by two or more persons jointly, so that during their lives they are equally entitled to the enjoyment of the land, or its equivalent in rents and profits; and upon the death of one his share vests in the survivor or survivors, until there is but one survivor, who takes it as an estate in severalty. There must be unity of interest, unity of title, unity of time, and unity of possession. This estate arises only by grant or purchase and is destroyed by destroying any of its four unities.

(d) A tenancy by the entirety is the tenancy by which husband and wife at common law hold land conveyed or devised to them by a single instrument which does not require them to hold it by another character of tenancy. They are neither tenants in common nor joint tenants, although they have the right of survivorship; but this right cannot be defeated by a conveyance by one of them or by sale under execution against one of them, as in case of a joint tenancy, and they are seised, not of moieties, but of entireties.

(e) A tenancy in common is an estate in lands held by two or more persons, with interests accruing under different titles, or accruing under the same title but at different periods, or conferred by words of limitation importing that the grantees are to take distinct shares. A tenancy in common requires only the unity of possession, and each holds his interest distinct and independently of the other.

(f) Title to realty, unless otherwise provided by statute, such as the Uniform Partnership Act, cannot be vested in a partnership as such. The legal title of property intended to belong to the partnership may be vested in one or more of the partners or in a stranger, who are regarded in equity as holding it in trust for the partnership so far as the rights of the members of the firm, as such, or of firm creditors are concerned. Partners who take title to realty for partnership purposes are regarded as tenants in common.

Auditing

May 19, 1944, 1:30 to 5:00 p.m.

No. 1.

The certificate should contain (1) a brief statement of the scope of the examination including the point as to whether or not the audit was made in accordance with generally accepted auditing standards applicable in the circumstances and (2) the auditor's opinion of the financial statements of the client as a result of his examination including any matters to which the auditor takes exception.

A typical short-form certificate

XYZ Company
Address:

We have examined the balance-sheet of the XYZ Company as of December 31, 1943, and the statements of income and surplus for the fiscal year then ended, have reviewed the system of internal control and the accounting procedures of the company and, without making a detailed audit of the transactions, have examined or tested accounting records of the company and other supporting evidence, by methods and to the extent we deemed appropriate. Our examination was made in accordance with generally accepted auditing standards applicable in the circumstances and included all procedures which we considered necessary.

In our opinion, the accompanying balance-sheet and related statements of income and surplus present fairly the position of the XYZ Company at December 31, 1943, and the results of its operations for the fiscal year, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

(Signature)

Certified Public Accountants

No. 2.

The purposes served by obtaining bank statements and paid checks as of a date later than the closing of an accounting period is to enable the auditor:

(1) To reconcile the bank account with the bank balance per the books.
(2) To ascertain that there are no unrecorded checks at the balance-sheet date which were subsequently paid by the bank.
(3) To check deposits in transit.

(4) To ascertain whether there are any charge-backs.
(5) To ascertain any other irregularities.

The bank statement and canceled checks should be delivered directly by the bank to the auditor who should check the canceled checks prior to the balance-sheet date against his list of outstanding checks as of that date. Deposits in transit should have been credited immediately in the subsequent bank statements. Any charges carried on the bank statement should be traced to determine their correctness.

Particular attention should be paid to the first bank endorsement on the canceled checks and to determine whether they had been cashed or deposited in some other bank account prior to the closing of the client's fiscal year.

No. 3.

The auditor's objectives are to determine:
(1) The purpose of the reserve.
(2) Its adequacy.
(3) That it has been provided out of earnings.
(4) That its creation or additions to it are properly authorized.

In auditing the reserves he should prepare an analysis for a period of years reconciling the provisions with the related charges to profit-and-loss account or surplus, as the case may be.

Reserve for insurance:

The provision, generally charged to profit and loss, should be checked to determine whether the premium rates used are comparable to those charged by insurance companies.

Reserve for injuries and damages:

The auditor should obtain all available information from the legal department or other departments handling these cases. It should also be ascertained whether the client is covered in part under insurance policies.

Reserve for pensions:

A copy of the company's plan and the actuarial computations should be obtained and studied to determine whether the provisions are being followed and the correct amounts entered on the records.

Reserve for contingencies:

If it is for an actual liability, it should be shown as such, under the current or deferred-liability section of the balance-sheet, depending upon the maturity date. If it is a valuation reserve, it should be so indicated and deducted from the asset to which it applies. If it is a surplus reserve, it should be shown under the surplus section of the balance-sheet, but with a name more descriptive than "contingencies." If it is created for the purpose of providing against a contingency which will in all probability occur, and the amount is indefinite, it should be shown, with a more descriptive title, under the "reserve" caption just above the net-worth section.

No. 4.

The point, generally at the end of a month, when no further sales are recorded for the period, is known as a "sales cut-off."

The auditor should examine the invoices entered within the last few days of the period and within the first few days of the subsequent period to determine that they were entered in the preiods during which the merchandise was shipped or the services were rendered. The dates of shipment entered on the invoices should be traced to the shipping records, copies of bills of lading, receipts from cartage companies, etc.

No. 5.

A suitable distribution of duties to provide adequate protection of disbursements follows:

(1) All accounting records of disbursements should be maintained by the accounting department.

(2) All checks should be signed by the treasurer or someone in his department.

(3) The canceled checks should be obtained directly from the banks and the bank accounts should be reconciled by a third department not responsible to the accounting or treasurer's departments.

(4) Periodic audits by an internal auditing department should be made of the disbursements.

No. 6.

Under the circumstances stated in the question the auditor should report the matter to the board of directors. His subsequent action would depend upon the outcome of that meeting.

If the amounts were substantial and seriously affected the financial condition of the company, an exception should be noted in the auditor's report. If the promotion expenses were illegal and not deductible for income-tax purposes, they should be eliminated in computing the amount of the reserve for income taxes.

No. 7.

(1) Additions to property accounts of a manufacturing company:

(a) Constructed by a company using construction work order records:
   (1) Examine the authorizations for the approval and the propriety of the accounts to be charged.
   (2) Check the authorizations against the minutes.
   (3) Examine the procedures followed in recording the issue of materials and supplies, and the distribution and accounting for payrolls. Also ascertain whether any overhead is included, and determine whether any such charges are proper.
   (4) Vouch a sufficient number of orders with outside invoices, material and supply issues, payrolls, etc.
   (5) Examine the treatment of any excess of expenditures over appropriations.
   (6) Trace the transfers of the completed work orders to the property accounts.

(b) Acquired by direct purchases from outside vendors:
   (1) Examine into the authority for the purchases.
   (2) Ascertain their propriety as capital items.
   (3) Trace the purchases into the property accounts.

(c) Acquired through consolidations, etc.:
   (1) Refer to the contracts, minutes, etc., for the purpose of ascertaining the authority and the basis of the valuation of the acquisitions.
   (2) Ascertain their propriety as capital items.
   (3) Trace the acquisitions into the property accounts.
   (4) If acquired from affiliated companies, eliminate any intercompany profits or losses in the consolidation.

(2) Retirements of property:

The auditor should satisfy himself that the physical retirements of property have been properly recorded in the accounts of the company. If property records are maintained, these should be tested for accuracy. He should also:

(a) Examine the miscellaneous income accounts, and credits to the property accounts.

(b) Discuss the matter of retirements, and changes in products and equipment with the plant officials.

(c) Study and compare appraisals, if available.

(d) Examine into the basis of valuation of the property retirements and the related depreciation reserves.

No. 8.

The entries which should arouse the suspicion of the auditor are:

(1) The incorrect footing of the discount column by $10.

(2) The incorrect cross-footing by $10 of the entry in the cash receipts book under date of July 24th—Customer C.

(3) The discount credit of $54 to Customer D on July 15th should probably be only $24 as the July 4th invoice of $1,500 was not paid within the discount period.

(4) The discount credit of $24 to Customer C on July 19th should probably not be allowed as the July 5th invoice was not paid within the discount period.

The above would indicate that while the checks may have been deposited, cash proceeds from the cash sales may have been diverted in the amount of the understatement. The details of the deposits shown in the cash receipts book should be compared with the details shown on copies of the bank deposit slips which should be obtained directly from the bank.

No. 9.

When the "positive" method is used communication is addressed to the debtor requesting that a reply be made to the auditor whether or not the information given in the request agrees with the debtor's records. The "negative" method requests a reply only if the person who received it does not agree with the information contained therein.

