1948

Unofficial answers to the Uniform certified public accountants examination, May 1945 to November 1947 inclusive

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UNOFFICIAL ANSWERS

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

MAY 1945 TO NOVEMBER 1947

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ANSWERS

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By
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INTRODUCTORY NOTE

The problems and questions prepared by the board of examiners of 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. The unofficial answers to these questions, which appear in *The Journal of Accountancy* from month to month, are published simultaneously in separate volumes, of which this is the sixth. These books, widely used in accounting courses in colleges, universities and other schools throughout the country, have proved to be of great value to candidates for the CPA certificate.

In presenting this new book of answers covering the period May 1945 to November 1947, we are responding to a continuing demand. The problems and questions of this period appear in a separate volume, which is being published concurrently with this. It cannot be emphasized too strongly that these answers are not in any sense official, but represent merely the opinions of the individuals who have prepared them for publication.

JOHN L. CAREY, *Secretary*

February 1948.

ANSWERS TO EXAMINATIONS OF MAY 1945

Accounting Practice—Part I

May 16, 1945, 1:30 to 6:00 p.m.

No. 1

Adjustments and Eliminations

(1)

Earned surplus—H Company	$ 5,320	
Investment in Company B		$ 5,320
To adjust investment amount to cost. (800 shares at $180 each) $144,000.		

(2)

Goodwill	26,285	
Capital stock—A Company	51,000	
Earned surplus—A Company	3,515	
Investment in Company A		80,800
To eliminate A Company's equity of capital stock and surplus of A Company. (See Schedule I)		

(3)

Goodwill	16,400	
Capital stock—B Company	80,000	
Earned surplus—B Company	47,600	
Investment in B Company		144,000
To eliminate H Company's equity of capital stock and surplus of B Company. (See Schedule I).		

(4)

Earned surplus	4,120	
Reserve for intercompany profit in inventories		4,120
To eliminate the intercompany profit from surplus and to set up reserves per Schedule II.		

(5)

Capital stock—A Company	9,000	
Earned surplus—A Company	1,650	
Minority interest (15%)		10,650
To eliminate minority interest in A Company.		

(6)

Capital stock—B Company	20,000	
Earned surplus—B Company	13,200	
Minority interest (20%)		33,200
To eliminate minority interest in B Company.		

Schedule I

H COMPANY AND ITS SUBSIDIARIES, A COMPANY AND B COMPANY

Computation of Consolidated Goodwill

December 31, 1944

	A Company			B Company
	July 1, 1944	October 1, 1944	Total	March 1, 1944
Purchase price	$67,000	$13,800	$80,800	$144,000
Book value:				
Capital stock	$60,000	$60,000		$100,000
Surplus	3,500	7,100		59,500
Total	$63,500	$67,100		$159,500
Percentage	70%	15%		80%
Equity acquired	$44,450	$10,065	$54,515	$127,600
Goodwill	$22,550	$ 3,735	$26,285	$ 16,400

Schedule II

H COMPANY AND ITS SUBSIDIARIES, A COMPANY AND B COMPANY

Computation of Intercompany Profit in Inventories

December 31, 1944

	Company					Intercompany	
Date 1944	Purchaser	Seller	Inventory	Cost	Profit	Holding	Profit
April 5	H	A	$3,600	$ 3,000	$ 600	None	$ —
August 15	H	B	5,000	4,500	500	80%	400
October 5	H	A	10,000	9,000	1,000	85	850
May 15	A	B	7,000	6,200	800	None	—
September 26	A	B	6,000	4,800	1,200	80	960
November 12	B	A	16,000	14,000	2,000	85	1,700
July 20	B	A	4,500	4,200	300	70	210
Total			$52,100	$45,700	$6,400		$4,120

Note.—A Company did not become a member of the affiliated group until July 1, 1944, when H Company acquired control through its 70 per cent stock interest. Therefore, the transactions of A Company prior to that date are not "intercompany."

H COMPANY AND ITS SUBSIDIARIES, A COMPANY AND B COMPANY

Consolidated Balance Sheet—Working Papers

December 31, 1944

	H Company	A Company	B Company	Adjustments and Eliminations Debit	Adjustments and Eliminations Credit	Consolidated Balance-Sheet
Assets						
Cash in banks	$ 86,000	$ 12,500	$ 35,000			$133,500
Notes receivable	18,000	6,000	8,000			32,000
Accounts receivable (less reserve)	52,000	13,000	34,000			99,000
Inventories	89,500	16,000	51,000			156,500
Reserve for intercompany profit					$ 4,120 (4)	(4,120)
Investment in Company A (at cost)	80,800				80,800 (2) 5,320 (1)	
Investment in Company B (at book value)	149,320				144,000 (3)	
Plant and equipment (less reserves)	225,000	56,500	101,000			382,500
Goodwill				$ 26,285 (2) 16,400 (3)		42,685
	$700,620	$104,000	$229,000			$842,065
Liabilities						
Notes payable	$ 9,000	$ 8,000	$ 12,000			$ 29,000
Accounts payable	73,600	22,400	46,200			142,200
Accrued liabilities	5,320	2,600	4,800			12,720
Capital stock—common, $100 par:						
H Company	400,000					400,000
A Company		60,000		51,000 (2) 9,000 (5)		
B Company			100,000	80,000 (3) 20,000 (6)		
Earned surplus:						
H Company	212,700			5,320 (1) 4,120 (4)		
A Company		11,000		3,515 (2) 1,650 (5)		214,295
B Company			66,000	47,600 (3) 13,200 (6)		
Minority interest					10,650 (5) 33,200 (6)	43,850
	$700,620	$104,000	$229,000	$278,090	$278,090	$842,065

H COMPANY AND ITS SUBSIDIARIES, A COMPANY AND B COMPANY

Consolidated Balance-Sheet

December 31, 1944

Assets

Current assets:			
Cash in banks		$133,500	
Notes receivable		32,000	
Accounts receivable (less reserve)		99,000	
Inventories	$156,500		
Less reserve for intercompany profits	4,120	152,380	$416,880
Plant and equipment (less reserves)			382,500
Goodwill			42,685
			$842,065

Liabilities

Current liabilities:		
Notes payable	$ 29,000	
Accounts payable	142,200	
Accrued liabilities	12,720	$183,920
Minority interests:		
A Company	$ 10,650	
B Company	33,200	43,850
Capital stock and surplus:		
Capital stock (4,000 shares of $100 par value)	$400,000	
Surplus	214,295	614,295
		$842,065

If the parent-subsidiary relationship of H Company and A Company were reflected retroactively to January 1, 1943 the reserve for intercompany profits, goodwill, and surplus accounts would be changed as follows:

	Solution	Adjustments	As Adjusted
Reserve for intercompany profits	$ 4,120	$ 820	$ 4,940
Goodwill	42,685	4,050	46,735
Surplus	214,295	3,230	217,525

The reserve for intercompany profits would be increased by including the proportionate interest in the profits of the two transactions with A Company prior to July 1, 1944. These were:

Date	Profit	Holding	Intercompany Profit
April 5	$600	30%	$180
May 5	800	80	640
Total			$820

The new basis for goodwill is shown in the following schedule:

COMPUTATION OF CONSOLIDATED GOODWILL

Schedule I (a)

December 31, 1944

	A Company — Dates of Purchase: January 1, 1943	July 1, 1944	October 1, 1944	Total	B Company: March 1, 1944
Purchase price	$25,000	$42,000	$13,800	$80,800	$144,000
Book value:					
Capital stock	$60,000	$60,000	$60,000		$100,000
Surplus (deficit)	(10,000)	3,500	7,100		59,500
Total	$50,000	$63,500	$67,100		$159,500
Percentage	30%	40%	15%		80%
Equity acquired	$15,000	$25,400	$10,065	$50,465	$127,600
Goodwill	$10,000	$16,600	$ 3,735	$30,335	$ 16,400

The change in the surplus account results from the two changes above:

Per solution		$214,295
Less increase in intercompany reserve		820
		$213,475
Add:		
Increase in goodwill of A company:		
Schedule I (a)	$30,335	
Schedule I	26,285	4,050
As adjusted		$217,525

No. 2

ACE CO., INC.
RECONCILIATION OF NET INCOME AND NORMAL TAX NET INCOME
FOR THE YEAR ENDED DECEMBER 31, 1944

Item No.	Gross Income	Normal Tax Net Income	Reconciling Items		Net Income Before Federal Taxes on Income
1.	Gross sales, $115,000; less returns and allowance $2,500	$112,500			$112,500
2.	Less cost of goods sold	69,675			69,675
3.	Gross profit from sales	$ 42,825			$ 42,825
12.	(a) Excess of net short-term capital gain over net long-term capital loss (Schedule C)	400		$ 875 (2)	1,275
	(b) Net gain (or loss) from sale or exchange of property other than capital assets (Schedule D)	(5,325)		7,750 (3)	2,425
13.	Dividends	4,500			4,500
	Bad debts recovered			150 (4b)	150
15.	Total income	$ 42,400			$ 51,175
	Deductions				
16.	Compensation of officers	$ 10,500			$ 10,500
17.	Salaries and wages	5,100			5,100
18.	Rent	3,600			3,600
19.	Repairs	150			150
20.	Bad debts (Schedule (G)	615	$ 510 (4a)		1,125
22.	Taxes	2,100			2,100
25.	Depreciation (Schedule J)	1,900		125 (5)	1,775
27.	Net operating loss deduction (see statement below)	2,850		2,850 (6)	—
29.	Other deductions authorized by law (Schedule K)	4,600			4,600
	Officers' life insurance premiums		812 (1)		812
	Provision for postwar contingency reserve		1,750 (1)		1,750
30.	Total deductions	$ 31,415			
31.	Net income for declared value excess profits tax computation	$ 10,985			
35.	Less declared value excess-profits tax	76		(Note)	76
38.	Adjusted net income	$ 10,909			
39.	Less income subject to excess-profits tax	$ 2,700		2,700 (8)	—
40.	Dividends received credit (85% of dividends, item 13)	3,825		3,825 (8)	—
	Total	$ 6,525			—
	Total				$ 31,588
41.	Net income reconciliation	$ 4,384	$ 3,072	$18,275	$ 19,587

	Reconciling Items	
Unallowable deductions:		
Officers' life insurance premiums		\$ 812 (1)
Provision for postwar contingency reserve		1,750 (1)
Net capital loss carryover	\$ 875 (2)	
Loss on sale of frame building	5,250 (3)	
Proceeds of sale of frame building previously written off	2,500 (3)	
Provision for bad debts		510 (4a)
Bad debts recovered (not taxable as it was charged off in a loss year)	150 (4b)	
Depreciation on frame building written off in prior years not recorded on books	125 (5)	
Net operating loss deduction	2,850 (6)	
Deductions eliminated	6,525 (8)	
	\$18,275	\$3,072

Note—The problem requires the candidate to "determine net income (before federal taxes on income)." In this solution the declared value excess-profits tax is not considered as a tax on income, because it is based on that portion of "net income" in excess of 10 per cent of the value declared on the capital-stock tax return. Had that value been set higher, an additional capital-stock tax would have been paid with a resulting decrease in or elimination of the declared value excess-profits tax.

There exists an irreconcilable difference between the item reported as 12 (a) and the underlying data reported in Schedule C. As an alternate solution, it may be proper to assume Schedule C to be correct and accordingly diminish the declared value excess-profits tax by \$26.40 (6.6% of \$400) because the excess of net long-term capital gain over net short-term capital loss, as reported in Schedule C, is not a factor in the computation of such tax.

No. 3 (Alternate for No. 2)

MORTON CITY
BALANCE-SHEET WORKING PAPERS
February 28, 1944
General Fund

	Trial Balance February 28, 1944	Adjustments Debit	Adjustments Credit	Balance-Sheet February 28, 1944 Debit	Balance-Sheet February 28, 1944 Credit
Cash in depositories	$ 125,000			$ 125,000	
Petty Cash	500			500	
Taxes receivable—current	215,000		$ 4,900 (2a)	210,100	
Taxes receivable—delinquent	20,000		1,050 (2a)	18,950	
Taxes receivable for other units—current	18,000			18,000	
Interest and penalties receivable on delinquent taxes	1,400		100 (2b)	1,300	
Expenditures	900,000	$ 30,000 (9)	800 (4) 929,200 (A)	—	
Estimated revenues	950,000		950,000 (B)	—	
Deferred charges		800 (4) 5,000 (5)		5,800	
	$2,229,900				
Vouchers payable	$ 130,000				$ 130,000
Notes payable	116,200				116,200
Due to special assessments fund	8,400				8,400
Due to other governmental units—State	21,600	1,440 (1c)	14,400 (3)		34,560
Due to other governmental units—County	5,400	360 (1c)	3,600 (3)		8,640
Unappropriated surplus	44,900	5,950 (2a) 100 (2b) 21,010 (1a) 4,050 (1b) 18,000 (3) 7,400 (A)	5,000 (5) 3,600 (B) 8,200 (C)		5,190
Appropriations	921,800	921,800 (A)			
Actual revenues	953,600	953,600 (B)			
Revenues not anticipated	8,200	8,200 (C)			
Taxes collected in advance	14,800				14,800
Emergency note	5,000				5,000
	$2,229,900				
Reserve for estimated losses against receivables:					
Current (10%)			21,010 (1a)		21,010
Delinquent, and interest and penalties thereon (20%)			4,050 (1b)		4,050
For other units—current (10%)			1,800 (1c)		1,800
Reserve for encumbrances			30,000 (9)		30,000
		$1,977,710	$1,977,710	$ 379,650	$ 379,650

Closing Entries (A) (B) and (C)

MORTON CITY

BALANCE-SHEET WORKING PAPERS

February 28, 1944

Special Assessments Fund

	Trial Balance February 28, 1944	Adjustments Debit	Adjustments Credit	Balance-Sheet February 28, 1944 Debit	Balance-Sheet February 28, 1944 Credit
Cash in depositories	$ 316,600			$ 316,600	
Special assessments receivable	320,000			320,000	
Due from general fund—Municipality's share of assessment improvements costs	8,400			8,400	
Special assessment liens	20,000			20,000	
Improvements other than buildings—completed	75,000		$ 75,000 (D)	—	
Improvements other than buildings—in progress	28,000	$ 5,000 (7)	33,000 (D)	—	
Interest receivable on special assessments liens		540 (6)		540	
	$ 768,000				
Vouchers payable	$ 15,000				$ 15,000
Notes payable	90,000				90,000
Contracts payable—uncompleted contracts	130,000				130,000
Bonds payable	350,000				350,000
Reserve for authorized expenditures	183,000	1,400 (8)			
		45,000 (9)			
Transferred to general fixed assets		108,000 (D)			28,600
	$ 768,000				
Unappropriated surplus construction			1,400 (8)		1,400
Unappropriated surplus—interest			540 (6)		540
Retained percentages on uncompleted special assessment contracts			5,000 (7)		5,000
Reserve for encumbrances			45,000 (9)		45,000
		$ 159,940	$ 159,940	$ 665,540	$ 665,540

MORTON CITY
BALANCE-SHEET WORKING PAPERS
February 28, 1944

Bond Fund

	Trial Balance February 28, 1944	Adjustments Debit	Adjustments Credit	Balance-Sheet February 28, 1944 Debit	Balance-Sheet February 28, 1944 Credit
Cash in depositories	$ 120,000			$ 120,000	
Accounts receivable	15,000			15,000	
Buildings—completed	120,000		$ 120,000 (E)	—	
Buildings—uncompleted	50,000		50,000 (E)	—	
Bonds authorized—unissued	100,000			100,000	
Expenditures	309,000		309,000 (F)		
	$ 714,000				
Vouchers payable	$ 25,000				$ 25,000
Contracts payable uncompleted contracts	68,700				68,700
Contracts payable—completed contracts	60,000				60,000
Reserve for authorized expenditures	560,300	18,000 (9)			
Transfer to general fixed assets		170,000 (E)			
Closing entry		309,000 (F)			63,300
	$ 714,000				
Reserve for encumbrances			18,000 (9)		18,000
		$ 497,000	$ 497,000	$ 235,000	$ 235,000
General Fixed Assets					
Land	$1,200,000			$1,200,000	
Buildings	3,400,000	$ 120,000 (E)		3,520,000	
Improvements other than buildings	640,000	75,000 (D)		715,000	
Machinery and equipment	325,000			325,000	
	$5,565,000				
Investment in property	$5,565,000		$ 33,000 (D)		
			75,000 (D)		
			50,000 (E)		
			120,000 (E)		$5,843,000
	$5,565,000				
Improvements other than buildings—in progress		33,000 (D)		33,000	
Buildings—uncompleted		50,000 (E)		50,000	
		$ 278,000	$ 278,000	$5,843,000	$5,843,000

Theory of Accounts

May 17, 1945, 9:00 a.m. to 12:30 p.m.

GROUP I

No. 1

When the corporation paid the 300% stock dividend it definitely capitalized the $300,000 of the earned surplus transferred to capital-stock account.

Later, when the corporation reduced the par value of each share of its stock to 25% of its former value, the $300,000 reduction in the capital-stock account should have been credited to capital surplus, against which the deficit of $180,000 could be applied as a part of the plan of reorganization.

It should be borne in mind that, having committed itself to a capitalization of part of its earned surplus, the corporation could not later reverse its position.

No. 2

(a) "Burden" is a term used to indicate all indirect manufacturing charges which cannot practically or conveniently be charged as a direct cost to production.

(b) "Material price variance" is a term applied to the difference between the actual unit price and the standard unit price of materials, applied to the total number of units.

(c) "Labor efficiency variance" is a term applied to the difference between the actual number of direct labor hours consumed and the number of standard direct labor hours which should have been consumed according to the amount produced.

(d) "Standard cost" is the predetermined cost, based on estimated cost for material, labor, and burden.

(e) "Actual cost" is the amount expended for material and labor, and a reasonable charge for burden.

No. 3

(a) If the additional $2,000 had been earned but not paid the amount should be shown as a current liability on the balance-sheet.

(b) If it had not been earned, the noncurrent liability should be shown in the balance-sheet somewhat as follows:

Mortgage (5%) due December 31, 1948................ $80,000
(Interest payable at the rate of 2½% per annum only if earned.)

Interest payable on mortgage—in arrears............... $2,000
As any unpaid interest becomes a lien on the property the liability must be shown in the balance-sheet whether earned or not.

No. 4

(a) LIFO (last-in, first-out). Under this method, it is assumed that the goods last purchased were the first used.

(b) FIFO (first-in, first-out). Under this method, it is assumed that the goods on hand at the end of the period were the most recently purchased and that withdrawals from the inventory were from the earliest acquisition.

(c) Base-stock. 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.

(d) Retail. 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 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.

(e) Average cost. Under this method, it is assumed that the cost of goods on hand at the end of the period is the weighted average of the opening inventory and the goods purchased or produced during the period.

No. 5

The partnership return is an information return showing each partner's distributive share of the partnership income. The partnership is not a separate taxable entity, and is not subject to income tax. Therefore, no federal income-tax liability should be shown on the partnership balance-sheet.

It might be well, however, to footnote the financial statements to the effect that the personal income-tax liability of the respective partners was not included therein.

GROUP II

No. 6

The notes should appear as long-term liabilities with full disclosure as to their terms. Each year as the profit is determined, notes of an amount equal to three-fourths of the year's profit should be transferred from the long-term liabilities to current liabilities until all of them have been liquidated.

No. 7

The annual budgeted sales of each class of product should be divided into the annual budgeted advertising cost to determine a percentage to be applied to the actual sales of each product sold each month. The amount thus determined should be charged to an advertising expense account for each class of product, with an offsetting credit to an advertising reserve account for each respective class of product. As actual advertising expenditures are made the reserve accounts should be charged.

The balances in the reserve accounts should be closed out at the end of the year to their respective expense accounts.

No. 8

(a) Bond discount and expense:

An unamortized bond discount and expense account should be charged with:

(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.

It is permissible to carry such an account in the balance-sheet (as a deferred charge and not as a current asset) because it represents compensation for the use of money. It should be written off over the life of the bonds.

(b) Prepaid rent, taxes, commissions, etc.

The above represent expenses paid in advance and applicable to future periods. The distinction sometimes made between prepaid expenses and deferred charges, such as bond discount and expense, is that prepaid expenses have a going concern value and often a realizable value upon sale or liquidation, whereas deferred charges do not.

Prepaid expenses may be shown below "current assets" in the balance-sheet and should be written off over the periods benefited.

No. 9

Since the routing of the production orders is at the convenience of the producer, it would not be proper to charge any particular job or jobs with overtime premiums. Otherwise similar jobs would bear varying rates of labor costs, and, if burden rates were based on labor, disproportionate charges for manufacturing overhead.

In so far as specific jobs do not cause overtime premiums, it would be better in most cases to charge such premiums to departmental overhead.

No. 10

Deferred income is income which has been received but which is applicable to future periods. Rentals, commissions, and subscriptions to publications collected in advance, commutation tickets of transportation companies, etc. are examples of deferred income. Such items should be shown on the balance-sheet above the net worth section under the caption "deferred credits." As the income is earned the account should be charged and the respective income accounts credited in the period in which earned.

Unrealized profit is the increase in the value of an asset over its book value, which increase has not as yet been realized. Examples are the excess of the market value over the cost or carrying value of securities and the excess of the appraisal over the cost of fixed assets. Unrealized profit should be fully disclosed in the balance-sheet where it is generally shown under the caption of "net worth."

No. 11

(a) A sinking fund is generally created for the purpose of liquidating an indebtedness. It is created by a transfer of cash or securities (including those to be retired through the fund) to a trustee or a special account.

(b) An endowment fund is one usually provided by gift to a hospital, technical association, school, or other nonprofit institutions. The principal is generally invested. The income from the investments may be restricted or may be used for general purposes.

(c) General fund is an operating fund more commonly used in municipal, charitable, religious, educational, or other nonprofit institutions. The money for this fund may be acquired by appropriation or from general revenues.

(d) An imprest fund is created for the purpose of paying minor disbursements by a transfer of a fixed amount of cash from the general operating fund. Disbursements made from the fund are reimbursed from general cash at the time the vouchers are presented. Cash on hand plus vouchers not reimbursed must at all times equal the fixed amount of the fund.

No. 12

(a) Amortization is the apportionment of the value of an asset (usually an intangible) over the period of its existence or during the period in which its benefits will be realized. Patents, copyrights, and leasehold improvements are examples of assets subject to amortization.

(b) Depletion is the charge made for the loss in the physical value of mineral deposits or other natural resources. The charge is based upon the ratio of the units withdrawn to the estimated total recoverable units. Timberlands, oil and mineral reserves are assets subject to depletion.

(c) Depreciation is the decrease in the value of fixed assets due to either physical causes such as wear and tear or functional causes such as obsolescence. Actual depreciation is the physical deterioration which has taken place, while theoretical depreciation is the amount charged on the books of account. Building, machinery, and furniture and fixtures are assets subject to depreciation.

Accounting Practice—Part II

May 17, 1945, 1:30 to 6:00 p.m.

Schedule A

No. 1

ESTATE OF BEN EAST

JOHN DOE AND RICHARD ROE, EXECUTORS

INVENTORY OF ASSETS

July 7, 1943

Cash	$ 52,000.00
Accounts receivable	18,000.00
Noninterest bearing notes	10,000.00
First mortgage bonds 6% (par value $8,000) appraised value	6,500.00
Interest accrued on mortgage bonds	9.21
United States savings bonds, 3% (par value $100,000) appraised value	101,500.00
Interest accrued on savings bonds	1,442.46
Shell Mining Co., 5,000 shares no par value, cost $50,000—appraised as valueless	—
Atlas Amusement Corp., 1,000 shares, par value $100, appraised value	102,000.00
Dividend—Atlas Amusement Corp.	2,500.00
Semi-precious stones	5,280.00
Clothing	1,375.00
Furniture	7,500.00
Total	$308,106.67

Schedule B

Assets Subsequently Discovered

From July 7, 1943 to September 30, 1944

Refund of 1943 overpayment of United States income tax:		
Declaration tax paid	$5,725.00	
Tax payable	5,350.00	
Refund received		$ 375.00

Schedule C

Gain or Loss on Realization

From July 7, 1943 to September 30, 1944

Assets Realized	Inventory Values, or Cost	Price Realized	Gain	Loss
Accounts receivable	$ 18,000.00	$ 15,000.00	$ —	$3,000.00
United States savings bonds	71,050.00	71,400.00	350.00	—
Interest accrued on savings bonds	1,442.46	1,442.46	—	—
Dividends — Atlas Amusement Corp.	2,500.00	2,500.00	—	—
Shell Mining Co.	—	500.00	500.00	—
Refund of 1943 overpayment of United States income tax	375.00	375.00	—	—
Sale of furniture	7,500	5,150.00	—	2,350.00
Short-term notes	5,025.00	5,000.00	—	25.00
Interest accrued on mortgage bonds	9.21	9.21	—	—
Total	$105,901.67	$101,376.67	$850.00	$5,375.00

Schedule D

FUNERAL AND ADMINISTRATION EXPENSES

From July 7, 1943 to September 30, 1944

Funeral expenses, etc.	$ 1,750
Administration expenses	5,250
Legal and accounting services	3,750
Total	$10,750

Schedule E

DEBTS OF DECEDENT PAID

From July 7, 1943 to September 30, 1944

Debts of testator	$14,450
United States Treasury Department—tax deficiency 1940	450
Interest on tax deficiency (note)	72
Total	$14,972

NOTE.—Information is not available for apportioning this interest charge between corpus and income.

Schedule F

LEGACIES PAID
From July 7, 1943 to September 30, 1944

Cemetery on The Mount		$10,000
P.M.W.:		
Semi-precious stones	$5,280	
Cash	9,720	15,000
Executors:		
John Doe	$5,000	
Richard Roe	5,000	10,000
Total		$35,000

Schedule G

STATEMENT OF INCOME COLLECTED
From July 7, 1943 to September 30, 1944

Date		Particulars	Amount
1943:			
July,	15	United States bonds—interest	$ 57.54
September,	15	Playa Co. bonds—interest	450.00
1944:			
January,	1	First Mortgage bonds—interest	230.79
January,	15	United States savings bonds—interest	1,500.00
January,	25	Atlas Amusement Corp.—dividend	2,500.00
March,	15	Playa Co. bonds—interest	450.00
July,	1	First Mortgage bonds—interest	240.00
July,	15	United States savings bonds—interest	450.00
July,	15	Short-term notes—interest	150.00
September,	15	Playa Co. bonds—interest	450.00
		Total	$6,478.33

Schedule H

STATEMENT OF RECEIPTS AND DISBURSEMENTS
From July 7, 1943 to September 30, 1944

	Income	Principal	Total
Executors' cash receipts:			
Cash balance, per inventory (Schedule A)	$ —	$ 52,000.00	$ 52,000.00
Proceeds of assets realized (Schedule C)	—	101,376.67	101,376.67
Interest and dividends (Schedule G)	6,478.33	—	6,478.33
Total receipts	$6,478.33	$153,376.67	$159,855.00

Executors' cash disbursements:			
Funeral and administration expenses (Schedule D)	$ —	$ 10,750.00	$ 10,750.00
Debts of decedent paid (Schedule E)	—	14,972.00	14,972.00
Legacies paid (Schedule F)	—	29,720.00	29,720.00
Securities purchased:			
Playa Co., 4½% bonds ($20,000 at 101)	—	20,200.00	20,200.00
Short-term notes, 6%	—	5,025.00	5,025.00
Accrued interest on Playa Co. bonds	375.00	—	375.00
Administration expenses	1,250.00	—	1,250.00
Total disbursements	$1,625.00	$ 80,667.00	$ 82,292.00
Balance on hand, September 30, 1944	4,853.33	72,709.67	77,563.00
Total	$6,478.33	$153,376.67	$159,855.00

Charge and Discharge Statement

From July 7, 1943 to September 30, 1944

As to Principal:		
We charge ourselves with:		
Assets, per inventory (Schedule A)	$308,106.67	
Assets subsequently discovered (Schedule B)	375.00	
Gain on realization (Schedule C)	850.00	$309,331.67
We credit ourselves with:		
Loss on realization (Schedule C)	$ 5,375.00	
Funeral and administration expenses (Schedule D)	10,750.00	
Debts paid (Schedule E)	14,972.00	
Legacies paid (Schedule F)	35,000.00	
Clothing given to charity	1,375.00	67,472.00
Balance, as to principal		$241,859.67
Consisting of:		
Cash	$ 72,709.67	
Non-interest bearing notes	10,000.00	
First mortgage bonds	6,500.00	
United States Savings Bonds, 3%	30,450.00	
Atlas Amusement Corp.	102,000.00	
Playa Co. 4½% bonds	20,200.00	
Total	$241,859.67	
As to Income:		
We charge ourselves with:		
Income collected (Schedule G)		$ 6,478.33
We credit ourselves with:		
Administration expenses	$ 1,250.00	

Accrued interest on bonds purchased (Playa Co. 4½% bonds)	375.00	1,625.00
Balance, as to income		$ 4,853.33
Consisting of cash	$ 4,853.33	

No. 2

Schedule I

SCHEDULE OF QUANTITIES OF RAW MATERIAL INGREDIENTS NECESSARY TO BE REQUISITIONED TO PRODUCE THE BUDGETED 1945 Production of Product X

	Raw Material Ingredients		
	"H"	"I"	"J"
Evaporation loss:			
Process No. 2	5.00%		
Process No. 3			4.00%
Waste—Process No. 2		10.00%	
10% (100%-5%)	9.50		
Total evaporation and waste losses	14.50%	10.00%	4.00%
Number of pounds per ton of product X:			
40% of 2,000 lbs.	800 lbs.		
36% of 2,000 lbs.		720 lbs.	
24% of 2,000 lbs.			480 lbs.
Add allowance for evaporation and waste:			
$\frac{14.5}{85.5}$ of 800 lbs.	135.67		
10/90 of 720 lbs.		80	
4/96 of 480 lbs.			20
Number of pounds necessary to produce one ton of product X	935.67 lbs.	800 lbs.	500 lbs.
Budgeted production of X:			
13,500 tons ÷ 60% = 22,500 tons			
Final yield of X and Y:			
22,500 tons ÷ 80% = 28,125 tons			
Tons of ingredients necessary to produce 22,500 tons of product X:			
$\frac{935.67}{2,000}$ of 28,125 tons	13,157.86 tons		
$\frac{800}{2,000}$ of 28,125 tons		11,250 tons	
$\frac{500}{2,000}$ of 28,125 tons			7,031.25 tons

THE DART CO.