The positive method is generally used when the balance involved is of outstanding materiality, and where the possibility of disputes, inaccuracies, or irregularities in the accounts is greater than usual. The negative type is used in other cases where there are no indications that it may be inadequate; its use conforms with generally accepted auditing standards.

No. 10.

The auditor should determine the reason for the difference. If the depreciation on the books and in the financial statements is incorrectly stated to a material extent, it should be adjusted to the correct amount. If incorrectly stated in the income-tax returns, the tax liability should be recomputed and correctly recorded.

If the client refused to make the adjustments on the records and in the financial statements, the auditor should make full disclosure and take exception in his report.

Answers to Examinations of November, 1944

Accounting Practice – Part I

November 8, 1944, 1:30 to 6:00 p.m.

No. 1.

ACME COMPANY
Corrected Property and Related Accounts as at January 1, 1943 and December 31, 1943

Date	Adjustments: Debits (Credits)	Property Account	Reserve for Depreciation	Property-Appraisal Increase	Reserve for Depreciation-Appraisal Increase	Capital Surplus	Reserve for Unrealized Increment per Appraisal	Profit and Loss Earned Surplus	Sale of Property
January 2, 1941	Appraisal write-up transferred	($ 40,000)		$40,000		$40,000	($40,000)		
	To provide depreciation on write-up for 1½ years at 5%				($3,000)		3,000		
	To increase depreciation from 4% to 5% for 1½ years on cost ($100,000)		($ 1,500)					$ 1,500	
December 31, 1941	To increase depreciation for year to 5%		(1,000)					1,000	
	To transfer depreciation for the year on write-up (4% of $40,000)		1,600		(1,600)				
	To increase depreciation on write-up to 5%				(400)			400	
April 1, 1942	To provide depreciation for 3 months on Unit A		(100)					100	
	To provide depreciation for 3 months on write-up applicable to Unit A (see Note A)				(40)			40	
	To reverse entry recording sale of Unit A	8,000	(800)			(2,700)			($ 4,500)
	To record correct entry of sale of Unit A (see Note B)	(8,000)	1,110	(3,200)	440			5,160	4,500
	To transfer unrealized increment applicable to Unit A (8% of $37,000)						2,960	(2,960)	
November 1, 1942	To transfer flood damage charge	(4,000)						4,000	
December 31, 1942	To reverse depreciation entry		6,320					(6,320)	

ACME COMPANY

Corrected Property and Related Accounts as at January 1, 1943 and December 31, 1943
(Continued)

		Property Account	Reserve for Depreciation	Property-Appraisal Increase	Reserve for Depreciation-Appraisal Increase	Capital Surplus	Reserve for Unrealized Increment per Appraisal	Profit and Loss Earned Surplus	Sale of Property
	To provide for depreciation for year:								
	5% of cost.......... $92,000 = $4,600								
	12½% on Unit B.......... 22,000 2,750								
	Total (on cost) $7,350		(7,350)					7,350	
	5% on unrealized increment of $36,800......				(1,840)			1,840	
	Net adjustments to January 1, 1943..........	($ 44,000)	($ 1,730)	$36,800	($6,440)	$37,300	($34,040)	$12,110	$ —
	Balances, per books January 1, 1943..........	158,000	(17,120)	—	—	(37,300)	—	—	—
	Corrected balances, January 1, 1943..........	$114.000	($18,850)	$36,800	($6,440)	$ —	($34,040)	$12,110	$ —
*May 1, 1943	To provide depreciation for 4 months:								
	On cost		($ 2,450)					$ 2,450	
	On unrealized increment				($ 613)			613	
	To reverse sale of property entry..........	$158,000	(17,120)			$ 5,140			($146,020)
	To record correct entry of sale of property (see Note C)	(114,000)	21,300	($36,800)	7,053			(23,573)	146,020
	To transfer unrealized increment..........						$34,040	(34,040)	
	Net adjustments for year ended Dec. 31, 1943.	$ 44,000	$ 1,730	($36,800)	$6,440	$ 5,140	$34,040	($54,550)	$ —
	Balances, per books, December 31, 1943.......					(42,440)			
	Net adjustments to January 1, 1943..........	(44,000)	(1,730)	36,800	(6,440)	37,300	(34,040)	12,110	—
	Corrected balances, December 31, 1943........	$ —	$ —	$ —	$ —	$ —	$ —	($42,440)	$ —

NOTE A: As the property was increased 40% ($40,000 ÷ $100,000) by the write-up, the amount applicable to Unit A was $3,200 (40% of $8,000). The depreciation on the write-up for the 3 months' period is therefore ¼ (5% of $3,200) or $40.

NOTE B:

Cost of Unit A..........	$8,000	
Write-up	3,200	$11,200
Depreciation: (2¾ years at 5%)		
Cost	$1,100	
Write-up	440	1,540
Net book value		$ 9,660
Selling price		4,500
Loss on sales		$ 5,160

NOTE C:

Cost	$114,000	
Write-up	36,800	$150,800
Depreciation:		
Cost	$ 21,300	
Write-up	7,053	28,353
Net book value		$122,447
Selling price		146,020
Gain on sale		$ 23,573

* This date is assumed to be the correct date. However, a solution based on either May 1, 1943, or July 1, 1943, would appear to be satisfactory.

No. 2.

CITY OF MARIWOOD

Statement Showing Segregation of Data into the Applicable Fund or Account—Group Trial Balances, June 30, 1943

Accounts	Trial Balance Per Books June 30, 1943		General Fund		Special Assessment Fund District No. 1		Working Capital Fund Garage		Bond Fund Bridge		General Fixed Assets		General Bonded Debt	
	Debits	Credits	Debits	Credits	Debits	Credits	Debits	Credits	Debits	Credits	Debits	Credits	Debits	Credits
Accounts payable—general...		$ 6,000		$ 6,000										
Appropriations—general		106,000		106,000										
Bonds payable—general		300,000												$300,000
Bonds payable—special assessment—District No. 1......		25,000				$25,000								
Bonds payable — premium — special assessment—District No. 1		1,000				1,000								
Building—garage	$ 20,000						$20,000							
Building—garage—reserve for depreciation		5,000						$ 5,000						
Buildings—other	300,000										$ 300,000			
Capital outlays for construction—bridge	70,000								$ 70,000					
Capital outlays for construction — special assessment — District No. 1...........	26,000				$26,000									
Cash	47,600		$ 5,000				2,000		35,000					
Cash for construction of pavement					2,000									
Cash for special assessment bond payments					1,600									
Cash for interest payments on special assessment bonds...					2,000									
Contracts payable—bridge ...		5,000								$ 5,000				
Depreciation—garage	2,500						2,500							
Encumbrances—bridge	25,000								25,000					
Encumbrances—general	7,000		7,000											
Equipment—garage	50,000						50,000							
Equipment—reserve for depreciation		10,000						10,000						
Equipment—other	75,000										75,000			
Estimated revenues	100,000		100,000											
Expenditures—general	104,000		104,000											
Garage—original appropriation		60,000						60,000						

CITY OF MARIWOOD

Statement Showing Segregation of Data into the Applicable Fund or Account—Group Trial Balances, June 30, 1943

(*Continued*)

Accounts	Trial Balance Per Books June 30, 1943		General Fund		Special Assessment Fund District No. 1		Working Capital Fund Garage		Bond Fund Bridge		General Fixed Assets		General Bonded Debts	
	Debits	*Credits*	*Debits*	*Credits*	*Debits*	*Credits*	*Debits*	*Credits*	*Debits*	*Credits*	*Debits*	*Credits*	*Debits*	*Credits*
Inventory of materials and supplies—garage	1,500						1,500							
Inventory of materials and supplies—general	4,000		4,000											
Labor—garage	5,000						5,000							
Land—garage	4,000						4,000							
Land—other	20,000										20,000			
Materials and supplies used—garage	2,000						2,000							
Overhead—garage	2,500						2,500							
Public improvements	1,250,000										1,250,000			
Receipts—interest on special assessments—District No. 1		1,000				1,000								
Reserve for authorized expenditures—bridge		100,000								100,000				
Reserve for authorized expenditures—special assessments		25,000				25,000								
Reserve for encumbrances—bridge		25,000								25,000				
Reserve for encumbrances—general		7,000		7,000										
Revenues—garage		12,500						12,500						
Revenues—general		102,000		102,000										
Special assessments receivable—District No. 1 deferred	18,000				18,000									
Special assessments receivable District No. 1 delinquent	400				400									
Surplus—unappropriated		1,419,000		71,000				3,000						
Investment in general fixed assets												$1,645,000		
To be provided for retirement of general bonds													$300,000	
Taxes receivable—delinquent	75,000		75,000											
Due to general fund			3,000			3,000								
Due from general fund				6,000	5,000		1,000							
Total	$2,209,500	$2,209,500	$298,000	$298,000	$55,000	$55,000	$90,500	$90,500	$130,000	$130,000	$1,645,000	$1,645,000	$300,000	$300,000

CITY OF MARIWOOD

Closing Entries

June 30, 1943

General Fund

Appropriations	$ 106,000	
Revenues	102,000	
Unappropriated surplus	3,000	
Encumbrances		$ 100,000
Estimated revenues		104,000
Expenditures		7,000
To close out the above accounts.		