STATEMENT SHOWING THE ESTIMATED COST OF PRODUCING 13,500 TONS OF X PRODUCT FOR THE PURPOSE OF BIDDING ON A GOVERNMENT CONTRACT TO BE COMPLETED DURING THE YEAR 1945

		Quantity	Amount	
		Tons	Per Ton	Total
Process No. 1:				
Raw material "H" (Schedule I)		13,157.86	$8.00	$105,262.88
Raw material "I" (Schedule I)		11,250.00	5.00	56,250.00
Total raw material		24,407.86		$161,512.88
Direct labor		24,407.86	5.00	122,039.30
Manufacturing overhead:				
Variable (90/75 of $60,000)				72,000.00
Fixed				30,000.00
Transferred to process No. 2		24,407.86		$385,552.18
Process No. 2:				
Transferred from process No. 1		24,407.86		$385,552.18
Direct labor		24,407.86	2.50	61,019.65
Manufacturing overhead:				
Variable (90/75 of $62,000)				74,400.00
Fixed				18,000.00
Totals		24,407.86		$538,971.83
Deduct:				
Evaporation loss—product "H" (5% of 13,157.86)	657.89			
Waste:				
Product "H" 10% (13,157.86-657.89)	1,249.97			
Product "I" 10% of 11,250	1,125.00			
Total waste	2,374.97		6.00	14,249.82
Total evaporation and waste		3,032.86		
Transferred to process No. 3		21,375.00		$524,722.01

	Quantity Tons	Amount Per Ton	Amount Total
Process No. 3:			
Transferred from process No. 2..........	21,375.00		$524,722.01
Raw material "J"........................	7,031.25	$7.00	49,218.75
Direct labor	28,406.25	3.00	85,218.75
Manufacturing overhead:			
Variable (90/75 of $50,000)...........			60,000.00
Fixed			20,000.00
Totals	28,406.25		$739,159.51
Deduct evaporation loss:			
Product "J" (4% of 7,031.25)..........	281.25		
Transferred to process No. 4............	28,125.00		$739,159.51
Process No. 4:			
Transferred from process No. 3..........	28,125.00		$739,159.51
Direct labor	28,125.00	4.00	112,500.00
Manufacturing overhead:			
Variable (90/75 of $40,000)............			48,000.00
Fixed			16,000.00
Total direct cost of processing...........	28,125.00		$915,659.51
General Manufacturing Overhead:			
Variable (90/75 of 60% of $60,000).......			43,200.00
Fixed			24,000.00
Cost of producing products X and Y........	28,125.00		$982,859.51
Deduct—estimated net profit on sale of product Y	5,625.00	17.50	98,437.50
Cost of producing product X............	22,500.00		$884,422.01
Cost of producing 13,500 tons of product X (60% of above)	13,500.00		$530,653.21

Commercial Law

May 18, 1945, 9 a.m. to 12:30 p.m.

No. 1

(a) Cody can recover from Bell. While it is true that an endorser to whom notice of dishonor is not given is discharged, where the parties to be notified are partners, notice to any one partner is notice to the firm even though there has been a dissolution.

(b) (1) "An endorsement is restrictive which either—
(A) prohibits the further negotiation of the instrument; or
(B) constitutes the endorsee the agent of the endorser; or
(C) vests the title in the endorsee in trust for the use of some other person."

(2) There are two general classes or types of restrictive endorsements—endorsements for collection or deposit and endorsements for the benefit of a third person.

(3) Negotiability is destroyed by a restrictive endorsement.

(4) The following are some common examples of restrictive endorsements:
"Pay to Allen only (signature)"
"For deposit (signature)"
"For collection (signature)"
"Pay to Allen for the account of Jones (signature)"

(5) A restrictive endorsement confers upon the endorsee the right—
(A) To receive payment of the instrument;
(B) To bring any action thereon that the endorser could bring;
(C) To transfer his right as such endorsee where the form of the endorsement authorizes him to do so.

No. 2

(a) The usual Statute of Frauds provides that a contract for the sale of personal property of more than a specified value (generally $500) shall not be enforceable unless—

(1) The buyer accepts part of the articles sold, and actually receives them; or

(2) The buyer gives consideration or makes part payment; or
(3) A memorandum in writing of the contract is signed by the party to be charged, or by his agent.

(b) A written memorandum is required to take the contract out of the Statute of Frauds unless the buyer has received and accepted part of the goods sold or given some consideration or part payment.

(c) To satisfy the Statute of Frauds there must be a written memorandum, signed by the party to be charged or by his agent, which indicates with reasonable certainty—

(1) The subject matter of the contract, and
(2) The parties to the contract, and
(3) The terms and conditions to which the party to be charged binds himself.

(d) The memorandum is not required to be in any special form. It may be made up of several writings so long as the writings together show the required terms of the contract and are properly signed by the party to be charged, or his agent.

(e) (1) Aiken is entitled to recover from Clark the price of the wheat sold to Clark.
(2) Bowen is not entitled to recover from Aiken.

The fire loss falls on Bowen and Clark, to whom title to the wheat had passed when Aiken measured it out and put it into bags. Nothing further remained to be done by the seller and delivery was complete.

No. 3

(a) Authority for cumulative voting must be given by statute or by the corporate charter or by-laws.

(b) Cumulative voting is a method whereby minority stockholders may obtain representation on the board of directors. By cumulative voting each stockholder may multiply the number of shares he owns by the number of directors to be elected, and may cast the entire number of votes for any one candidate, or may distribute his votes among the candidates in any way he deems to his best interest.

(c) (1) By ordinary voting, Abel's majority ownership of stock will enable him to elect all three of the directors, and Bach can elect none.
(2) By cumulative voting, Bach could multiply the number of his shares by three, the number of directors to be elected, and use his 90 votes to elect one of the three directors. Abel would have a total of 210 votes, which,

if split three ways among the three directors, would enable him to elect only two.

(d) Directors may not vote by proxy at directors' meetings. A director is a fiduciary and he cannot delegate the exercise of a power which involves discretion.

(e) The treasurer cannot vote this stock. Shares of its own stock acquired by a corporation are regarded as in suspension until they are reissued. A corporation cannot be a shareholder in itself. It cannot vote shares of its own stock held by it in the name of a trustee.

No. 4

(a) Aaron can be held on the purchase contract made by Barrow. An agent need not be of full age in order to bind his principal.

(b) The deed did not convey Anderson's land. The deed is the deed of Barclay, the words "agent of Anderson" being merely descriptive.

(c) Allison, the agent, can be held by Carr Co. An undisclosed agent can be held personally liable at the election of the person dealing with him.

No. 5

(a) The gift-tax exclusion is an allowance of $3,000 against the gross value of gifts to each individual from any donor in any calendar year. A donor is entitled to as many exclusions as there are persons to whom he makes gifts of present interests during the year. The exclusion is limited to the value of the gift where such value is less than the full amount of the exclusion. The exclusion from any gift must be claimed for the year in which the gift was made.

(b) The specific exemption of every donor is $30,000 in excess of exclusions. The donor may subtract the exemption from the aggregate value of all gifts before he becomes liable for gift taxes, but it can be used only once. It may be used in whole or in part in any manner that the donor sees fit, over as many years as he may wish, but when exhausted, it is not again available in any subsequent year.

(c) The tax is based on the value of "net taxable gifts." The term "net taxable gifts" means the total amount of gifts made during the calendar year, less the exclusions, the deductions allowed by statute, and such part of the unused exemption as may be claimed. The donor is liable for the tax. In the event it is not paid when due, the donee becomes personally liable for the tax to the extent of the value of his gift.

(d) In the case of property acquired by gift after December 31, 1920, the basis in the hands of the donee is as follows:

For gain—The same as in the hands of the donor or the last preceding owner by whom it was not acquired by gift.

For loss—(1) The same as in the hands of the donor, or last preceding owner by whom it was not acquired by gift or (2) the fair market value of the property at the time of the gift, whichever is lower.

No. 6

(a) The following elements will give rise to a bailment where the object of the proposed bailment is legal:

(1) Actual or constructive delivery of an existing chattel or chattels by one person, the bailor, to another, the bailee.
(2) Acceptance of the chattel by the bailee.
(3) An agreement between the bailor and bailee for the return, actual or constructive, of the chattel in the same or altered form by the bailee to the bailor when the object of the bailment has been accomplished.

(b) The receipt was negotiable under the Uniform Warehouseman's Receipt Act, which provides that a warehouse receipt negotiable in form shall not be rendered nonnegotiable by the insertion of any provision to that effect.

(c) The bank is not liable. Most decisions hold that the bank as gratuitous bailee in such a case owed the bailor the duty of exercising only slight care. Although more recent decisions speak of a duty to exercise reasonable care in such a case, it seems clear that the bank performed its duty and was guilty of no negligence under either standard.

(d) Burt is not liable. When property in the hands of a bailee is taken by valid legal process against the bailor, the bailee is not responsible to the bailor if he promptly gives notice to the bailor.

No. 7

(a) In the creation of an express private trust of personal property, the following are essential elements:

(1) A settlor or donor who has sufficient capacity and who manifests an intent to create a trust.

(2) A trustee to administer the property which is placed in trust. Generally, however, the fact that a trustee is not designated or is incapable of serving does not prevent the creation of the trust, unless the settlor manifests an intention to the contrary.

(3) A designated beneficiary.

(4) Designated trust property.

(5) Actual or constructive delivery or conveyance of the trust property to the trustee, except where the settlor declares himself trustee.

(b) (1) The validity of the purpose of a trust of real property is determined by the law of the state of the situs of the property.

(2) The validity of a testamentary trust of personal property is generally held to be governed by the law of the testator's domicile at the time of his death, although the law of the situs governs as to immovable personal property, such as leaseholds.

(c) (1) Normally, a trustee should allocate to income current exexpenses, i.e., expenditures necessary to maintain the integrity of the principal of the trust.

(2) Payments which are to protect or enhance the value of the principal should be made from the trust principal.

(3) Net income from the trust property is generally to be distributed to the beneficiaries.

Exceptions to the general rules stated in (1), (2), and (3) above are created by provisions to the contrary in the trust instrument.

(d) The trustee sustains the loss personally, under the general rule, and is liable to the estate. The trustee is under a duty to keep trust property separate from his individual property and to see that it is earmarked as trust property. Even though a trustee's breach of this duty did not cause the loss of the trust funds, the courts have generally imposed an absolute liability on the trustee. A few decisions have made an exception where the trustee acted in good faith.

No. 8

(a) The partnership was dissolved, for the bankruptcy of any partner operates as an immediate dissolution of the partnership.

(b) Cranstoun cannot recover from Ajax. There was no intention to create a partnership, and the relationship between Ajax and Billups was that of landlord and tenant. Sharing of gross returns or profits in payment of rent to a landlord does not establish a partnership.

(c) Upon the death of a partner, his personal representative is entitled to an accounting, settlement of the accounts and repayment upon distribution, if there are sufficient assets, of advances made by the deceased to the firm, his capital contribution and his share of the profits.

(d) (1) Both Alden and Bruer are liable. Under the Uniform Partnership Act, all partners are jointly liable (in some states, statutes provide that liability shall be both joint and several) for the debts of the partnership. While any partner may enter into a separate obligation to perform a partnership contract, unless Connors had impliedly or expressly agreed to be bound by the agreement between Alden and Bruer, he could hold them both answerable.

(2) The result would be the same even if the co-partnership articles stipulated that Bruer was a limited partner. A so-called limited partner who takes part in the control of the business becomes liable as a general partner.

No. 9

(a) The following are essential elements of a valid contract, the absence of any one of which would render it void:

(1) A sufficient consideration must be given; that is something of value, which may be either a benefit to the promisor or a detriment to the promisee, given in exchange for the promise sought to be enforced.

(2) Two or more competent parties must make the contract; that is, parties who have legal capacity to make a contract.

(3) A manifestation of mutual assent to the terms of the contract; such manifestation takes the form of an offer and its acceptance.

(4) The agreement must be one that is not void by statute or common law.

(5) The consent of the party sought to be charged must not have been induced by duress, fraud, mistake or undue influence, for in such cases the party may avoid the contract.

(b) (1) An offer made by mail is completed upon receipt by the offeree.

(2) An acceptance sent by mail is completed when the acceptor deposits it in the mails, post-paid and correctly addressed to the offeror, provided the acceptor was authorized to use the mails as a means of transmission either expressly or by implication from the fact that the offer was sent by mail or the use of the mail is customary in such transactions. If transmission by mail was not authorized, the acceptance may be operative when received by the offeror.

(3) An offer may be withdrawn at any time before acceptance of the offer. An acceptance, once given, cannot be withdrawn, because the acceptance of an offer results in a contract.

(c) This is an enforceable contract. The landowner's letter was an unequivocal acceptance of the offer. While the manner of acceptance suggested by the form of the offer as a written agreement was not complied with, the landowner's acceptance by letter was not precluded in the absense of an indication that the offeror positively required the suggested method of acceptance. The landowner's acceptance therefore created a contract. While the Statute of Frauds requires that a contract for the sale of an interest in land must be in writing and signed by the party to be charged, the landowner's signed letter, incorporating by reference the offer, was a sufficient compliance with the Statute.

No. 10

(a) A lease of real property is a contract which creates the relationship of landlord and tenant when the lessee enters into possession. It is a conveyance of an interest or estate for life, for years, at will or for a term less than that of the grantor in consideration of a return of rent or other recompense.

(b) The principal provisions of a lease that are of importance to an accountant are:

(1) The amount of each rental payment and when it is to be made and whether it includes taxes, interest, or other charges;

(2) The duration of the lease;

(3) Names and identity of the parties to the lease;
(4) Covenants as to who is to make repairs, comply with city or governmental orders; who is to pay for various kinds of insurance;
(5) Covenants as to fixtures;
(6) Option to cancel or renew the lease;
(7) Provisions as to security or deposit;
(8) Description of the leased premises;
(9) Rights and obligations in case of fire or taking of the premises by eminent domain.

(c) The assignee of a lease of real estate is bound by all the covenants that run with the land of the original lease such as to pay rent, insure, repair, and pay taxes, but not by the purely personal covenants.

A sublessee of a lease is not bound in any way by the original lease as there is no contract or privity between him and the lessor.

(d) A license is a permission to do some act on or to the detriment of the land of the licensor. A license is a personal privilege, not an estate, and is not ordinarily assignable. Licenses are generally revocable except when coupled with an interest or, in some states, when the licensee relying on the authority given has erected improvements on the licensor's land.

An easement is a right of doing a certain class of act on, or to the detriment of, the land of another, or a right against another that he refrain from doing a certain class of act on or in connection with his own land. The holder of an easement has rights against members of the community generally that they shall not interfere with the exercise or enjoyment of the easement, unlike a licensee, who has a privilege and nothing more. An easement is not revocable.

No. 11

(a) (1) Under a surety contract the death of the surety will not affect the creditor's rights and the creditor may hold the surety's estate for any amount which would have been recoverable against the surety had he lived.

(2) Where a surety is responsible under a surety contract for future obligations of the principal the surety's estate can be held for all obligations incurred by the principal after as well as before the time the creditor received notice of the surety's death. A surety contract, not being a

contract requiring the exercise of personal skill or taste, is not terminated by the death of the surety.

(b) Albert is not liable. As a general rule, the surety of a partnership is not liable in respect of transactions or defaults subsequent to the addition of a new partner to its membership.

(c) (1) Burton cannot recover from Alec. An infant has only a limited legal capacity to enter into contracts. His contracts, for the most part, are voidable and the infant may disaffirm the contract. Infancy is a personal defense which must be pleaded.

(2) Burton can recover from Chase. The surety is liable even though the debtor on the obligation avoided his contract. The defense of infancy is personal to Alec and is not available to Chase, the surety. The courts in some states, however, hold the surety released if the infant disaffirms and retains no consideration.

No. 12

(a) The following types of claims against a bankrupt are not discharged in bankruptcy:

(1) Federal, state, and local taxes.

(2) Debts created by fraud, embezzlement, misappropriation or defalcation while acting as an officer or in any fiduciary capacity.

(3) Debts not scheduled in time for proof and allowance, unless the creditor had actual notice.

(4) Liabilities for obtaining property by false pretenses or false representations, willful and malicious injuries to the property of another, alimony, maintenance of wife or child, seduction, or criminal conversation.

(5) Wages due workmen, clerks, traveling or city salesmen or servants, which have been earned within three months before the commencement of bankruptcy proceedings.

(6) Money deposited by employees to secure faithful performance of their employment.

(b) (1) Creditors may proceed under the Federal Bankruptcy Act against an insolvent debtor who refuses to make an assignment for the benefit of creditors or take any action to pay them. Upon petition by three or more creditors who have provable claims against the debtor aggregating at least five hundred dollars (unless the creditors are less than twelve, when only one such creditor with a claim of at least five hundred dollars may make such petition) the assets of the debtor will be liquidated and distributed in accordance with the Bankruptcy Act.

(2) Technically the mere allegation of insolvency is insufficient to sustain a petition for involuntary bankruptcy of a debtor. There must be in addition the allegation of the commission of an act of bankruptcy as defined in Section 3 of the Bankruptcy Act, such as a transfer or concealment of property of the debtor, a preferential transfer or payment, or preferential sale through legal proceedings, or permitting a judgment, levy or other lien to be obtained against the debtor.

(3) Bankruptcy proceedings may be taken against any natural person and any moneyed, business, or commercial corporation owing more than one thousand dollars, except a wage earner, a farmer, a municipal, railroad, insurance or banking corporation, or a building and loan association.

(c) The note would be worth $2,080. The value of the collateral, $1,800, is subtracted from the face value of the claim. The dividend of 40 per cent is payable on this difference of $700 and equals $280, which, added to $1,800, equals $2,080. The Bankruptcy Act provides that the value of securities held by secured creditors shall be determined by converting the same into money according to the terms of agreement pursuant to which the said securities were delivered to such creditors, and the amount of such value shall be credited upon such claims and a dividend shall be paid only on the unpaid balance.

(d) The following are differences between a dividend paid by a trustee in bankruptcy and a dividend paid by a corporation:

(1) A dividend in bankruptcy is paid out of the principal of the bankrupt estate whereas a corporate dividend is paid out of earnings and surplus.

(2) A dividend in bankruptcy is paid toward the liquidation or discharge of a debt whereas a corporate dividend is a payment or share of the profit.

(3) A dividend in bankruptcy is paid by the trustee in bankruptcy only upon order of the court whereas a corporate dividend is declared and paid pursuant to action of the board of directors of the corporation.

Auditing

May 18, 1945, 1:30 to 5:00 p.m.

No. 1

Letters requesting confirmation should be prepared and sent:

(1) To the banks for bank balances (at balance-sheet date and at the cut-off date), loan balances, collateral, and securities held in safekeeping.

(2) To correspondent brokers for balances and securities held.

(3) To transfer agents for securities in transfer.

(4) To others for securities due to and owed by the brokerage firm for customers' accounts, for transit items, joint venture accounts, and guarantees.

(5) To brokers for amounts due to or from brokers.

(6) To customers for account balances, safekeeping accounts, and security position.

(7) To partners for trading-account balances, capital-account balances, and security position.

No. 2

The treasury-stock transactions for the period should be analyzed. The purchases and sales should be verified by examination of the advices received from the broker who executed such transactions, the cancelled checks, or other evidence. The minutes of the meetings of the board of directors or of committees authorized to deal in the company's own stock should also be examined. The certificates for the stock held in the treasury should be inspected or confirmed by the transfer agent. The accounting records should segregate the different classes of the treasury stock and should show the stated or par value of the shares, the paid-in surplus, and premium or discount, if any, applicable to such shares.

No. 3

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 should 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 inventorying the work in process is necessary. It may be possible to complete the work in process to a point in the operations where its valuation may be readily determined.

(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 call for 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 compared 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.

The purpose of the foregoing procedures is to satisfy the auditor that the quantities and the condition of the inventory are as represented by the management.

No. 4

For purposes of analysis the statement may be broken down into two parts. "In accordance with generally accepted auditing standards" means that the examination procedures followed those recommended by the writings of recognized authorities and pronouncements of recognized accounting organizations. "Applicable in the circumstances and included all procedures which we considered necessary" means that the accountant applied such procedures which he, in his judgment, considered necessary and adequate in this particular case; that he did not apply some procedures which might be followed in other cases.

The accountant includes this statement in his report or opinion for the purpose of indicating that he has followed recognized practices in his examination before he rendered his opinion of the correctness of the financial statements.

No. 5

The assistant should be particularly alert and inquisitive with respect to checks which have been altered; which are payable to "cash," "petty cash," "bearer"; which are payable to any officer or employee and are not regular salary or payroll checks; which are payable to an officer or an employee who has also signed the check; which have been endorsed by an officer or employee other than the payee; and those checks which bear numbers not in the current series.

No. 6

The detailed trade-accounts receivable should be aged. Particular attention should be paid to the older accounts, as these are less likely to be collected in full.

Items which are still open on an account where subsequent items have been paid, and those on which a part payment has been made, often indicate a dispute or unentered credit.

Noncompliance with credit terms may be an unfavorable sign.

Payment by note contrary to the usual practice, particularly where the customer had in the past paid by check, may indicate a change in his financial position and a possibility of future uncollectibility.

Payments of round amounts on account rather than against specific invoices do not indicate an unfavorable condition unless the analysis shows a trend of increasing balances and decreasing sales.

No. 7

A schedule should be prepared showing the bonds, mortgage notes, and mortgages on hand at the beginning of the year, those acquired and those sold or otherwise disposed of during the year, and those still on hand at the end of the year. The schedule should show the description, cost, par (face) value, where deposited, date acquired, due date, interest rate, interest received, accrued interest, and other pertinent data.

All bonds, mortgage notes, and mortgages on hand should be inspected and checked against the prepared schedule. Those out as collateral or on trust receipt should be confirmed. All accompanying documents, such as title guarantees, tax bills, assessments, appraisals, insurance policies, etc., should be examined to acertain such points as arrearages on taxes and assessments, adequacy of the coverage of the loan and insurance on the mortgaged property, etc. The mortgages should be examined for the purpose of determining that they have been properly assigned and recorded. (The title and validity can be established only by reference to the public records and this work should be performed by attorneys.)

The unpaid balances on the mortgages and the accrued interest should be confirmed by direct correspondence with the makers. Interest income should be traced through the cash records, and the accrued interest computed. Past due and irregular payments, and defaulted mortgages and bonds should be reviewed with the client, and a loss reserve, if necessary, set up.

No. 8

The understatement of the value of an asset or the overstatement of the amount of a liability, or both, with a consequent understatement of the amount of net assets, results in creating a hidden or secret reserve. These reserves might be created by:
(1) Providing excessive depreciation.
(2) Charging capital expenditures to revenue.
(3) Charging assets against surplus.
(4) Overstating of liabilities.

The auditor should not give an unqualified certificate with respect to the accuracy of the financial statements which contain secret reserves, for, obviously, the financial condition of the business is not reflected in such a statement. In his report he should take exception to hidden reserves and indicate their amount.

No. 9

The auditor should carefully review the methods of determining and applying the depreciation rates to ascertain the sufficiency of the reserve. In considering the adequacy of rates, the company's own experience should be examined, comparison should be made with other companies in the same or similar industries, and reference should be made to standard tables of depreciation. However, unusual circumstances should be recognized and carefully considered.

The accounts should be examined to ascertain whether fully depreciated fixed assets or fixed assets which have been disposed of are accounted for properly.

No. 10

(a) An Investment Trust

Income from investments

A schedule should be prepared from the securities ledger showing stock or bond number, description, par (stated) value, or amount, cost, interest earned, dividends received, etc. The securities on hand should be checked against this schedule on the balance-sheet date. The amounts shown as interest income may be verified by inspection of the bonds to determine what interest collections should have been received during the period of ownership. Dividend income can be verified by examination of publications showing dividend payments of companies, or confirmations may be obtained from the issuing companies with respect to the dates and rates of dividend payments. Any arrearages should be carefully investigated.

Gain or loss on sales of securities

In accounting for the changes in securities during the period and for profits or losses on sales, the auditor should examine the brokers' memoranda. Securities no longer held should be traced through the cash receipts book to the bank statement to account for their disposal. Sales and purchase prices should be apportioned between accrued income and principal, and be so recorded, so that a proper distinction may be made between financial income and profit or loss on the sale of the security.

The profit or loss recorded on the disposal of a portion of the holdings of a security bought at various dates and at various prices can be manipulated to some extent by applying early, late, or average costs against the selling prices. The auditor can scarcely challenge any reasonable policy with respect to this matter, but he should see that a uniform policy is adopted, rather than a varying policy intended to produce a desired showing. So far as possible the auditor should also assure himself that the recorded profits on securities disposals are not the result of "wash sales" or similar transactions.

Other income

Income from participation syndicates should be verified by an examination of the syndicate's records or by reference to the audit report of those records.

Agreements covering service fees should be examined in connection with the verification of income from this source and to determine that such income has been properly allocated.

(b) A Public Hospital

Room charges and meals

A test should be made by checking the register of the private patients against the daily room-charge record and the record of meals served and charged. If the patient is a subscriber to a hospitalization plan all or a part of the charges would be charged to the "Plan."

Operating room income

A test should be made by checking the daily journal of the operating room against the entries in the earnings record for selected periods. The scale of charges for use of the operating room, X-rays, etc., should be noted and tested against the charges entered in the record.

Nurses

If private nurses are not paid directly by the patients, the amount charged for their services should offset the amount paid to them. If charges are made for services of floor-nurses, check against the room charge record or the nurses' time reports.

Medical supplies, etc.

The requisitions for medical supplies, etc., should be test-checked against the charge register and the earnings record.

City or county aid

The record of ward patients should be checked to determine that the amount allowed by the city or county has been correctly computed. This income should be traced to the income account.

Gifts, bequests, etc.

Reference should be made to deeds of trust, certified copies of wills, and other evidence. The advice of legal counsel may be required. Any restriction on the use of principal or income should be noted.

Income from investments

Follow procedures outlined for investment trusts (a) above.

(c) A Private School for Boys

Tuition

The tuition income should be checked against a computation of fees receivable based upon the enrollment and scholarship records maintained by the registrar, scholarship committee, or the board of trustees.

Room and board, dormitory charges

The income from room and board or dormitory charges should be checked in much the same manner as outlined for tuition income. Variations in room or dormitory rates, scholarship allowances, etc., should be checked against authorizations.

Supplies, service, etc.

Students are generally required to sign "chits" for books, supplies, barber, cleaning and other services, spending allowances, etc. These vouchers should be test-checked against the charge register and the postings therefrom should be checked to the income accounts.

Gifts, bequests, etc.

See procedure for a public hospital above.

Income from investments

See procedure for investment trusts above.

ANSWERS TO EXAMINATIONS OF NOVEMBER 1945

Accounting Practice—Part I

November 7, 1945, 1:30 to 6:00 p.m.

No. 1

THE ZANE DEPARTMENT STORE

Explanatory Adjusting Entries

(1) Interest on note payable—January and February, 1944

(2) Interest on bonds accrued:

October 1, 1943 to January 31, 1944 (4 months)		$ 133.33
April 1, 1944 to August 31, 1944 (5 months)		166.67

(3) Depreciation—buildings:

Cost $\left\{\frac{\$60{,}000}{80{,}000} \text{ of } \$60{,}000\right\}$ or	$45,000	
Life—15 years		
Monthly provision $\left\{\frac{\$45{,}000}{12 \times 15}\right\}$	250	
Provision:		
March 1, 1943 to January 31, 1944 (11 months)		$ 2,750.00
February 1, 1944 to August 31, 1944 (7 months)		1,750.00

(4) Depreciation—furniture and fixtures:

Cost	3,000	
Life—10 years		
Provision:		
Monthly provision $\left\{\frac{\$3{,}000}{12 \times 10}\right\}$	25	
February 1, 1943 to January 31, 1944 (12 months)		300.00
February 1, 1944 to August 31, 1944 (7 months)		175.00

(5) Officers' salaries—January, 1944 .... 3,000.00

(6) Fire Insurance:

Charge for period:	
March 1, 1943 to January 31, 1944 (11/36 of $640) or..	195.56
February 1, 1944 to August 31, 1944 (7/36 of $640)	124.44
Prepaid insurance at August 31, 1944 (18/36 of $640)	320.00
Total	$ 640.00

(7) Real-estate taxes—(200 per month):		
Charge for January, 1944		$ 200.00
Provision for July and August, 1944		400.00
(8) Charge sales:		
1943 fiscal-year receivables collected in 1944		12,000.00
(9) Interest on notes receivable accrued to January 31, 1944		600.00
(10) Profit on sale of X Co. stock (75 shares):		
Selling price	$15,000	
Cost (75/300 of $40,000)	10,000	
Profit		5,000.00
(11) Dividend income:		
Declared January 23, 1944; paid February 15, 1944		$ 1,200.00
(12) Purchases:		
Amount owing January 31, 1944, paid in 1944		10,000.00
(13) Officers' salaries:		
Amount payable for August, 1944		3,000.00
(14) Federal capital-stock tax:		
Provision for period July 1, 1943 to January 31, 1944 (7/12 of $2,400)		1,400.00
(15) Federal income tax:		
To eliminate amount paid on 1943 cash-basis income		1,500.00
(16) Charge sales:		
Balances of accounts receivable at September 1, 1944, originating since April 1, 1944		13,500.00
(17) Purchases:		
Balances of accounts payable for merchandise at September 1, 1944, originating since April 1, 1944		15,000.00
(18) Miscellaneous selling, administrative, and general expenses:		
Balances of accounts payable for these expenses at September 1, 1944, originating since April 1, 1944		3,800.00
(19) Federal capital-stock tax:		
Provision for period June 1, 1944 to August 31, 1944 (2/12 of $3,000)		500.00
(20) Charge sales:		
Notes received in 1943 directly from customers for sales ($8,800) and in settlement of customers' open accounts ($11,200)		20,000.00
(21) Inventory:		
To eliminate estimated inventory at January 31, 1944		10,000.00