Special Assessment Fund

Bonds payable—premium	1,000	
Receipts—interest	1,000	
Unappropriated surplus		2,000
To transfer the premium on bonds payable and interest receipts to unappropriated surplus.		
Reserve for authorized expenditures	26,000	
Capital outlays for construction		26,000
To transfer expenditures to the reserve.		

Working Capital Fund—Garage

Revenue	12,500	
Depreciation		2,500
Labor		5,000
Materials and supplies used		2,000
Overhead		2,500
Profit and loss		500
To transfer revenue and expense accounts to profit and loss.		
Profit and loss	500	
Unappropriated surplus		500
To transfer profit-and-loss balance to unappropriated surplus.		

Bond Fund—Bridge

Reserve for authorized expenditures	95,000	
Capital outlays for construction		70,000
Encumbrances		25,000
To close out the expenditure and encumbrance accounts to the reserve.		

No. 3.

A. & B. CO. (PARTNERSHIP)
Working Papers—Pro-Forma Balance-sheet
Giving Effect to the Proposed Reorganization Agreement
December 16, 1943

		Balance-Sheet of Corporation December 16, 1943		Transactions Prior to Dissolution		Transferred to Partnership	
Assets		*Debits*	*Credits*	*Debits*	*Credits*	*Debits*	*Credits*
Cash		$ 95,000		(4) $ 80,000	(5) $ 97,000 (6a) 30,000 (6c) 12,500	$ 35,500	
Receivables, less reserve $22,000		135,000				135,000	
Inventories		225,000				225,000	
Investments		20,000			(6b) 20,000		
Property—stated at appraisal value determined as at December 16, 1943	$125,000						
Less reserve for depreciation	27,500						
Book value of property		97,500				97,500	
Treasury preferred stock (par value $40,000), at cost		47,250			(x) 47,250		
Other assets		10,000				10,000	
Prepaid expenses		4,500				4,500	
Liabilities							
Note payable—Mr. Case, stockholder			$ 30,000	(6a) 30,000			
Accounts payable—trade			110,000				$110,000
Accrued liabilities			8,000				8,000
Accrued federal income tax			24,000				24,000
Mortgage payable					(4) 80,000		80,000
Reserve for contingencies			50,000	(6c) 50,000			
Capital stock:							
Preferred stock—par value $100 (entitled to $110 in liquidation), authorized 1,000 shares; in treasury 400 shares, outstanding 600 shares			100,000	(5) 20,000 (x) 40,000			
Common stock—no-par-authorized 200,000 shares; issued and outstanding, 100,000 shares stated at nominal value of $1.00 per share			100,000	(5) 25,000			
Paid-in surplus			150,000	(5) 45,000			
Revaluation surplus arising from property appraisal as at December 16, 1943			50,000				
Earned surplus			12,250	(5) 7,000 (x) 7,250	(6b) 15,000 (6c) 37,500		
Partnership capital accounts							320,500
Brown				(6b) 35,000		35,000	
		$634,250	$634,250	$339,250	$339,250	$542,500	$542,500

A. & B. CO. (PARTNERSHIP)

Computation of Equity in Net Assets Received in Dissolution of the Big Three Corporation and of Capital Accounts at December 16, 1943

		Total	Adams	Brown
Applicable to common stock:				
Common stock		$ 75,000		
Paid-in surplus		105,000		
Revaluation surplus		50,000		
Earned surplus—less 10% premium applicable to preferred stock ($50,000 less $4,000)		46,500		
Total		$276,500		
Allocated on basis of holdings:				
35/75			$129,033	
40/75				$147,467
Applicable to preferred stock:				
Par value	$40,000			
Premium on liquidation (10%)	4,000			
Total		44,000		
Allocated on basis of holdings:				
¾			33,000	
¼				11,000
Equity in net assets received		$320,500	$162,033	$158,467
Investments distributed to Brown		35,000		35,000
Remainder		$285,500	$162,033	$123,467
Investment by Brown to equalize his partnership interest		38,566		38,566
Capital accounts, December 16, 1943		$324,066	$162,033	$162,033

A. & B. CO. (PARTNERSHIP)

Pro-Forma Balance-Sheet—December 16, 1943
After Giving Effect to the Dissolution of the Big Three Corporation in Accordance with a Proposed Reorganization Agreement

Assets

Current assets:		
Cash	$ 74,066	
Receivables, less reserve $22,000	135,000	
Inventories	225,000	$ 434,066
Property	$ 125,000	
Less reserve for depreciation	27,500	97,500
Other assets		10,000
Prepaid expenses		4,500
		$ 546,066

Liabilities and Capital

Current liabilities:		
Accounts payable	$ 110,000	
Accrued liabilities	8,000	
Accrued federal income tax	24,000	$ 142,000
Mortgage payable		80,000
Capital:		
Adams	$ 162,033	
Brown	162,033	324,066
		$ 546,066

Theory of Accounts

November 9, 1944, 9 a.m. to 12:30 p.m.

GROUP I

No. 1.

(a) The following are acceptable methods of inventory valuation commonly used:

Retail

This method is frequently used in department and retail stores because it offers a practical means of control of the merchandise. Because of the volume of units, a detailed record of each unit would be too cumbersome to keep.

Under this method, a record of the opening inventory and the purchases is kept to show both the cost and the retail selling prices. Adjustments for any increases and decreases in the selling prices are made to the account. As the balance in the account shows the cost and the adjusted selling prices, the ratio of cost to retail can readily be obtained. If the total of the sales is deducted from the adjusted selling price of the opening inventory and purchases, the resulting balance should represent the inventory on hand at adjusted selling prices. This amount may then be compared with the physical inventory which is taken at selling price.

The application of the ratio of cost to retail may then be applied to the inventory to reduce it to a basis of the lower of cost or market.

Base-Stock

This method is used by companies who use one or more basic commodities which require a long conversion period. Because of this long period of fabrication, it is necessary that a rather large supply of stock be kept on hand. The investment in the inventory is considered more or less fixed and should not fluctuate in value with the market.

Under this method, "normal" or minimum inventory quantities are carried from year to year at the same fixed value. Quantities in excess of the "base" amount are valued at the customary basis of cost or market, etc.

Last-In, First-Out

This method is used as an alternative to the base-stock method by companies which maintain a minimum inventory of one or more basic commodities. It serves the purpose of applying current costs to current sales.

Under this method, it is assumed that the goods last purchased were the first used.

Cost or Market

Under this method each item in the inventory is valued at the lower of cost or market. Cost may be determined in numerous ways, depending upon which best suits the requirements of the particular business. Market is the lower of the current bid price for the particular goods in the quantities usually purchased or the estimated selling price, less the related selling expenses.

(b) The following methods of inventory valuation should be considered improper:
   (1) Those which are based on records which are not supported by physical count or a dependable system of perpetual inventory.
   (2) Those which are stated at an arbitrary or nominal amount.
   (3) Those which do not include all of the merchandise or stock.
   (4) Those which do not give effect to an adjustment for unsalable, unusable, or obsolete merchandise or stock.
   (5) Those which have been written down below cost or market value.

No. 2.