(22) Inventory:

To record inventory as computed below.................. 5,806.50

Merchandise line	Per Cent of merchandise line sales to total sales	Sales for fiscal year January 31, 1944	Per Cent of cost of sales of merchandise line	Cost of sales
1	10%	$ 28,620	60%	$ 17,172.00
2	15	42,930	70	30,051.00
3	20	57,240	75	42,930.00
4	20	57,240	65	37,206.00
5	25	71,550	75	53,662.50
6	10	28,620	60	17,172.00
	100%	$286,200		$198,193.50

Purchases, per working papers........................	204,000.00
Inventory, January 31, 1944...........................	$ 5,806.50

(23) Federal income tax:

To provide for income tax on the accrual basis:

FY January 31, 1944 (25% of $23,884.27)............. $ 5,971.07

Seven months ended August 31, 1944 (25% of $14,027.40) 3,506.85

THE ZANE DEPARTMENT STORE

WORK SHEET

Income Statements on the Accrual Basis
For the Periods from February 1, 1943 to January 31, 1944 and
from February 1, 1944 to August 31, 1944

	Period from February 1, 1943 to January 31, 1944				Period from February 1, 1944 to August 31, 1944			
	Per Books	Adjustments Additions or (Deductions)	Transferred from or to 1944 Additions or (Deductions)	As Adjusted	Per Books	Adjustments Additions or (Deductions)	Transferred from or to 1943 (Additions) or Deductions	As Adjusted
Sales:								
Cash	$168,200.00			$168,200.00	$112,000.00			$112,000.00
Charge	86,000.00	$20,000.00 (20)	$12,000.00 (8)	118,000.00	52,000.00	$13,500.00 (16)	$12,000.00 (8)	53,500.00
Total sales	$254,200.00			$286,200.00	$164,000.00			$165,500.00
Cost of sales:								
Inventory at beginning	$ —			$ —	$ 10,000.00	5,806.50 (22)	10,000.00 (21)	$ 5,806.50
Purchases	194,000.00		$10,000.00 (12)	204,000.00	123,000.00	15,000.00 (17)	10,000.00 (12)	128,000.00
Total	$194,000.00			$204,000.00	$133,000.00			$133,806.50
Inventory at end	10,000.00	(10,000,00) (21) 5,806.50 (22)		5,806.50	18,000.00			18,000.00
Cost of sales	$184,000.00			$198,193.50	$115,000.00			$115,806.50
Gross profit	$ 70,200.00			$ 88,006.50	$ 49,000.00			$ 49,693.50
Expenses:								
Depreciation—buildings	$ —	2,750.00 (3)		$ 2,750.00	$ —	1,750.00 (3)		$ 1,750.00
Depreciation—furniture and fixtures	—	300.00 (4)		300.00	—	175.00 (4)		175.00
Miscellaneous selling, administrative and general expenses	24,000.00			24,000.00	12,000.00	3,800.00 (18)		15,800.00
Officers' salaries	33,000.00		3,000.00 (5)	36,000.00	21,000.00	3,000.00 (13)	3,000.00 (5)	21,000.00
Federal capital-stock tax	2,000.00		1,400.00 (14)	3,400.00	2,400.00	500.00 (19)	1,400.00 (14)	1,500.00
Fire insurance	640.00	(320.00) (6)	(124.44) (6)	195.56	—		(124.44) (6)	124.44
Real-estate taxes	2,200.00		200.00 (7)	2,400.00	1,200.00	400.00 (7)	200.00 (7)	1,400.00
Total expenses	$ 61,840.00			$ 69,045.56	$ 36,600.00			$ 41,749.44
Operating profit	$ 8,360.00			$ 18,960.94	$ 12,400.00			$ 7,944.06
Other income and expense:								
Dividend income	2,840.00		1,200.00 (11)	4,040.00	1,200.00		1,200.00 (11)	—
Interest on bonds	200.00		133.33 (2)	333.33	200.00	166.67 (2)	133.33 (2)	233.34
Interest on notes receivable	—		600.00 (9)	600.00	1,500.00		600.00 (9)	900.00
Profit on sale of X Co. stock	—				—	5,000.00 (10)		5,000.00
Interest paid on notes payable	—	(50.00) (1)		(50.00)	—	(50.00) (1)		(50.00)
Profit before federal income taxes	$ 11,400.00			$ 23,884.27	$ 15,300.00			$ 14,027.40
Federal income tax	—	5,971.07 (23)		5,971.07	1,500.00	(1,500.00) (15) 3,506.85 (23)		3,506.85
Net income after federal income tax	$ 11,400.00			$ 17,913.20	$ 13,800.00			$ 10,520.55

THE ZANE DEPARTMENT STORE

INCOME STATEMENTS (ACCRUAL BASIS) FOR THE FISCAL YEAR
From February 1, 1943 to January 31, 1944 and
the Seven Months from February 1, 1944 to August 31, 1944

	Fiscal Year Ended January 31, 1944		Seven Months Ended August 31, 1944	
Sales:				
Cash	$168,200.00		$112,000.00	
Charge	118,000.00		53,500.00	
Total sales		$286,200.00		$165,500.00
Cost of sales:				
Inventory at beginning	$ —		$ 5,806.50	
Purchases	204,000.00		128,000.00	
Total	$204,000.00		$133,806.50	
Inventory at end	5,806.50		18,000.00	
Cost of sales		198,193.50		115,806.50
Gross profit		$ 88,006.50		$ 49,693.50
Expenses:				
Depreciation:				
Buildings	$ 2,750.00		$ 1,750.00	
Furniture and fixtures	300.00		175.00	
Total depreciation	$ 3,050.00		$ 1,925.00	
Miscelleaneous selling, administrative and general expenses	24,000.00		15,800.00	
Officers' salaries	36,000.00		21,000.00	
Federal capital-stock tax	3,400.00		1,500.00	
Fire insurance	195.56		124.44	
Real-estate taxes	2,400.00		1,400.00	
Total expenses		69,045.56		41,749.44
Operating profit		18,960.94		$ 7,944.06
Other income and expense:				
Dividend income	$ 4,040.00		$ —	
Interest on bonds	333.33		233.34	
Interest on notes receivable	600.00		900.00	
Profit on sale of X Co. stock	—		5,000.00	
Total	$ 4,973.33		$ 6,133.34	
Deduct—interest paid on notes payable	50.00		50.00	
Total		4,923.33		6,083.34

Profit before federal income taxes	$ 23,884.27	$14,027.40
Federal income taxes......	5,971.07	3,506.85
Net income after federal income taxes	$ 17,913.20	$10,520.55

No. 2

RHODES CITY

MUNICIPAL GARAGE REVOLVING FUND
Entries to Record Transactions and Adjustments
For the Year Ended February 28, 1945

Entries (A) (B) and (C), per problem:

(1)

Superintendence	$ 3,000	
Office salaries	1,300	
Office supplies	200	
Heat and light	620	
Miscellaneous	80	
Depreciation	2,000	
Accrued pay roll..		$ 4,300
Accounts payable		900
Reserve for depreciation..		2,000

To record expenses listed under (1) in the problem.

(2)

Accounts payable	14,180	
Cash		14,180

To record accounts payable paid during year. Balance unpaid at February 28, 1945 amounts to $1,100, per problem.

(3)

Gas, oil and grease..	10,230	
Inventories of gas, oil and grease....................		10,230

To record charges for gas, oil and grease used, per schedule in problem.

(4)

Repair and maintenance materials........................	3,770	
Inventories of repair and maintenance materials......		3,770

To record repair and maintenance materials used, per schedule in problem.

(5)

Inventory shrinkage	90	
Inventories of:		
Gas, oil and grease..		30
Repair and maintenance materials..................		60

To record the inventory shrinkage, as follows:

	Balance Per Books	Physical Inventory	Shrinkage
Gas, oil and grease........	$ 920	$ 890	$30
Repair and maintenance....	2,060	2,000	60
Totals	$2,980	$2,890	$90

(6)

Repairs and maintenance—direct labor..................	$ 9,000	
Accrued payroll		$ 9,000
To record the direct labor, per schedule in the problem.		

(7)

Accrued payroll	13,300	
Cash		13,300
To record the payment of the payroll.		

(8)

Due from:		
General fund	156	
Highway fund	126	
Police fund	168	
Fire fund	90	
Services rendered to departments.................		540

To record the supplemental billing to the various departments, as shown below.

Chargeable overhead:	
Superintendence	$3,000
Office salaries	1,300
Office supplies	200
Heat and light.........................	620
Miscellaneous	80
Depreciation	2,000
Inventory shrinkage	90
Total	$7,290
Estimated overhead billed	6,750
Remainder to be charged (supplemental billing)	$ 540

	Direct Labor	Supplemental Rate (6%)	Overhead
General fund	$2,600	6%	$156
Highway fund	2,100	6%	126
Police fund	2,800	6%	168
Fire fund	1,500	6%	90
Totals	$9,000		$540

RHODES CITY

Working Sheet Showing Balances of Municipal Garage Revolving Fund
As At February 28, 1945

	Trial Balance March 1, 1944		Transactions and Adjustments During the Year Ended February 28, 1945		Profit and Loss for Year Ended February 28, 1945		Balance-Sheet February 28, 1945	
	Debits	Credits	Debits	Credits	Debits	Credits	Debits	Credits
Cash	$ 3,000		$ 29,900 (B)	$ 14,180 (2) 13,300 (7)			$5,420	
Inventories of gas, oil and grease	1,050		10,100 (C)	10,230 (3) 30 (5)			890	
Inventories of repair and maintenance materials	2,250		3,580 (C)	3,770 (4) 60 (5)			2,000	
Due from general fund	900		9,740 (A) 156 (8)	10,400 (B)			396	
Accounts payable		$ 700	14,180 (2)	13,680 (C) 900 (1)				$1,100
Property	50,000						50,000	
Reserve for depreciation		4,000		2,000 (1)				6,000
Capital advances from general fund		50,000						50,000
Current surplus		2,500						2,500
	$57,200	$57,200						
Due from highway fund			7,045 (A) 126 (8)	7,000 (B)			171	
Due from police fund			8,280 (A) 168 (8)	8,000 (B)			448	
Due from fire fund			4,685 (A) 90 (8)	4,500 (4)			275	
Services rendered to departments				29,750 (A) 540 (8)		$30,290		
Superintendence			3,000 (1)		3,000			
Office salaries			1,300 (1)		1,300			
Office supplies			200 (1)		200			
Heat and light			620 (1)		620			
Miscellaneous			80 (1)		80			
Depreciation			2,000 (1)		2,000			
Accrued pay roll			13,300 (7)	4,300 (1) 9,000 (6)				
Gas, oil and grease			10,230 (3)		10,230			
Repair and maintenance materials			3,770 (4)		3,770			
Inventory shrinkage			90 (5)		90			
Repairs and maintenance—direct labor			9,000 (6)		9,000			
			$131,640	$131,640	$30,290	$30,290	$59,600	$59,600

No. 3

SCHEDULE I

THE JOHNSON MEAT PACKING COMPANY

STATEMENT SHOWING ALLOCATION OF EXPENSES

Based On (1) Number of Orders and (2) Number of Items

For the Period from Blank Date to Blank Date

	Based on Number of Orders			Based on Number of Items		
Order-size Class	Number of Orders	Cost Per Order	Expenses	Number of Items	Cost Per Item	Expenses
Under 50 pounds	2,800	$.55	$1,540.00	4,090	$.11	$ 449.90
50-199 pounds	2,900	.55	1,595.00	8,410	.11	925.10
200-499 pounds	600	.55	330.00	2,280	.11	250.80
500-999 pounds	400	.55	220.00	2,400	.11	264.00
1,000 pounds and over	100	.55	55.00	820	.11	90.20
	6,800		$3,740.00	18.000		$1,980.00

THE JOHNSON MEAT PACKING COMPANY

STATEMENT SHOWING DISTRIBUTION COSTS PER CWT. OF MEAT PRODUCTS

FOR EACH SIZE-CLASS OF ORDER

For the Period from Blank Date to Blank Date

		Expenses Based on Number of Orders		Expenses Based on Number of Items		Expenses Based on Number of Cwt.		Total Cost	
Order-size Class	Total Cwt.	(Schedule I) Amount	Cost Per Cwt.	(Schedule I) Amount	Cost Per Cwt.	Amount	Cost Per Cwt.	Amount	Cost Per Cwt.
Under 50 pounds	700	$1,540.00	$2.2000	$ 449.90	$.6427	$ 91.00	$.13	$2,080.90	$2.9727
50-199 pounds	2,610	1,595.00	.6111	925.10	.3544	339.30	.13	2,859.40	1.0955
200-499 pounds	1,860	330.00	.1774	250.80	.1348	241.80	.13	822.60	.4422
500-999 pounds	2,800	220.00	.0786	264.00	.0943	364.00	.13	848.00	.3029
1,000 pounds or over	1,030	55.00	.0534	90.20	.0876	133.90	.13	279.10	.2710
	9,000	$3,740.00		$1,980.00		$1,170.00		$6,890.00	

Theory of Accounts

November 8, 1945, 9:00 a.m. to 12:30 p.m.

GROUP I

No. 1

(a) Accounts receivable should be stated at their estimated realizable value. The method most generally followed is to deduct from the total accounts receivable a reserve for possible losses.

(b) Fixed assets are generally stated in the balance-sheet at cost, less a reserve for the accumulated depreciation or depletion.

(c) Inventories are generally stated at the lower of cost or market in order to provide for any possible losses and not anticipate any profits not yet realized.

(d) Marketable securities are generally stated at cost, with a parenthetical notation of the market value. However, if the market value is considerably lower than cost and such shrinkage appears to be permanent, it would be well to show the asset at cost less a reserve to reduce it to the market value. Another method often used is to state marketable securities at the lower of the total cost or total market value in order to anticipate any probable losses, and to avoid anticipating any unrealized profits.

(e) Prepaid expenses should be stated at cost less the amount apportioned and written off over the previous accounting periods.

No. 2

(a) (1) Intangibles having a limited term of existence are patents, copyrights, licenses, leases, and franchises for a fixed term.

(2) Intangibles having no such limited term of existence are goodwill, trade names, secret processes, perpetual franchises, and organization costs.

(b) At the time of acquisition all intangibles, regardless of the term of their existence, should be recorded at cost. Those with a limited term of existence should be amortized by systematic charges against income over the periods benefited. Those having no limited term of existence should continue to be carried at cost until such time when it becomes evident that the term of existence has become limited or that they have become worthless. At such time as it is decided that the usefulness of such an asset is limited, it should be systematically written off over the expected remaining life of its usefulness. As soon as it has been determined that any intangible asset has become worthless, it should be written off by an appropriate charge against income or earned surplus.