(1) Cash should be classified in the balance-sheet as a current asset except for that portion which may be in the custody of the sinking fund trustee, or which may be restricted under a bond and mortgage agreement for use to finance construction. Cash in the hands of a sinking fund trustee should be carried under investments or other assets; that restricted for the purpose of financing construction should be shown under the fixed asset caption.

(2) Marketable securities should be shown as a current asset if it is the intent of the company to hold such securities only as a temporary investment of surplus funds. Investments in affiliated or subsidiary companies should be shown under investments and not as current assets.

(3) Treasury stock should be deducted from the capital stock and surplus accounts on the balance-sheet unless it is the intent of the company to dispose of such treasury stock.

(4) If it is the intent of the company to realize the cash surrender value of life insurance within the current period, it may be shown as a current asset. Otherwise, it should be classified under investments or other assets.

(5) If it is the intent of the company to use United States Tax Savings Notes in payment of its income-tax liability, the value of such

notes may be shown as a deduction from such liability. Otherwise, they should be shown as current assets.

No. 3.

(a) The following items may properly be included in the unamortized bond discount and expense account:
   (1) The difference between the face value of the bonds and the proceeds received from the sale.
   (2) The legal, accounting, and other fees paid or accrued for services rendered in connection with the issue.
   (3) Selling commissions, advertising, printing, stamp taxes, and other expenses paid or accrued in connection with the issuance of the bonds.

(b) It is permissible to carry such an account in the balance-sheet because it represents cost (prepaid expense) for the use of money. It should be written off over the life of the bonds.

(c) The "bonds outstanding" method of amortization is simple and is generally accepted.
   As an example, assume the following:

Amount of issue	$ 500,000
Annual retirement	100,000
Life of bonds	5 years
Bond discount	$ 9,000

TABLE OF AMORTIZATION

Year	Bonds Outstanding	Fraction	Amortization Per Year
1st	$ 500,000	5/15	$ 3,000
2nd	400,000	4/15	2,400
3rd	300,000	3/15	1,800
4th	200,000	2/15	1,200
5th	100,000	1/15	600
Total	$1,500,000	15/15	$ 9,000

No. 4.

The decline or impairment in the value of an asset should be recognized in the financial statements as soon as the extent has been determined or a reasonable estimate can be made.

(1) The decline in the value of inventories should be recorded by a write-down in the current period.

(2) Any decrease in the value of securities representing a temporary investment of surplus funds should be recorded during the current period. If the securities represent investments in affiliated com-

panies or are permanent investments, a reduction in the value of such asset is generally not recorded unless it is material in amount.

(3) Uncollectible accounts receivable should be written off or provided for in a reserve account during the current period.

(4) Depreciation of fixed assets should be provided for during each period over the estimated life of such assets. Obsolescence, unless considered in setting the rate of depreciation, should be recorded as soon as it becomes known.

(5) The uninsured portion of fire, casualty, or theft losses of any asset should be provided for as soon as the loss has been incurred.

No. 5.

The description of the operations of the company indicates that the accounting system being used is known as branch-office accounting. The accounts of all the branches are controlled at the home office, which maintains a record of the accounts receivable and inventories at the warehouse and the branches. These inventories are supported by perpetual inventory records, which are verified or adjusted by physical count. An imprest cash system is used to control the cash at each branch.

GROUP II

No. 6.

Fixed expenses are those not likely to be affected greatly by changes in production volume in a given accounting period. Such items as rent, depreciation, real estate taxes, etc., are examples of fixed expenses.

Variable expenses are those which are likely to increase or decrease with the production volume. Such items as indirect labor, manufacturing supplies, insurance on inventories, etc., are examples of variable expenses.

The segregation of these two classes of expenses is generally made for the purpose of facilitating the determination of the reasons for fluctuations in unit cost during the period of change in production volume, and for adjusting any sales prices which may be based on cost.

No. 7.

As title does not pass to the consignee, only a memorandum record should be made of the merchandise received, in order that this merchandise be segregated from the purchases and inventories of his regular stock. Proceeds from the sale of consigned merchandise, commissions, other expenses, and remittances should be entered in a clearing account—"Consignments-in (J. W. Jones Co.)."

The consignor should carry memorandum accounts of the consigned merchandise. The accounts to be kept by him are largely dependent upon the amount of information desired. The "account sales" rendered by the consignee should contain the details of the consignment transaction.

No. 8.

The facts given in the question should be recognized in current financial statements by charging the income account and crediting a reserve for repairs, inasmuch as the current operations receive the benefit of the accelerated usage of the machinery. Depreciation rates should be adjusted upward because of the shortening of the remaining useful life of the asset.

No. 9.

(a) Contingent liability for notes receivable discounted may be shown:
  (1) As a deduction from the gross amount of notes receivable.
  (2) As a current liability.
  (3) As a footnote to the balance-sheet.
(b) A reason for or against each method follows:
  (1) The contingent nature of the liability may be overlooked.
  (2) Neither the discounted notes nor the liability are assets or liabilities of the company; they are merely contingent. Furthermore, the working capital ratio is distorted by including the amount of the discounted notes in the totals of both the current assets and the current liabilities.
  (3) As footnotes to balance-sheets imply qualifications, many companies would prefer other methods of showing the transaction.

No. 10.

Generally, sales should not be recorded until title passes. The passage of title usually takes place at the time of delivery to the customer or a common carrier. If, in the given case, title has passed and the company has consistently followed the practice outlined, there should be no objection on the part of the accountant.

No. 11.

As the excess parts cannot be used for other work, their cost, less any salvage value, should be charged to the special contract.

No. 12.

The undepreciated cost of the plant and equipment, less the estimated salvage value, should be written off over the estimated life of the mine. The depreciation rate, based on time or recoverable tonnage, should be revised accordingly.

Accounting Practice – Part II

November 9, 1944, 1:30 to 6 p.m.

No. 1.

THE TYLER TRADING COMPANY—IN RECEIVERSHIP
J. THOMPSON—RECEIVER IN EQUITY

STATEMENT OF REALIZATION AND LIQUIDATION, AND OF THE OPERATIONS DURING THE PERIOD OF RECEIVERSHIP
From February 1, 1943, to January 31, 1944

	Assets to be Realized	Asset Subsequently Valued	Supplementary Charges	Net Proceeds of Assets Realized	Discount Allowed	Assets Written Off	Assets Consumed in Operations	Assets not Realized
Assets—February 1, 1943:								
Notes receivable	$ 80,000			$ 70,910		$ 8,090		$ 1,000
Notes receivable—discounted (contra)	10,000			7,500		2,500		
Accrued interest on notes receivable	3,000			3,000				
Accounts receivable	138,000			104,500	$ 2,000	3,500		28,000
Reserve for bad debts	(7,500)					(3,500)		(4,000)
Inventory	174,200						$54,200	120,000
Subscribers to capital stock	20,500			19,500		1,000		
U. S. government bonds	25,000							25,000
Buildings	121,400							121,400
Reserve for depreciation—buildings	(56,540)						3,600	(60,140)
Prepaid insurance	1,400						300	1,100
Securities		$4,700		4,700				
	$509,460	$4,700	$	$210,110	$ 2,000	$11,590	$58,100	$232,360
Assets—Receiver's:								
Accounts receivable			$260,000	$214,400	$10,600			$ 35,000
Reserve for bad debts			(800)					(800)
Accrued interest on notes receivable			1,700	1,400				300
Accrued interest on government bonds			500	500				
	$	$	$261,400	$216,300	$10,600	$	$	$ 34,500
TOTALS	$509,460	$4,700	$261,400	$426,410	$12,600	$11,590	$58,100	$266,860

THE TYLER TRADING COMPANY—IN RECEIVERSHIP
(*Continued*)

	Liabilities to be Liquidated	Receiver's Certificates	Supplementary Credits	Payment of Liabilities Liquidated	Discount Earned	Liabilities not Liquidated
Liabilities—February 1, 1943:						
Notes receivable—discounted (contra)	$ 10,000			$ 10,000		
Notes payable	127,500			65,200		$ 62,300
Accrued interest on notes payable	9,800			9,800		
Accounts payable	296,000			255,000	$5,000	36,000
Mortgage payable on buildings	60,000					60,000
Accrued interest on mortgage	1,200			1,200		
	$504,500	$	$	$341,200	$5,000	$158,300
Liabilities—Receiver's:						
Receiver's certificates		$120,000		$ 40,000		$ 80,000
Accounts payable				122,000	$2,000	32,000
Purchases of merchandise			$110,000			
Selling expenses			33,000			
General expenses			13,000			
Accrued taxes			3,700			3,700
Accrued interest on notes payable			4,000	1,200		2,800
Accrued interest on mortgage payable			2,600	1,400		1,200
Accrued interest on receiver's certificates			5,810	5,810		
Receiver's fees			8,000	8,000		
	$	$120,000	$180,110	$178,410	$2,000	$119,700
TOTALS	$504,500	$120,000	$180,110	$519,610	$7,000	$278,000