No. 3

(a) Reserve for fire insurance is an appropriation of earned surplus reserved against the probability of a fire loss sometime in the future. It should, therefore, be shown under the caption "reserves" in the net-worth section of the balance sheet.
(b) Surplus invested in plant is the earmarking or reserving of a portion of earned surplus by the board of directors. The board by its action informally capitalized that amount of surplus, but may return it to earned surplus or make it available for dividends. It should be shown as a separate item in the surplus section of the balance-sheet.
(c) Advances received on sales contracts is a current liability and should be shown as such in the balance-sheet, even though payment thereof will be with goods or services and not cash.
(d) Call for retirement of preferred stock one month after the balance-sheet date is a current liability and should be so shown, as it will require the payment of cash or other current assets.
(e) Coupon book sales to customers should be shown as a current liability if redeemable in merchandise included in the inventory. However, under some circumstances the amount may be shown under the heading of deferred liabilities.
(f) Prospective loss on purchase commitments is generally shown as a footnote to the balance-sheet because it may represent a contingent loss on future transactions, and because the amount of such probable losses cannot be accurately determined.

No. 4

(a) The completed sales basis of measuring revenue is a sound one 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.
This method is generally acceptable largely because of its expediency. Specific objections to the method are:
(1) All of the costs may not be incurred before the time of sale;

(2) While some of such costs may be known, the amount may be difficult to estimate;

(3) Collection costs and bad debt losses may be difficult to estimate; and

(4) The cost and revenue, in cases where the performance may run over two or more periods, may be difficult to apportion equitably between the periods.

(b) (1) Percentage of completion. 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.

(2) 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 representative.

(3) Installment collection basis. Income (gross profit) on installment sales is generally taken up on a basis of collections where it is impracticable to estimate amounts to be reserved for collection, repossession expenses, and bad debts, because of the length of the terms for settlement.

No. 5

(a) Overhead of a concern which builds its own equipment. While there can be no real objection to the inclusion of any overhead directly resulting from the construction of its own equipment, the amount must not exceed the normal overhead of production. If some of the normal overhead is capitalized, with a resulting decrease in the overhead charge to cost of production, the profits of the current period would be overstated by that amount, and the profits of future periods would be understated by the amount of the depreciation charged on the capitalized overhead.

(b) Cost of constructing new models of machinery. A reasonable amount of overhead may be capitalized in constructing new models of machinery, as it is expected that the cost of developing such new models will run higher than those which later come off the production line. Experimental expenses arising from tests and corrections should not, however, be capitalized.

(c) Cash discounts on purchases of equipment. Some accountants treat all cash discounts as financial or other income, regardless of whether they arise from the payment of invoices for merchandise or capital assets. Others take the position that only the net amount paid for capital assets should be capitalized, on the basis that the discount is a saving and not income.

GROUP II

No. 6

(a) *General fund.* This fund receives its revenues from sources not otherwise allocated to specific purposes. As it is unrestricted as to use, it is therefore available for any purpose for which no special revenue has been allocated.

(b) *Special assessment fund.* This fund is set up for the purpose of financing improvements or services which are paid for, wholly or in part, by the owners of the properties benefited. Interest on the assessments is an additional source of revenue.

(c) *Special revenue fund.* This fund receives its revenue from the receipts of specific taxes or other sources. Its purpose is to finance certain definite activities, usually of a continuing nature.

(d) *Utility fund.* This fund receives its revenue from sales of such commodities or services as gas, water, light, and transportation. Its purpose is to finance the construction, operations, and maintenance of the utility furnishing these goods or services.

(e) *Working capital fund.* This fund receives its revenue generally from charges made to other departments of the municipality for services, such as shops, garages, central purchases, and store's departments. Its purpose is to finance such activities. This fund is sometimes called a revolving fund.

No. 7

(a) An annuity is a series of equal payments (which are called rents) made at equal intervals. Each rent of an annuity due is payable at the beginning of the period.

(b) Capitalization is a process for the determination of value. It is the division of an amount representing the annual rent of a perpetuity by an interest rate.

(c) Anticipation is an expenditure of money before it is due to be paid.

(d) Interpolation is the term applied to the process of estimating intermediate readings of mathematical tables.

No. 8

(a) The "single-step" income statement is one which:

(1) Lists all items of income;

(2) Shows the total of all items of income;

(3) Lists all items of costs, expenses, losses, and taxes, including income taxes;

(4) Shows the total thereof;

(5) Shows the deduction of the latter from the total of all income as a balance representing net income.

(b) Those who advocate the use of this form of statement claim that it is more simple, readable, understandable, and less likely to be misleading. They argue that no distinction should be made between gross income, other income, and financial income, nor should any be made between manufacturing, general, administrative, selling, and other expenses.

The argument against the "single-step" form of statement is its oversimplification—that business operations are better shown and more valuable and significant data is presented in the conventional income statement form.

No. 9

(a) All profit accrued to the effective date of the termination of the contract should be set up as of that date. Any unrealized profit on the unprocessed material in work-in-process should be included therein.

(b) The amount of the claim, based upon determinable elements, should be shown as a current asset. If the undeterminable elements of the claim are significant in amount, they should be disclosed by a footnote or otherwise in the balance-sheet.

(c) Advance payment received on the contract before termination should be shown as a deduction (appropriately explained) from the amount of the claim.

(d) The loans secured by the claim should be shown as a current liability, with a parenthetical note indicating the security.

No. 10

(a) No entry is required at the time a stock option is issued to an employee until the option is exercised. At that time the amount received is credited to capital stock, or capital stock and paid-in surplus.

(b) The employee may be considered to have received additional compensation (taxable income) if the option price of the stock is substantially below the market at the time (1) he receives the option, or (2) he exercises it. Some accountants recommend that this additional compensation be taken up on the books as a charge to the income statement for the period during which such income was realized by the employee. Others follow the simpler method of considering only the actual amount received from the employee when the option is exercised. In either case, the credit is to capital stock or capital stock and paid-in surplus.

No. 11

(a) If the selling price is based on the cost of production, including depreciation, the statement is true. Generally, however, the price of the product is set by competitive conditions, regardless of cost, and the recording of depreciation will have no effect upon its income and the amount of assets which come into the business.

(b) If the income covers all of the expenses, including the depreciation, and the payments of dividends are not in excess of the amount of depreciation provided, the statement is true.

(c) The recording of depreciation does not result in the accumulation of liquid funds for reinvestment. Funds retained are not generally segregated, but are used for the purchase of assets and the payment of liabilities and dividends.

Accounting Practice—Part II

November 8, 1945, 1:30 to 6:00 p.m.

No. 1

HOLDING CO. AND ITS WHOLLY OWNED SUBSIDIARY

July 31, 1944

ADJUSTING, JULY, 1944, TRANSACTIONS, AND ELIMINATING ENTRIES

(These entries are not required, but are given for explanatory purposes)

(1)

Buildings, less reserve	$ 100,000	
Undivided profits		$ 100,000
To record increase to the appraisal value of buildings.		

(2)

Notes payable	100,000	
Undivided profits		100,000
To exclude the notes payable (A & Co.) not included in consolidation.		

(3)

Undivided profits	125,000	
Buildings, less reserve		125,000
To exclude buildings of X Corp. not included in consolidation.		

(4)

Goodwill	75,000	
Capital accounts:		
Partner A	350,000	
Partner B	100,000	
Capital stock—X Corp.	800,000	
Undivided profits	175,000	
Capital stock—Consolidated Co.		1,500,000
To record the purchase of goodwill and the issuance of 15,000 shares of $100 par value common stock of Consolidated Co. per agreement.		

(5)

Cash	$ 57,750	
Donated surplus		$ 57,750
To record the amount donated by A for working capital:		

A's capital account			$350,000
A's share of undivided profits (½)			100,000
A's share of profit on sale of assets:			
Selling price		$950,000	
Book value:			
Per statement	$650,000		
Notes payable	100,000	750,000	
Assumed profit		$200,000	
A's share (½)			100,000
Par value of stock received			550,000
10% thereof donated			$ 55,000
Selling price per share			$ 105
Amount received and donated			$ 57,750

(6)

Cash	25,000	
Earned surplus		25,000
To record increase in cash during month of July, 1944.		

ELIMINATIONS

(7)

Goodwill	17,250	
Capital stock—Consolidated Co.	1,500,000	
Donated surplus	57,750	
Earned surplus	25,000	
Investment in Consolidated Co.		1,600,000
To eliminate the above accounts.		

HOLDING CO. AND ITS SUBSIDIARY, CONSOLIDATED CO.

CONSOLIDATED BALANCE-SHEET

July 31, 1944

Assets

Current assets:		
Cash	$ 382,750	
Accounts receivable	665,000	
Inventory	585,000	$1,632,750
Investment in securities		600,000
Fixed assets:		
Land	$ 50,000	
Buildings, less reserves	1,100,000	
Machinery, less reserves	265,000	1,415,000
Other assets:		
Patents	$ 10,000	
Goodwill	92,250	102,250
		$3,750,000

Liabilities and Net Worth

Accounts payable		$ 800,000
Bond and mortgage payable		$ 600,000
Net worth:		
Capital stock	$2,000,000	
Earned surplus	350,000	2,350,000
		$3,750,000

HOLDING CO. AND ITS SUBSIDIARY, CONSOLIDATED CO.
Consolidated Working Papers July 31, 1944

	Balance-sheets June 30, 1944		Adjustments, and July, 1944, transactions		Holding Co.	Eliminations debit or	Consolidated balance-sheet
Assets	A. & Co.	X Corp.	Debits	Credits	July 31, 1944	credit *	July 31, 1944
Land	$ 50,000						$ 50,000
Buildings, less reserves	1,000,000	$ 125,000	$ 100,000 (1)	$ 125,000 (3)			1,100,000
Machinery, less reserves	250,000	15,000					265,000
Inventory	150,000	435,000					585,000
Patents	10,000						10,000
Cash	25,000	125,000	57,750 (5) 25,000 (6)		$ 150,000		382,750
Accounts receivable	165,000	500,000					665,000
Goodwill			75,000 (4)			$ 17,250 (7)	92,250
Investment in Consolidated Co.					1,600,000	$1,600,000* (7)	—
Securities—other					600,000		600,000
	$1,650,000	$1,200,000			$2,350,000	$1,582,750	$3,750,000
Liabilities							
Bond and mortgage payable	$ 600,000						$ 600,000
Notes payable	100,000		100,000 (2)				—
Accounts payable	300,000	$ 500,000	175,000 (4)	100,000 (2)			800,000
Capital and undivided profit (loss):							
Partner A	350,000		350,000 (4)				—
Partner B	100,000		100,000 (4)				—
Capital stock		800,000	800,000 (4)				—
Undivided profit (loss)	200,000	(100,000)	125,000 (3) 175,000 (4)	100,000 (1) 100,000 (2)			—
Capital stock—Consolidated Co.				1,500,000 (4)		$1,500,000 (7)	—
Donated surplus				57,750 (5)		57,750 (7)	—
Earned surplus				25,000 (6)		25,000 (7)	—
Capital stock—Holding Co.					$2,000,000		2,000,000
Earned surplus					350,000		350,000
	$1,650,000	$1,200,000	$1,907,750	$1,907,750	$2,350,000	$1,582,750	$3,750,000

ROWE CORPORATION

Schedule I

Computation of Material Costs in Inventories

At June 30, 1944

	Cost per Unit		Units	Amount
Raw-material inventory:				
June purchases	900	$5.20	900	$4,680
Work in process inventory:				
June purchases	300	5.20	300	$1,560
Total June Purchases............	1,200			
May purchases	200	5.10	200	1,020
Total—work in process...........			500	$2,580
Finished-goods inventory:				
May purchases	700	$5.10	700	$3,570
Total May purchases.............	900			
April purchases		5.00	100	500
Total finished goods			800	$4,070

Schedule II

Computation of Direct Labor Cost, Per Unit

Total direct labor cost, per records..............			$30,000
Retroactive increase of 5%....................			1,500
Total direct labor cost..................			31,500
Units produced		4,600	
Units in work in process inventory, June 30, 1944..	500		
Effective production thereof (80%)......		400	
Effective production for period ended June 30, 1944		5,000	
Direct labor cost, per unit................			$ 6.30

Schedule III

COMPUTATION OF WORK IN PROCESS INVENTORY AT
JUNE 30, 1944

	Units	Amount
Raw materials (Schedule I)	500	$2,580
Direct labor (400 units at $6.30 per unit—Schedule II)		2,520
Manufacturing overhead (120% of direct labor)		3,024
Totals	500	$8,124

COMPUTATION OF FINISHED GOODS INVENTORY AT
JUNE 30, 1944

Schedule IV

	Units	Amount
Raw materials (Schedule I)	800	$ 4,070
Direct labor (800 units at $6.30 per unit)		5,040
Manufacturing overhead (120% of direct labor)		6,048
Totals	800	$15,158

Schedule V

COMPUTATION OF OVER-APPLIED MANUFACTURING OVERHEAD

Amount applied, per records	$36,000
Under-applied	300
Total	$36,300
Amount based on direct labor paid plus retroactive 5% increase	37,800
Over-applied	$ 1,500

ROWE CORPORATION

Statement of Cost of Goods Sold

For the Six Months Ended June 30, 1944

	Quantity	Unit Cost	Amount
Raw-materials inventory, January 1, 1944	700		$ 3,600
Purchases of raw materials	5,300		26,165
Total	6,000		$29,765
Deduct—inventory, June 30, 1944	900	$ 5.20	4,680
Raw materials used	5,100	4.9186	$25,085
Direct labor (Schedule II)			31,500
Manufacturing overhead (120% of direct labor)			37,800
Cost of manufacturing	5,100	18.5067	$94,385
Deduct—work in process inventory (Schedule III)	500	16.2480	8,124
Cost of goods manufactured	4,600	18.7524	$86,261
Add—finished goods inventory, January 1, 1944	300	20.6667	6,200
Total	4,900	18.8696	$92,461
Deduct—finished goods inventory, June 30, 1944 (Schedule IV)	800	18.9475	15,158
	4,100	18.8544	$77,303
Deduct—over-applied manufacturing overhead (Schedule V)			1,500
Cost of goods sold	4,100	18.4885	$75,803

No. 3

JOHN JEFF

Work Sheet Showing Taxable Income

For the Year Ended December 31, 1944

	Estimate	Adjustments Additions		Adjustments (Deductions)		Taxable Net Income
Income:						
Salary	$18,000	$ 1,500	(1)	($ 275)	(2)	$19,225
Dividends	5,000	2,875	(3)			7,875
Net profit from business	6,500	4,500	(5-1)	(1,000)	(5)	
		100	(5-2)	(320)	(5-3)	9,780
Security sales	—			(1,000)	(4-6)	(1,000)
Total income	$29,500					$35,880
Deductions:						
Interest	$ 1,375			30	(8)	$ 1,405
Taxes	1,220			470	(9)	1,690
Contributions	—			2,500	(7)	2,500
Medical expenses	—			—		—
Other deductions	4,000	(4,000)	(14)	450	(12)	450
Total deductions	$ 6,595					$6,045
Net income	$22,905	$12,975		$6,045		$29,835

		Debit	Credit
Adjustments:			
(1) Bonus—constructively received			$ 1,500 (1)
(2) Business expense—not reimbursed		275 (2)	
(3) Dividends:			
Mineral Mining			750 (3)
Dominion Rayons, Ltd.			2,125 (3)
(4) Security Sales:			
(a) Short-term capital loss.	($3,750)		
(b) Short-term capital gain	5,250		
(c) Capital loss carry-over.	(1,200)		
(6) Bad debt—nonbusiness	(2,000)		
Total	($1,700)		
(4-6) Net short-term loss (limited to $1,000)		1,000 (4-6)	
(5) To adjust to correct profit.		1,000 (5)	
(5-1) Drawings by Jeff			4,500 (5-1)
(5-2) Auto repairs (25% of $400)			100 (5-2)
(5-3) To write off unrecovered cost of furniture:			
Cost (1-1-38)	$800		
Less depreciation to 6-30-44	520		
Net	$280		
Less proceeds	150		
Loss on sale	$130		
Add—depreciation for period 1-1-44 to 6-30-44	40		
Eliminate proceeds already on books	150		
Total	$320	320 (5-3)	

		Debit	Credit
(7) Deductible contributions:			
American Red Cross	$1,000		
War Fund	1,000		
Community Chest	500		
Total	$2,500	2,500 (7)	
(8) Interest paid:			
On mortgage account balance	$ 655		
On mortgage on residence	750		
Total	$1,405		
Less estimate	1,375		
Balance	$ 30	30 (8)	
(9) Taxes:			
State income	$ 715		
Real estate	975		
Total	$1,690		
Less estimate	1,220		
Balance	$ 470	470 (9)	
(10) Medical expenses nondeductible (not in excess of 5% of adjusted gross income)		—	
(11) Custodian fees paid for maintaining nontaxable securities—nondeductible		—	
(12) Periodic alimony payments		450 (12)	
(13) Refund of 1940 federal income tax—nontaxable		—	
(14) To eliminate estimate of other deduction			4,000 (14)
Totals		$6,045	$12,975

NOTE: The Canadian withholding tax of $375 on the dividend received from Dominion Rayons, Ltd. may also be treated as a tax credit. If this method were elected, the taxable income shown above would be increased to $30,210.