THE TYLER TRADING COMPANY—In Receivership
J. Thompson—Receiver in Equity
Summary Statement of Cash
For the Period February 1, 1943 to January 31, 1944
(This statement is not required)

Balance—February 1, 1943		$ 48,000
Add:		
Net proceeds of assets realized	$ 426,410	
Less notes receivable discounted (paid by makers)	7,500	418,910
Proceeds from receiver's certificates		120,000
Total		$ 586,910
Deduct:		
Payment of liabilities liquidated	$ 519,610	
Less notes receivable discounted (paid by makers)	7,500	512,110
Balance—January 31, 1944		$ 74,800

THE TYLER TRADING COMPANY—In Receivership
J. Thompson—Receiver in Equity
Summary Statement of Assets and Liabilities
At the Consummation of Receivership—January 31, 1944

Assets

Cash	$ 74,800
Assets not realized—see statement	266,860
	$ 341,660

Liabilities

Liabilities not liquidated—see statement	$ 278,000
Net book value of assets transferred to company	$ 63,660

THE TYLER TRADING COMPANY—In Receivership
J. Thompson—Receiver in Equity
Reconciliation of Net Worth at February 1, 1943, with the Net Book Value of Assets Returned to the Company January 31, 1944
(This statement not required)

Net worth—February 1, 1943:			
Capital		$ 100,000	
Less—deficit		47,040	$ 52,960
Net loss on realization and liquidation:			
Discounts allowed	$ 2,000		
Assets written off	11,590	$ 13,590	

Less:			
Assets subsequently discovered and sold...	$ 4,700		
Discounts earned	5,000	9,700	3,890
Remainder			$ 49,070
Income from operations of receiver:			
Supplementary charges	$261,400		
Discounts earned	2,000	$263,400	
Less:			
Assets consumed in operations............	$ 58,100		
Discounts allowed	10,600		
Supplementary credits	180,110	248,810	14,590
Net book value of assets transferred January 31, 1944			$ 63,660

No. 2. Schedule I

TAD CO., INC.

SCHEDULE OF UNITS FINISHED AND EFFECTIVE PRODUCTION
for the Period January 1, 1944 to March 31, 1944

	Departments No. 20	Departments No. 30
Finished production:		
Delivered or transferred units..........................	5,900	5,700
Inventory, March 31, 1944.............................	500	800
Total	6,400	6,500
Inventory, January 1, 1944.............................	800	600
Units delivered from Department 20.................	—	5,900
Units placed in process—Department 20.............	5,600	—
Effective production:		
Inventory, January 1, 1944:		
In terms of incomplete units:		
60% of 800.......................................	480	
70% of 600.......................................		420
Transferred	5,600	5,900
Total	6,080	6,320
Inventory, March 31, 1944:		
In terms of incomplete units:		
60% of 500.......................................	300	
30% of 800.......................................		240
Effective production	5,780	6,080

TAD CO., INC.

Schedule of Adjusted Manufacturing Cost of Departments No. 20 and No. 30
For the Period January 1, 1944 to March 31, 1944

Schedule II

		Direct Labor	Direct Departmental Manufacturing Overhead	General Manufacturing Overhead	Tools Manufactured	Adjusted Cost
Department No. 20						
Amount per books		$40,000	$50,000	$5,600		
Overstatement due to clerical error ($200) and incorrect classification ($1,000) (11b)		(1,200)				
Correction for loss on sale of machine ($800) and to accrue depreciation ($200) (11c)			1,000			
Adjustment due to correction of direct labor cost:						
Direct labor—Department 20	$\frac{38,800}{398,800} \times \$56,000 = \$5,448$					
Total direct labor						
$5,600—$5,448=$152				(152)		
		$38,800	$51,000	$5,448		
Transfers to tool cost (11a)		(3,000)	(6,000)		$ 9,000	
Direct manufacturing overhead:						
As adjusted	$\frac{45,000}{38,800} \times \$3,000 = \$3,479$		(3,479)		3,479	
General manufacturing overhead:						
As adjusted	$\frac{5,448}{38,800} \times \$3,000 = \$\ 421$			(421)	421	
Totals, as adjusted		$35,800	$41,521	$5,027	$12,900	$ 95,248
Deduct cost of tools on hand:						
60% of $12,900	$7,740					
Less depreciation of 60%	4,644					
Net value	$3,096				3,096	3,096
Manufacturing cost, Department No. 20, as adjusted, for the period January 1, 1944 to March 31, 1944					$ 9,804	$ 92,152
Department No. 30						
Amount, per books		$48,000	$60,200	$6,720		
Loss on sale of machine ($800) and accrued depreciation ($200) (11c)			(600)			
Adjustment due to correction of direct labor cost:						
Direct labor—Department 30	$\frac{48,800}{398,800} \times \$56,000 = \$6,740$					
Total direct labor						
$6,740—$6,720=$20				20		
Manufacturing cost, Department No. 30, as adjusted, for the period January 1, 1944 to March 31, 1944		$48,000	$59,600	$6,740		$114,340

Manufacturing cost per unit:

	Quantity (Schedule I)	Cost (Schedule II)	Unit Cost
Department No. 20	5,780	$ 92,152	$15,94
Department No. 30	6,080	114,340	18.81

Schedule III

TAD CO., INC.

SCHEDULE OF WORK IN PROCESS OF DEPARTMENTS No. 20 AND No. 30
March 31, 1944

Department No. 20	Quantity	Unit Cost	Total
Direct materials (500 units):			
"O"	1,000	$ 3.50	$ 3,500
"P"	500	2.00	1,000
Direct labor, direct and general manufacturing overhead:			
500 units 40% complete	200	15.94	3,188
Total department No. 20			$ 7,688
Department No. 30			
Direct materials (800 units):			
"O"	1,600	$ 3.50	$ 5,600
"P"	800	2.00	1,600
Direct labor, direct and general manufacturing overhead:			
Transferred from Department No. 20	800	15.94	12,752
800 units, 70% complete	560	18.81	10,534
Total department No. 30			$ 30,486
Total both departments			$ 38,174

Schedule IV

TAD CO., INC.

SCHEDULE OF RAW MATERIAL INVENTORY TO BE CHARGED TO CONTRACT AS AT MARCH 31, 1944

	Material "O"	Material "P"
Units purchased:		
Amount delivered under contract prior to December 31, 1943 (2)	3,000	1,500
On hand, January 1, 1944 (3a)	2,000	1,000
In process, January 1, 1944 (3b)	2,800	1,400
Purchased between January 1, 1944 and March 31, 1944 (4)	16,000	5,100
Total	23,800	9,000
Units used:		
Delivered under contract (2) (8)	14,400	7,200
In process, March 31, 1944 (6)	2,600	1,300
Total	17,000	8,500

		Material "O"	Material "P"
Units on hand		6,800	500
Units to be returned to supplier		3,800	—
Total units to be charged against contract		3,000	500
Unit price		$ 3.50	$ 2.00
Amount to be charged		$ 10,500	$ 1,000
Add vendors' cancellation claim (11d)			300
Amount to be reimbursed	$ 11,800	$ 10,500	$ 1,300

TAD CO., INC.

Statement of Undelivered Inventories at Cost Plus an Allowance for General and Administrative Expenses Applicable to Contract as at March 31, 1944, the Date of Cancellation

Raw materials (Schedule IV)	$ 11,800
Work in process (Schedule III)	38,174
Total	$ 49,974
General and administrative expenses (15%)	7,496
Amount of claim	$ 57,470

Commercial Law

November 10, 1944, 9:00 a.m. to 12:30 p. m.

GROUP I

No. 1.

(a) Black's gross income from the premises is $5,500 because the taxes paid by the tenant are treated as additional rent. Black is entitled to deduct the amount of tax, $500. Adams, the tenant, is entitled to deduct as rent $5,500 paid as an ordinary and necessary business expense.

(b) The interest payment of $200 and property taxes of $300 are deductible. As to those items, they are deductible because there are no distinctions made between those that are personal and those which relate to taxpayer's business.

The insurance and repair items are not deductible since they are personal expenses. Sewer assessment is not deductible when paid as it is an assessment for a local benefit and becomes part of the cost to be deducted when the property is sold.

No. 2.

(a) Assuming that Abbott neither authorized nor assented to the addition of the provision for interest, Coffey can recover the amount of the principal from Abbott because he is a holder in due course. Coffey has a claim against Brown for interest because Brown made a material alteration.

The Negotiable Instruments Law provides: "Where a negotiable instrument is materially altered without the assent of all parties liable thereon, it is avoided, except as against a party who has himself made, authorized or assented to the alteration and subsequent indorsers. But when an instrument has been materially altered and is in the hands of a holder in due course, not a party to the alteration, he may enforce payment thereof according to its original tenor." "Any alteration which changes . . . 2. The sum payable, either for principal or interest, . . . or any other change or addition which alters the effect of the instrument in any respect, is a material alteration."

(b) The Uniform Negotiable Instruments Law provides: "The holder may at any time strike out any indorsement which is not necessary to his title. The indorser whose indorsement is struck out, and all indorsers subsequent to him, are thereby relieved from liability on the instrument."

(c) Collins has no rights as to Anthony and Belton. Where the holder of a check presents the same to the drawee when due, and procures it to be certified instead of paid, it is as between him and the drawer and indorsers, treated as payment, and operates to discharge them from liability thereon. Collins has a claim in bankruptcy against the X Bank.

No. 3.

(a) 1. Yes, Carlton can recover from Bass.

2. The principle of law involved is the right of a third person—known as a "creditor beneficiary"—to maintain an action on a contract in which the promisor undertakes to discharge a debt of the promisee to such third person. Unlike the usual suit on a contract, it is maintained by one who was not a party to the contract and who did not furnish the consideration. The creditor-beneficiary has, of course, no rights unless the contract between his debtor and the promisor is valid and subsisting at the time he brings suit or materially changes his position in reliance on the contract.

(b) Austin has no remedy. A promise by one party to do that which he is already under a legal obligation to perform is insufficient to constitute a consideration to support a contract.

(c) Under the Statutes of Frauds in the various states the following contracts generally must be in *writing* and *signed* by the person against whom the contracts are to be enforced:

1. Promises or contracts of executors and administrators to pay out of their personal estable debts due from the estate they are administering.
2. Bilateral contracts, so long as they are not fully performed by either party, which cannot be performed within one year from the making thereof.
3. Contracts with an obligee (or creditor) to answer to him for the debt, default or miscarriage of his obligor (or debtor). This refers to suretyship contracts.
4. Promises made in consideration of marriage or a promise to marry, except mutual promises by two persons to marry each other.
5. A contract for the sale of personal property in excess of a fixed amount which varies in the different states.
6. A contract for the sale of an interest in lands.

No. 4.

(a) 1. The voting rights remain vested in the transferor, whose name is on the corporate books.

2. Dividends are paid to the pledgee who must apply or hold them for the benefit of the pledgor.

(b) At common law, Dodd would have no rights as against Bays, the true owner, inasmuch as the title claimed by Dodd is derived through a theft. This is true even though the certificate is endorsed in blank, if the certificate was not entrusted by the owner to the person who stole it. Under the Uniform Stock Transfer Act, however, Dodds as an innocent purchaser for value of a certificate endorsed in blank may hold the certificate as against Bays, the true owner, even though it was stolen.

No. 5.

(a) An 80% coinsurance clause means in substance that the insured is required to maintain insurance on the property covered equal to 80% of its actual value and failing to do so becomes a coinsurer to the extent of the deficiency so that he must himself bear his proportionate part of any fire loss.

(b) From the standpoint of the insured, the reason for a coinsurance clause is that it reduces the premium rate. From the insurer's standpoint, the clause is intended to encourage the maintenance of a reasonable amount of insurance or to reduce the insurance company's share of the loss.

(c) The insured would recover only $3,000. Since the $6,000 insurance which he carried was only three-fourths of the amount which he was required to carry by the 80% coinsurance clause, he himself must bear the remaining one-fourth of the loss. He can therefore recover three-fourths of the $4,000 loss, or $3,000.

(d) The general rule is that contracts of fire insurance are not assignable before loss without the consent of the insurer. They are classed as contracts involving personal confidence, which are not assignable, because of the confidence reposed by the insurer in the owner of the property.

(e) When the insured takes out a policy on his own life, it is not necessary that the person named as beneficiary have an insurable interest in the life of the insured, in the absence of a statute to the contrary. One who has no insurable interest may not, however, take out a policy on the life of another.

GROUP II

No. 6.

(a) Excess profits net income for the taxable year or a base period year is the normal-tax net income (before deduction of the excess profits tax) adjusted for various items provided for in the excess profits tax law.

(b) Base period years are the taxable years beginning after December 31, 1935, and before January 1, 1940.

(c) Briefly stated, average base period net income is the average excess profits net income for the base period years.

(d) Invested capital represents the taxpayer's investment including paid in capital, paid in surplus, accumulated earnings and profits, a percentage of borrowed capital and a percentage of new capital.

(e) Excess profits credit is either (1) 95% of the average base period net income with additions or subtractions for adjustments in capital during the year, or (2) a percentage of the invested capital.

(f) Specific exemption is an exemption of $10,000 which is allowable to each corporation (in the case of a mutual insurance company, other than life or marine, which is an inter-insurer or reciprocal underwriter, the specific exemption is $50,000).

(g) Adjusted excess profits net income is the balance after deducting the excess profits credit and the specific exemption from the excess profits net income for the taxable year. It is the amount on which the excess profits tax is levied.

(h) The unused excess profits credit is the excess of the excess profits credit for any taxable year beginning after December 31, 1939, over the excess profits net income for such taxable year.

(i) The amount of the unused excess profits credit for any taxable year beginning on or after January 1, 1942, may be carried back two preceding taxable years to offset the excess profits net income in those years.

No part of the unused excess profits credit may be carried back to a year beginning prior to January 1, 1941.

The amount of unused excess profits credit which was not used as a carry back may be carried forward for two taxable years and applied against the excess profits net income in those years.

This is known as the "carry back and carry forward" of unused excess profits credit.

No. 7.

(a) In almost all jurisdictions, a document which is not executed as a will may be incorporated into a will by reference. In order to incorporate such a document by reference, it is essential (1) that the will itself refer to the document as being in existence at the time of the execution of the will and in such a way as reasonably to identify such document and show the testator's intent to incorporate it in his will; (2) that such document be in fact in existence at the time of the execution of the will; and (3) that such document correspond to the description in the will and be shown to be the instrument therein referred to.

(b) An attestation clause is a certificate in which is set forth the facts concerning the execution of the will which the witnesses have observed, and which is signed by the witnesses. While such a clause is not necessary to the validity of a will in the absence of a statute requiring it, it is prima facie evidence of the truth of the facts recited therein if the genuineness of the signatures of the witnesses is proved.

(c) The general doctrine is that the descent of real property is governed by the law of the place where the land is situated, and that the distribution of personal property is determined by the law of decedent's domicile at the time of his death.

(d) The principal duties of an executor are to collect the assets of the estate; to pay the debts, expenses of administration and other valid obligations of the estate; and to distribute the estate to the legatees and devisees.

In addition, executors are usually required by statute to prepare and file an inventory of the assets of the estate within a prescribed time. Statutes also require executors to render accounts to the probate court.

In some states an executor is by statute under a duty to probate the will, although in the absence of statute the person named as executor has no such duty.

At common law, an executor was under a duty to provide for the suitable burial of the deceased. The modern view, arising from the circumstance that letters testamentary are seldom issued before the funeral has taken place, is that the right of burial belongs to the surviving spouse or next of kin rather than the executor.

No. 8.