Commercial Law

November 9, 1945, 9:00 a.m. to 12:30 p.m.

GROUP I

No. 1

(a) The certificate or articles of incorporation must set forth the essential information required under the statutes of the state where the corporation is incorporated. These generally are:

(1) State of incorporation.
(2) Date of incorporation.
(3) Name of the corporation.
(4) The purpose for which the corporation was formed.
(5) The capital stock, the number of shares, the par value per share, or if the corporation is to issue shares without par value the number that may be issued without par value.
(6) If shares are classified—the number of shares in each class, and all the preferences, privileges, and voting powers of each class.
(7) Location of the principal office.
(8) Duration of the corporation, which in most states may be perpetual.
(9) The number of directors.
(10) The qualifications of directors and whether or not they must be stockholders. (Required in some states.)
(11) Names and addresses of subscribers of the certificate of incorporation and number of shares subscribed to.
(12) Names and addresses of directors for the first year.
(13) Any special or particular powers of the corporation or the board of directors.

Of the items or articles listed above those of particular interest to an accountant on making an audit are those numbered 1, 2, 3, 4, 5, 6, and 8.

(b) The capital of a corporation is the total of all its assets less its liabilities. This may vary in amount from time to time as the corporation operates. Its authorized capital stock is fixed by the certificate of incorporation. Its issued capital stock is that part of the authorized capital stock which has been issued to stockholders.

(c) The powers and authority of the directors of a corporation are generally restricted to the regular business affairs of the corporation. They cannot amend the charter of the corporation, or terminate its existence. Directors thus ordinarily have no authority to do any of the following acts unless authorized by the stockholders:

(1) Dissolve the corporation.

(2) Amend the charter.

(3) Increase or decrease the capital stock.

(4) Consolidate with other corporations.

(5) Sell all the corporation's assets, unless it is necessary to do so in order to pay debts or because of other imperative necessity.

No. 2

(a) Yates cannot levy on or seize the goods, unless the receipt has first been surrendered to the warehouseman or its negotiation enjoined and the receipt impounded by the Court.

(b) Young could not hold truck No. 2 for payment of repairs made on truck No. 1. At common law an artisan is entitled to retain possession of the goods upon which he has performed a service until his services are paid for. This lien, however, is lost when the artisan parts with possession of the goods. Young is entitled only to a lien for the services performed upon the truck No. 2 still in his possession.

(c) This was a sale, rather than a bailment. In a bailment the bailee only receives possession; the title remains in the bailor. Hence the bailee is required to return the identical article given to him by the bailor even in an altered form. In this case the title to the apples passed to Bates and Bates was not obligated to return cider made from the identical apples. If Bates were so obligated the transaction would be a bailment. Under the Uniform Sales Act the price in a sale may be made payable in any personal property.

No. 3

(a) Cox can recover from Allen. Under the Negotiable Instruments Law an accommodation party, who has signed an instrument without receiving value therefor, and for the purpose of lending his name to some other person, is liable on the instrument to a holder for value, notwithstanding such holder at the time of taking the instrument knew him to be only an accommodation party.

(b) Coty can recover from Blue and not from Amos. An infant who executes, accepts, or endorses a negotiable instrument may avoid his contract even though the instrument is in the hands of a holder in due course. Blue, however, cannot set up the infancy of Amos as a defense, since the defense is personal to Amos.

No. 4

(a) In most jurisdictions, this would not be a valid contract. There was no legally sufficient consideration to support Alex' promise to relinquish part of the debt due him from Bowers. The payment by Bowers of the balance does not constitute a valuable consideration since Bowers is doing that which he is already obligated to do and the claim is an undisputed liquidated claim. In a few jurisdictions this common-law rule has been changed by statute or decision.

(b) A contract arises upon the deposit of Bateman's letter of acceptance in the mail if the letter is properly stamped and addressed to Aaron, and not upon its receipt by Aaron. Where the offeror himself sends his offer by mail, this of itself implies authority to send an acceptance by mail. The contract is regarded as complete upon mailing the acceptance for the reason that the acceptor is complying with the request or authority given to him by the offeror.

(c) The buyer need not go on with the contract. Where a contract of sale is entire but delivery is to be made by installments, a failure to deliver or accept a single installment in accordance with the contract is usually considered a material breach of the contract which gives the injured party a right to rescind the entire contract and sue for damage for the breach.

Where, however, a contract is divisible, consisting of several independent agreements, a breach of one gives no right to rescind the others.

(d) The seller can hold the buyer in an action on the contract. Under the Statute of Frauds, the contract or memorandum required to be in writing must be signed by the party to be charged, namely the defendant in a suit. It is not necessary that it be signed by the plaintiff provided the memorandum discloses who are the parties to the agreement.

No. 5

(a) (1) A gratuitous agent ordinarily is not liable for nonfeasance, since his promise is not supported by consideration. If, however, the principal has suffered detriment by changing his position in reliance upon his expectation of performance by the agent a situation may arise where the agent will be liable for nonperformance.

(2) A gratuitous agent is liable for misfeasance. Although there might be no duty upon the agent to perform the service, nevertheless, having undertaken the performance, a duty arises to use reasonable care.

(b) Brown may hold Ajax personally liable by reason of his failure to disclose his principal, or he may elect to hold the undisclosed principal, Coates, on the ground that in fact Ajax was acting as agent for Coates. A suit against Coates, however, must be for the goods and not upon the note, since under the Negotiable Instruments Law no person is liable whose signature does not appear upon the instrument.

(c) The agent is liable for the extra cost to his principal. It was the duty of the agent to fulfill his principal's instructions according to the letter thereof. The agent cannot permit his own judgment to supersede the express instructions of his principal.

GROUP II

No. 6

(a) (1) A trustee who buys bonds for the trust at a premium should amortize the premium over the life of the bond; that is, he should deduct from the income of such bonds a sum sufficient to make up the premium at the maturity of the security. The amortization belongs to the corpus, the balance to the income account. In a few jurisdictions, a trustee is not under a duty to amortize premiums on bonds purchased by him.

(2) If the trust property includes an asset of a wasting character, such as a patent, the trustee should sell the property and invest the proceeds in proper trust investments. Pending such a sale the trustee should set aside from income a proper reserve for amortization, which reserve becomes part of the principal, and should pay only the balance of the income to the life beneficiary. One method employed is to set aside a fund which will make up for loss in value as the patent reaches the end of its life. Another method is to fix the value of the patent at the time it became

part of the trust property and to pay the life beneficiary interest on the sum so fixed at the usual rate of return on trust investments, reserving the balance of the income as an amortization fund.

(b) (1) Generally, the trustee should pay the cost of purchases, investments, permanent improvements and other expenses relating to the corpus of the estate out of principal.

(2) Ordinary current expenses in connection with the administration and management of the trust, the collection of the income and the cost of keeping the trust property in repair are payable out of income.

(c) While special facts or circumstances may cause variations in the general rules, it is usually held that items (1), (2), and (4) listed above—cost of litigation to construe the meaning of trust provisions, cost of creating or continuing the trust and cost of finding trust assets—are chargeable to principal, and items (3), (5), and (6)—premium on the trustee's bond, insurance, and interest on a mortgage—are chargeable to income.

No. 7

(a) A bill of lading may be defined as a written acknowledgment of the receipt of personal property and a contract to transport and deliver it at a certain place to a specified person or on his order.

(b) (1) A straight bill of lading is one in which it is stated that the goods therein described are consigned or destined to a specified person.

(2) An order bill of lading is one in which it is stated that the goods are consigned or destined to the order of a person named therein.

(c) The shipment of goods under order bills of lading serves the following purposes:

(1) A carrier cannot properly deliver the goods without requiring production of the document, in order to assure that delivery is made to the party entitled to receive them under the terms of the document.

(2) That the carrier will not deliver without production of the document enables the party who holds the document to control possession of the goods and makes possible dealing with the documents as symbols of the goods themselves.

(3) Unpaid sellers, by shipping under order bills of lading can retain control of the goods until the purchase price is paid or otherwise satisfactorily secured.

(4) Commercial usage, now recognized in the Uniform Sales Act, attributes to such documents certain traits of negotiability not attributed to the goods themselves.

(d) Box can do nothing. Under the Uniform Sales Act, a contract to sell or a sale of goods of the value of $500 or more is not enforceable unless some note or memorandum in writing of the contract or sale is signed by the party to be charged or his agent, or unless the buyer accepts and actually receives part of the goods or makes part payment for them. The usual Statute of Frauds had a similar provision for sales above $50. In a few states where there is no such statute, the contract between Anson and Box would be enforceable.

No. 8

(a) The firm is liable. Where a tort is committed by one of the members of a partnership in the transaction and prosecution of a partnership enterprise, they are all liable, although the others had no connection with, knowledge of, or participation in the tort.

(b) Under the Uniform Partnership Law Conick could not hold Arrow. A person admitted as a partner into an existing partnership is liable for all the obligations of the partnership arising before his admission as though he had been a partner when such obligations were incurred, but this liability can be satisfied only out of partnership property. At common law the rule is that the new partnership is distinct and the partnership is not liable for debts contracted by the old firm unless there was an assumption of liability on the part of the new partnership expressly or by estoppel.

(c) No, Daniels does not become a partner as to Yates and Zachary; and is not a partner as to third parties. The mere receipt by an employee of a share of the profits of a business in payment for his services does not make him partner in the business. Persons who are not partners as to each other are not partners as to third persons, unless there is a partnership by estoppel as to such third persons.

(d) Unless authorized by all the partners, or unless they have abandoned the business, no partner or any number of partners less than all have authority to perform any of the listed acts.

No. 9

(a) (1) A common carrier of merchandise is in effect an insurer of the goods carried, except for damage caused by acts of God, public enemies or public authority, by the inherent nature of the property carried, or by act or fault of the shipper.

(2) A common carrier of passengers is under duty to employ a high degree of care in the carriage of persons.

(b) The railroad company is not liable for the loss of the goods. When goods reach their destination, they must be called for within a reasonable time. If they are not, the railroad's strict liability as a carrier terminates, and it becomes a mere bailee or warehouseman. As a bailee the railroad can be held liable only for negligence.

(c) The carrier may rescind the contract. The contract is void as it is against public policy. A common carrier cannot discriminate in its freight rates for the carriage of goods between one shipper and another even though the discrimination is the result of error or accident and made by the carrier or its agent.

(d) The shipper can recover the value of the goods from the railroad company. A common carrier of merchandise is in effect an insurer of the goods carried, except for damage caused by acts of God, public enemies or public authority, by the inherent nature of the property carried, or by act or fault of the shipper.

No. 10

(a) Allen cannot recover $4,000 from Bell. He can only compel Bell to pay him $2,000, the amount in excess of one-half of the debt. The obligation of one of two co-sureties is to pay the whole debt. If he does so, he may recover of his co-surety one-half. If he pays less than the whole debt, he can only recover from his co-surety the amount he has paid in excess of his proportionate share.

(b) A suretyship contract is an undertaking by one person to answer for the debt, default, or miscarriage of a principal to the principal's creditor. The liability of the surety arises immediately upon the default of the principal and the creditor can assert his right against the surety without taking any action against the principal.

A guaranty, on the other hand, is generally defined as an undertaking to be liable for the debt, default, or miscarriage of another only after due proceedings have been ineffectually taken to enforce the claim against the principal. In some jurisdictions, by statute or decision, this distinction between guaranty and suretyship is not made.

A contract of indemnity is one where a person agrees to save another harmless from some loss, irrespective of the liability of a third person. In this sense, indemnity is synonymous with insurance—either against liability incurred by the indemnitee by reason of harm to others or against loss by reason of accident or the default of another. Unlike both suretyship and guaranty, which always involve three parties and where the normal expectation is that the liability will be satisfied by the third person, indemnity contemplates only two parties, at least at the time of making the contract, and the indemnitor, upon the happening of the stipulated contingency, is liable whether or not the indemnitee has any recourse against a third person.

No. 11

(a) The amount of tax to which employers were subject, with respect to both the old-age and survivor-benefits tax and the unemployment insurance tax for 1942, was based upon only the first $3,000 paid by each employer to each employee. An employee was subject only to the old-age and survivor-benefits tax, and if by reason of his rendering services for two or more employers, the tax was withheld by his employers on wages totalling over $3,000, he was entitled to claim a refund of the tax paid on wages in excess of $3,000. The computation of the tax is as follows:

Unemployment-insurance tax:	
Employer Austin	$90 ($3,000 at 3%)
Employer Bird	75 (2,500 at 3%)
Employee John Roe..................	no employee tax
Old-age and survivor-benefit tax:	
Employer Austin	$30 ($3,000 at 1%)
Employer Bird	25 (2,500 at 1%)
Employee John Roe..................	55 (5,500 at 1%)

John Roe, after his employers withheld $55 for 1942, may obtain a refund of $25 (the amount of the tax on the total wages in excess of $3,000).

(b) The federal old-age and survivor-benefit tax on employers is deductible by the employer as an excise tax.

By the terms of the statute, the federal old-age and survivor-benefit tax on the employee is not deductible by the employee.

(c) An individual is entitled to monthly old-age benefits (primary insurance benefits) if he

(1) is fully insured after Dec. 31, 1939, and

(2) has attained the age of 65, and

(3) has filed an application.

Actual and complete retirement is not required; but monthly benefits will not be paid for a month if an otherwise eligible person earns $15 or more *in covered* employment in any month.

No. 12

(1) This is a certificate of deposit. A certificate of deposit is usually drawn so that it is not a negotiable instrument, but in this particular form it has been held negotiable, on the theory that the phrase "upon the return of this certificate properly endorsed" indicates an intention that the instrument shall be payable to the depositor or his order.