(a) In general, the payment of contractual interest is governed by the law of the place where it is payable rather than the place where the contract was made. In the case of a contract made in one state and to be performed in another, the intention of the parties themselves to regard it as a contract of one or the other state will be determinative as to the governing law, provided the parties were acting in good faith. The rate of interest allowed as part of the damages for breach of contract is, by the majority view, determined by the law of the place of performance. The minority rule is that the law of the forum, i.e., the place where suit is brought, is controlling. There is likewise a conflict among different jurisdictions as to whether interest on a foreign judgment is governed by the law of the forum or the law of the place where the judgment was rendered, with perhaps the better authority supporting the latter view.

(b) Interest is not allowed on an unliquidated open and running account in the absence of an agreemet by the parties for the payment of interest.

(c) Interest is allowed on an "account stated" in the absence of agreement to the contrary.

(d) Interest begins to run at the time fixed by the express or implied agreement of the parties. In the absence of an agreement for interest, interest is allowed from the date of the breach of a contract to pay a definite sum of money (i.e., from the date when the debt becomes due) or to render a performance the money value of which is definitely fixed or mathematically ascertainable.

(e) Interest will stop running in the following instances:

(1) On payment or performance of the principal obligation;

(2) On tender of the amount of a debt at or after maturity;

(3) During the period when the act or omission of the creditor prevents the debtor from making payment, although the debtor is able, willing and intends to make payment.

(4) During the period when the debtor is prevented from making payment by reason of an injunction issued by a court of competent jurisdiction, a deposit in court of the fund or, generally, the pendency of litigation in which third parties make conflicting claims to the fund.

(5) In general, during the period in which the debtor is prevented by a state of war between his country and that of the creditor from making payment. If the creditor or his known agent authorized to receive the debt remains in the country of the debtor so that payment can be made, the running of interest is not suspended.

No. 9.

(a) The general rule is that the tenant or his representative may remove all articles annexed by the tenant to the land which fall in the following categories:

(1) Trade fixtures, i.e., articles annexed for the purpose of aiding in the conduct of a calling exercised for pecuniary profit, provided the calling is not exclusively agricultural.

(2) Domestic and ornamental fixtures, i.e., articles annexed by the tenant of a dwelling to render it more comfortable and attractive as a dwelling.

(3) In some jurisdictions, agricultural fixtures.

The right of the tenant to remove the above classes of fixtures cannot be exercised if the premises will be thereby substantially damaged; if the tenant's fixture was substituted for one on the premises when he took possession and which has been injured or permanently removed; or, in some jurisdictions, if the fixture cannot be removed without losing its identity or being disintegrated.

(b) The authorities are in conflict as to the precise time limit of a tenant's right to remove fixtures. Some decisions hold that the right expires with the term of the tenancy. Others hold that the right of removal continues during the period when the tenant holds over after the expiration of his term without relinquishing possession of the land; some of these decisions limit the continuance of the right to cases where the tenant holds over rightfully. If a tenancy is of uncertain duration, the tenant has a "reasonable time" after its termination to remove the fixtures provided termination was not the result of his voluntary act and provided he has not relinquished possession. Some decisions give a tenant a reasonable time after loss of possession by forfeiture in which to remove fixtures. The decisions are in conflict as to whether the tenant's acceptance of a new lease or renewal of the old lease terminates the right to remove the fixtures.

(c) A building may be considered a trade fixture if it is erected for business purposes and if it may be removed without substantial damage to the premises. Whether or not Arthur has the right to remove such a building in the case cited would depend upon the jurisdiction in which it is located. The majority of jurisdictions formerly held that the right to remove trade fixtures is lost by the tenant's taking of a new or renewal lease which does not in terms reserve that right. The present trend of decisions seems to be to avoid a "forfeiture" by allowing the tenant to remove the fixtures where the terms of the renewal indicate that it is a mere extension or continuation of the original lease. In some states statutes expressly provide that the right to remove fixtures shall not be lost by the tenant's acceptance of a new lease.

No. 10.

(a) The creditors who are parties to the agreement are not liable as partners. Under the provisions of the Uniform Partnership Law, which are in accord with the modern common law authorities, only those who are partners between themselves may be charged for partnership debts by others, except in the case of one who has represented himself as a partner to others who have relied on such representation. An agreement, in order to establish a partnership, must contemplate an association of two or more persons to carry on as co-owners a business for profit. The creditors in this case are not co-owners of the business. Their interest in the profits is not that of ownership, but is in securing the repayment of debts owing to them.

(b) The United States is not entitled to payment out of the firm estate in priority to firm creditors. The income tax due from partner A was an individual tax, and not a debt of the partnership, despite the fact that it was based on income derived from partnership business. Under the Bankruptcy Act, partnership debts have prior claim on partnership assets. The statutory priority given in cases of bankruptcy to debts due the United States extends only to partner A's share in the surplus of the partnership assets after partnership debts are paid.

No. 11.

(a) It is the duty of a depositor in a bank to examine canceled checks returned to him by the bank within a reasonable time after receiving them, and to report to the bank any forgeries or discrepancies in the amounts which he may discover. The examination should be made in good faith and with ordinary diligence and the care required by the circumstances. The duty does not extend to examination of indorsements for genuineness. It is generally held that the depositor may properly delegate his duty to a competent and trustworthy employee. Should the depositor fail to fulfill his duty, he may be estopped to question irregularities, forgeries and alterations provided the bank has suffered damage from his dereliction of duty, and provided the bank was not guilty of negligence in failing to discover forgery or fraud.

(b) The depositor has a duty to examine statements of his account or balanced passbooks sent him by the bank within a reasonable time after receiving them. Upon his failure to do so and to notify the bank of any irregularities, the depositor may be presumed to have acquiesced in the bank's statement of the account and it becomes an account stated which is binding upon the depositor and the bank unless duly impeached for fraud or error.

(c) The certification of a check by the bank upon which it is drawn makes the bank legally bound to pay it to one rightfully entitled to the funds. The certification is equivalent to an acceptance. It imports that the check is drawn upon sufficient funds in the possession of the bank, that they have been set apart for the satisfaction of the check, and that they shall be so applied whenever the check is presented for payment by a holder entitled to the fund.

(d) The bank is primarily liable on a certified check to the holder of the check until discharged by payment, release, or statute of limitations.

(e) The drawer is not relieved from liability to the payee or holder when the drawer himself procures the certification of the check. When the payee or holder has the check certified, the drawer is discharged.

No. 12.

(a) (1) A trustee ordinarily is under a duty personally to perform his fiduciary duties and Arms cannot properly delegate the entire administration of his trust duties to an agent unless the trust expressly so provides. He can delegate only the performance of acts which it is unreasonable to require him personally to perform, taking into consideration the amount of discretion involved, the value and character of the property involved, whether the property is principal or income, the proximity or remoteness of the subject matter of the trust and whether the act requires professional skill or facilities possessed or not possessed by the trustee himself.

(2) Arms is liable to the beneficiary for Bush's fraudulent misappropriation of funds. The applicable principle of law is that a trustee is liable to the beneficiary for the acts of agents employed by him in the administration of the trust where such acts if done by the trustee would constitute a breach of trust and where the performance of such acts was delegated by the trustee in violation of his fiduciary duty.

(b) An auctioneer is usually defined as a person authorized or licensed by law to sell goods or lands of other persons at public auction for a commission or other compensation.

(c) An auctioneer is primarily the agent of the owner of the property being sold, and remains so up to the moment he accepts the bid of the purchaser and sells the property to the purchaser, when he becomes the agent of the purchaser also to the extent of binding the purchaser by entering his name as purchaser and signing a memorandum of sale.

(d) The implied powers of an auctioneer are:

(1) to fix the terms of sale, when they are not prescribed by the owner;

(2) to receive the price, or sue for it in his name, unless the terms of his employment provide otherwise.

(e) The following are limitations on the powers of an auctioneer:

(1) An auctioneer cannot delegate his power to sell;

(2) He cannot sell on credit unless authorized to do so;

(3) He cannot sell at private sale, except possibly when all efforts to dispose of property at public auction have proved abortive;

(4) He has no authority to warrant the quality or title of goods sold except by instruction or by statute.

Auditing

November 10, 1944, 1:30 to 5:00 p.m.

No. 1.

Verification of real estate owned by a real estate company should more closely follow audit procedures used in verifying stock in trade, instead of those followed in verifying fixed assets.

The accountant should examine the abstracts of title, deeds, title guarantees, tax bills, appraisals, assessments, insurance policies, etc. As the title and validity, and the recorded mortgages and liens can be established only by reference to the public records, this work should be performed by attorneys, whose certificates should be sufficient.

The basis of valuation of the real estate and improvements thereon should be determined by reference to purchase contracts, bills of sale, canceled checks, construction contracts, assessment bills and invoices. A comparison should be made of the selling price of recent sales of similar lots to the carrying value of those unsold. Improvements material in amount should be physically inspected.

The accounting records should be carefully checked and analyzed to determine that lots sold have been accurately credited out of the accounts at the carrying values.

No. 2.

The system of internal control covering purchases, receipt of merchandise, and the procedures followed in handling and paying the bills should be examined.

Steps to be taken in the examination of the current liabilities follow:

(1) Confirm the balances of notes payable, loans payable, liability to affiliated persons or firms, other major or unusual items, and, if practicable, of trade accounts payable.

(2) Ascertain whether any of the firm's assets are hypothecated with note holders, trade creditors, etc., and obtain confirmations from the holders thereof.

(3) Sight notes paid during the period, verify payment of interest, and the provision for accrued interest.

(4) Obtain a list of accounts payable, compare with the detail record maintained, and reconcile the total with the control account.

(5) Examine the available creditors' statements in verification of the accounts payable and reconcile any differences.

(6) Verify the adequacy of the provisions for all taxes; sight tax bills paid during the period and the returns filed and/or examined. Accruals for social security and sales taxes can be verified

by reference to the payroll and sales accounts. Correspondence with the state and federal treasury departments, including any amended tax returns or refunded claims, should be examined.

(7) Ascertain that salaries and wages accrued since the close of the last payroll period have been recorded as accrued.

(8) Determine that provision has been made for any amounts payable under bonus or profit-sharing arrangements.

(9) Review the purchase voucher, journal voucher, and disbursement records subsequent to the balance-sheet date to ascertain whether any of the entries were for merchandise received prior to the balance-sheet date.

(10) Inquire into the existence and nature of purchase commitments, contracts or orders.

(11) Inquire into the existence of pending lawsuits, damage claims, judgments, etc., and ascertain what provision has been made for any liability thereunder.

(12) Obtain a certificate as to liabilities, actual and contingent, from a responsible official of the company.

(13) Examine the receiving records for some time prior to the balance-sheet date to determine that the merchandise received before that date has been recorded in the inventory and that the liability therefor has been entered in the accounts.

(14) Check accruals for expenses, freight payable, and the computation of unpaid salesmen's commissions.

(15) Examine the minutes for any dividends declared but unpaid, and for clues to other unrecorded liabilities.

No. 3.

The adjustment resulting from the change in the method of valuing the inventory at the end of the year may be shown as a separate deduction from the opening inventory, or it may be included as an adjustment in the cost-of-sales section of the profit-and-loss statement.

However, the more common practice is to append a footnote to the income statement explaining the change and its effect upon the net income before and after federal income and excess-profits taxes.

The balance-sheet should bear a footnote explaining the change and the amount of the reduction in the inventory valuation resulting therefrom.

A paragraph should be included in the report commenting upon the change in the method of valuing the inventory and the effect of such change upon the financial statements. That section of the report having to do with the comment on the consistent application of accounting principles, should be qualified.

No. 4.

If at all possible, the auditor should be present at the close of business on the balance-sheet date, or at the opening of business the next business day. Petty cash, undeposited cash and checks should be counted simultaneously. The cash and checks to be deposited should be kept under the control of the auditor until deposited. The auditor should accompany the employee when the deposit is being made and obtain a duplicate deposit slip authenticated by the receiving teller. A subsequent cut-off should be made of the cash and bank accounts, and particular attention paid to any items charged back by the bank which might represent uncollectible items undeposited on the balance-sheet date.

If it is not practicable for the auditor to be present on the balance-sheet date or the first business day following, he should make a cut-off at a date subsequent to the balance-sheet date. This cut-off should include a simultaneous count of all cash and undeposited checks and a reconciliation of all the bank accounts as of the same date.

No. 5.

The accountant should ascertain who in the client's employ is to be responsible for the taking of the inventory. All instructions to him and those assigned to actually taking the inventory must be in writing. The following matters should be covered:

(1) The date and time of the taking of the inventory, including a schedule showing the individuals responsible for the various divisions of the work.

(2) An arrangement of the merchandise and stock to facilitate its count and accessibility. Any consigned goods or stock held for the account of outsiders should be segregated and so marked.

(3) Careful planning of inventory in the work in process is necessary. It may be possible to complete the work in process to a point in the operation where its valuation may be relatively simple.

(4) Control or cut-off of receipts and requisitions of materials being counted and a corresponding cut-off in the records covering purchases, sales, transfers between departments, etc. should be provided.

(5) Method of taking the inventory, which procedure may be by the use of prenumbered control cards or tags, or by direct listing. The

inventory should be initialed by those responsible for the various steps of the work. The responsibility for the control of the cards, tags, etc. must also be set.

(6) Specific instructions regarding the basis of pricing, including the sources of price data, etc.

(7) If ledger accounts of the stock are carried, the balances in the accounts should be compaired with the quantities shown in the inventory. Any material differences should be investigated and adjustments made. If no stock records are kept, responsible executives who are familiar with the various divisions of the stock should be requested to review the inventories and to thoroughly check any apparent differences.

No. 6.

The independent auditor reviews a client's internal control in order to determine the extent to which he can depend upon it in laying out his audit procedure.

The two principal questions that he asks are: (1) Is the system of internal control tight enough to prevent a misstatement of financial facts, whether accidental or deliberate? (2) Is the prescribed system actually being followed?

In the case of a first examination for a new client the auditor should examine almost all of the phases of internal control in some detail. In the case of an old client it will not be necessary to examine all phases of the system, as the auditor can rely to some extent upon his experience in the past. In each audit he should select certain sections to be tested, although the entire system should be covered over a short period of years.

No. 7.

The following should be considered as important provisions of a system of internal control in connection with accounts receivable:

(1) The credit or collection departments should not be permitted to have any control over the accounts-receivable ledgers or handle any cash receipts.

(2) Persons handling currency should not be permitted to authorize any write-offs, such as allowances for bad debts.

(3) The authority to grant credits for returned merchandise should not be vested in any person having to do with cash receipts or with the inventory.

(4) Statements mailed to customers should be compared with the

ledger accounts by some person other than the accounts-receivable-ledger clerks or anyone handling the cash receipts.

(5) The ledger clerks should be rotated in preparing the monthly statements of the customers' accounts.

No. 8.

...............National Bank

...............Illinois

Gentlemen:

In connection with a regular examination of the books and records of our company as of close of business December 31, 1943, we shall be obliged if you will furnish the undermentioned information direct to our auditors,................ and..........., at.........Illinois. An addressed, stamped envelope is enclosed therefor.

Yours very truly,

A.B.C. Importing Company

Information requested as of close of business December 31, 1943:

(1) The amount of the balances to the credit of the company, showing the designation of accounts and any limitations on the right of withdrawal by check.

(2) The amount of any direct liability to you in respect of loans, acceptances, etc., showing the amount of each loan, date of loan, due date, interest rate, date at which interest has been paid, and a description of the liability, collateral, liens, endorsers, etc.

(3) Statement of contingent liability as endorser of notes discounted and/or as guarantor, showing the amount, name of the maker, date of note, due date of note, and any remarks.

(4) Statement of other direct or contingent liability, open letters of credit, relative collateral, etc.

No. 9.

The auditor should make certain that there is no so-called "hollow square" within what appears to be a solid formation. It would be well to inspect the stack from above or remove enough of the packages to determine that the formation is solid. Tests should also be made of some of the packages to ascertain that the contents are what they are purported to be.

No. 10.

(a) The auditor should state specifically in his report that the accounts receivable were not confirmed by direct correspondence, and should take exception in his opinion with respect to this item. If the amount of the accounts receivable is of relatively large amount no opinion should be rendered by the auditor.

(b) As the examination of the minutes of the board of directors' meetings is essential to the audit, the auditor should refuse to render an opinion unless he is allowed access to the minutes.

(c) If the amount due from the wholly-owned subsidiary is material in amount in relation to the assets of the parent, no opinion as to the financial statements of the parent company should be rendered by the auditor.

INDEX