(2) This is a due bill. It is a mere acknowledgement of a debt. It is not a negotiable instrument under the Act. There is no promise to pay and it is not "to order."

(3) This is a note, a negotiable instrument. The provision that the note is payable in English pounds, shillings and pence does not destroy negotiability, provided the note meets the other requirements of negotiability, i.e., was signed by the maker, was payable on demand or at a fixed or determinable future time, contained an unconditional promise to pay, and was payable to order. If the money called for in the instrument were current at the place of payment, it could be regarded as negotiable for that reason; and if not current at the place of payment, it is negotiable on the theory that the instrument calls for American money to an amount equal to the sum expressed in the foreign currency at the current rate of exchange.

(1) and (3) should be classified as notes receivable, (2) as an account receivable. Valuation of (3) would be based on current rate of exchange. Valuation of all would depend on solvency of makers.

Auditing

November 9, 1945, 1:30 to 5:00 p.m.

No. 1

(a) The auditor should secure from the client written statements concerning such assets, liabilities, and other items which he cannot satisfactorily verify by the usual methods and tests. These statements reduce to writing oral representations made by the client, and are obtained primarily to avoid later misunderstandings and to impress upon the client that his is the primary responsibility for the correctness of the accounts.

(b) The following outlines of certificates indicate the extent of responsibility assumed by the client:

Inventories

Quantities

The client certifies that the inventories were taken in accordance with written instructions, a copy of which has been delivered to the auditor; that the quantities were determined by actual count, weight, or measurement; that the stock records have been adjusted to the physical inventory; that if a physical inventory was not taken, an adequate perpetual-inventory record is maintained and is supported by physical tests (the frequency and coverage of such tests should be stated).

Title and ownership

The inventory is represented to be the unencumbered property of the company; to include no goods consigned to the client by others; to contain no items invoiced by the company to its customers prior to the audit date, nor any for which the liability has not been taken up on the books.

Valuation

The client should indicate the basis of pricing the inventory (such as cost, market, cost or market whichever was lower), and the method of computation (such as base-stock, first in-first out, last in-first out, average cost, or other method); that the method used does not result in a valuation in excess of cost; that the method used in valuing the inventory has been consistent with the method followed in the past; that the inventory value has not declined materially since the balance-sheet date; that no obsolete or deteriorated materials or merchandise are included in the inventory at prices in excess of net realizable value.

Liabilities

General

Liabilities in relation to any obligation actually existing as of the date on which the audit is made are covered by a general statement in the certificate that all known liabilities are provided for.

Commitments

The client attests, in either the inventory or liability certificate, that no sales or purchase commitments exist below inventory prices or in excess of current market prices, respectively, or in excess of normal requirements.

Contingent liabilities

All contingent liabilities are listed, with an accompanying statement that no other known contingent liabilities exist. This statement is sometimes given by the legal counsel of the client.

Other Balance-sheet Items

Property, plant and equipment

The company represents that it has an unencumbered title to all property, plant, and equipment; that the property is being utilized in current operations; that no obsolete equipment is included in the account; that the basis on which the property has been carried is properly described in the statements and the results of any appraisal fully set forth.

Reserve for depreciation

The annual provision for depreciation and depletion is stated to be adequate and provided on a basis consistent with the previous year.

Accounts receivable

The client certifies that the accounts receivable represent valid and unencumbered claims against customers and other debtors; that accounts representing indebtedness of officers, stockholders, and employees, and merchandise shipped on approval or consignment, are so described; that the accounts receivable as summarized do not include any charges with respect to merchandise shipped subsequently to the balance-sheet date, and are not subject to deductions for discounts (other than ordinary cash discounts), allowances or any other deductions except as provided for in reserve accounts; that all accounts known to be uncollectible have been charged off; that the reserve for doubtful accounts is adequate to provide for all losses incurred in collecting the accounts.

(c) The following is a short, typical representation which an auditor might request an officer of a corporation to sign:

Gentlemen:

In connection with your examination of the records of the Blank Corporation for the year ended December 31, 1944, I hereby certify that, to the best of my knowledge and belief all direct liabilities of the company on December 31, 1944, were recorded on its books as of that date and prior to the completion of your examination, or were called to your attention during the course of your audit, and that the company has no contingent liabilities on December 31, 1944, except as follows:

. . . . .

	________________ Signature
________________ Date	________________ Title

No. 2

The following columnar headings are suggested for the work sheet:

1. Confirmation number
2. Customer's name
3. Address
4. Date of mailing first request
5. Date of mailing second request
6. Date of receipt of reply
7. Amount of the balance per books
8. Amount confirmed
9. Amount not confirmed
10. Date of subsequent collections
11. Amount of subsequent collections
12. Remarks

No. 3

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 taking the inventory should be in writing.

The features to be especially noted are:

(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 inventorying the work in process is necessary. It may be possible to complete the work in process to a point in the operations where its valuation may be readily determined.

(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 call for 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 compared 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 check thoroughly any apparent differences.

The purpose of the foregoing procedures is to satisfy the auditor that the quantities and the condition of the inventory are as represented by the management.

No. 4

The plan under which the coupons, trading stamps, etc. are issued to customers should be thoroughly understood, and the system of internal control over those issued or unissued should be investigated. Inventory of unissued coupons or stamps should be compared with the accounts to ascertain whether it is substantially in agreement with the records. A review of the client's past experience should be made in order to determine the percentage of those issued to those presented for redemption. On the basis of this past experience, and of present circumstances, the approximate liability for the outstanding coupons, stamps, etc. may be determined.

No. 5

The system of internal control is weak in that one payroll clerk prepares the payroll from time sheets, checks the time cards against these payroll sheets, and distributes the pay envelopes. Therefore it would be advisable to widen the scope of the examination.

Without notice to the payroll clerk the accountant should supervise several times the distribution of the pay envelopes to both shifts after observing the filling of the envelopes and making test checks of the amounts. Any unissued or unclaimed envelopes should be controlled by the accountant until they are turned over to the cashier, with whom the accountant should discuss the procedure of handling any unclaimed wages. The disposition of the unissued or unclaimed envelopes which were not paid out at the time the accountant supervised the payoffs should be investigated. If receipts are obtained from the employees these receipts should be checked against the payroll records for names and amounts, and the signatures on the receipts should be compared with those in the employment office records. The payroll records for each of the weeks selected for testing should be footed and the postings of the totals checked against the general records. The hours shown on the time cards should be compared with those entered on the payroll sheets and the hourly rates checked against properly approved schedules or other authorizations. These sheets should bear the signatures of the responsible foremen. The record of the gross earnings of the individual employees should be checked against the quarterly state and federal payroll-tax returns.

No. 6

The patents account should be analyzed and a schedule prepared therefrom showing the following:

1. Patent number
2. Brief description
3. Date acquired
4. Cost
5. Expiration date
6. Whether acquired by purchase for cash or other property or on direct application by the client.

If purchased the patent should be verified by examining the contract, bill of sale, correspondence with the patent attorney, and any other pertinent document. If acquired for other than cash the basis of the valuation should be examined. If acquired by application by the client the cost should be verified by examining the bills for services of the patent attorneys, fees paid to the government, and any other disbursements.

The patent letters should be examined to ascertain that the patents have been registered in the name of the client.

The experimental and development expense account should be analyzed to determine whether any such expenses should have been capitalized and that no change has been made in the current year in accounting for those expenses.

Inquiry should be made to determine whether all patents recorded on the books are still in use. Those which no longer have useful value should be written off immediately.

The schedule of amortization should be examined to ascertain whether the cost is being consistently written off over the expected life of the patents. The unamortized costs shown by the schedule should be checked against the total in the control account in the general ledger.

No. 7

The system of internal control should be examined to determine the amount of detailed checking necessary in auditing the accounts.

The invoices should be made out in the name of the client and should be checked as to price, quantities, terms, clerical accuracy, and should bear the approval of the purchasing department. They should be checked against a purchase order signed by the purchasing department and against the receiving record signed by the receiving clerk. They should be compared with the entries in the invoice register and the dates should be examined in order to ascertain that an invoice of an earlier date had not been substituted. It should also be observed that the invoices are entered in the proper month and that the amounts have been correctly distributed. In cases where no invoice is available duplicates should be obtained or the matter should be reported to the proper official. The accuracy of invoices for freight charges should be tested. Duplicate invoices should receive particular attention. Tests should be made by checking some of the invoices against the record of payment in the cash-disbursements books and with the canceled checks. The entries in the register in the months following examination should be scanned to determine that there are no invoices included therein which properly belong in the period under review. The footings of the register should be proved and the postings checked against the entries in the controlling account of the general ledger.

No. 8

(a) *Land*

Examine the deed evidencing title; title search or title insurance policy; mortgage or other liens. Observe description of the land; the amount of any liens such as mortgages, tax arrearages, judgments, etc.; and whether the land is used in the conduct of the business or is held as an investment.

(b) *Real-estate tax*

Examine the tax bill and any checks issued for payment. Observe description of the properties; against whom assessed; period covered; due date; nature of the tax; assessed value and tax rate; and if payment has been made, the receipt or canceled check.

(c) *Renegotiation settlement*

Examine the agreement with the renegotiation authorities; the correspondence relative to the income-tax credit; and if a corporation, the approval of the board of directors. Observe the period covered; the amount of the refund; the amount of the credit for income taxes; the terms upon which the net refund is to be made; and any provisions covering any possible additional refunds.

(d) *Rent expense*

Examine the lease. Observe the description of the premises; the rental and payment dates; the period of the lease; and any renewal options.

(e) *Registered stock held by client as collateral*

Examine the stock certificate; letters assigning or hypothecating the stock; and all powers of attorney. Observe that the securities are in the name of the client, or are endorsed in his favor; the market value of the stock; and the amount of the debt secured thereby.

No. 9

Audit Program for Balance-Sheet Examination of a Medium-Size Trading Corporation

General. The auditor should examine into the nature and extent of the internal check and control in order to satisfy himself that it is adequate. He should also determine that accepted accounting practices have been followed during the period under his examination, and that they have not been changed in any material respect since the previous period. Trial balances of the general ledger for the beginning and end of the period should be compared in order to learn whether any major changes have occurred during the period. The general ledger should be reviewed to ascertain if any transactions recorded in the accounts opened and closed during the period have any effect on the financial position at the close of the period. The charter, by-laws, and minutes of directors' and stockholders' meetings should be examined and notes made of any matters contained therein which affect the accounts. The footings of all columns in all books of original entry should be verified for at least one month, and the postings for the month chosen should be checked. Balances of all general-ledger accounts should be verified by footing the year's posting in each account.

Cash on hand. The count should be made at the balance-sheet date, if possible. If not a count should be made during the course of the audit and an examination should be made of the recorded transactions between the balance-sheet date and the date of the count. Any undeposited receipts should be traced into the bank.

Cash in bank. The bank account should be reconciled as of the balance-sheet date and as of the date of the cash and securities count; confirmations as of both dates should be obtained from the depositary direct. At least one month's cash transactions should be checked thoroughly. Bank statements and canceled checks as of the date of the cash and securities count (if subsequent to the balance-sheet date) should be obtained from the bank direct; items in transit and checks outstanding at the balance-sheet date should be traced into the bank. The canceled checks, for at least a month, should be examined as to date, signatures, payees, and amounts, and checked against the cash-disbursements record. The endorsements and the bank's perforation indicating payment should be examined. The daily record of deposits should be compared with daily record of deposits as shown by the bank on its statement.

Accounts receivable. The customers' statements as of the balance-sheet date should be checked against their accounts and mailed by the auditor with the request that the accounts be confirmed to him directly. The envelopes in which the statements are mailed should bear an address in order that any undelivered letters will be returned directly to the auditor. A list of the customers' accounts should be prepared showing the name, amount owing, and the aging of the accounts; subsequent collections, allowances for discounts, etc., and returns should be entered thereon. The doubtful accounts should be noted and discussed with the credit department for the purpose of determining the adequacy of the reserve for bad debts. Credit balances, accounts with officers and employees, advances to suppliers, and all accounts other than those arising from sales transactions with customers should be set out separately in the balance-sheet.

Notes receivable. At the time of the count of the cash, the notes receivable should be examined; those out for collection, discount, or collateral should be confirmed directly to the auditor. A confirmation should be requested of the maker. All of the notes should be scheduled showing the name of the maker, the date, the date of maturity, the amount of the note, the rate of interest, endorsements, etc. Any notes collected prior to the examination should be verified by tracing the cash collected into the cash records and thence into the bank. The interest-earned account should also be examined to learn if the interest on the notes has been recorded, or if there has been any interest credited in the accounts on notes which were not recorded as such. Consideration must be given to the adequacy of the bad-debt reserve applicable to the notes.

Inventory. The auditor or one of his representatives should be present at the taking of the inventory and by suitable observation and inquiry satisfy himself as to the effectiveness of the methods used. A comparison of the quantities with previous purchases and sales or with book inventories should be made. The auditor should ascertain that goods held as consignee or as bailee, or goods sold but undelivered, are not included in the inventories, and that any merchandise held by others but owned by the client is included. Merchandise in transit and merchandise for the succeeding season received under post-dated invoices should be included. An examination should be made of the receiving records just prior and subsequent to the balance-sheet date. A certificate should be obtained from responsible officers and employees as to the ownership, and as to the correctness of the quantities, costing and the indication of spoiled, damaged or otherwise unsalable or unusable materials or merchandise. The pricing may be verified by examination of purchase invoices, market quotations, and sales made immediately after the balance-sheet date. Freight, drayage, duty, handling costs, etc., may be included as a part of the price. A comparison with the prices of previous inventories should be made. The mathematical accuracy of the inventory may be verified completely or by tests. If copies of the inventories have been submitted to the auditor he should check these copies against the original inventory sheets.

Prepaid insurance. The insurance policies should be examined and scheduled, showing the name of the insurer, the policy number, the kind of insurance, the amount of coverage, the premium, the date of issuance, and the date of expiration. The unexpired portion of the premium should be computed and set up as a prepaid expense. The beneficiary under the policies should be noted to ascertain whether an assignment has been made to protect a mortgagee.

Furniture and fixtures. If this is an annual audit, only the changes in furniture-and-fixtures account (and its related reserve) during the year should be verified. The correctness of the provision for depreciation should be determined.

Vouchers payable. A list of the unpaid vouchers should be prepared from the voucher register and the total checked against the controlling account in the general ledger. The receiving records prior to the balance-sheet date should be checked against the recorded vouchers, and vouchers subsequent to the balance-sheet date should be examined, to ascertain that the liability has been taken up for all goods received. If direct confirmation from the suppliers is impracticable, the auditor should request that the creditor's statements be held available for him to check against the records. The liability for any merchandise in transit should be taken up. Purchase commitments and the corporate minute book should be examined to learn of any unrecorded liabilities or possible losses.

Accrued liabilities, such as accrued wages, salaries, commissions, taxes, interest, etc., can be verified by examining supporting documents and subsequent payments. Expenses applying to one month, but payable in the following month, such as telephone, telegraph, light, power, etc., must be recorded as an expense for the month which received the benefit. Particular attention should be given to the reserve for taxes. A comparison of the accrued liabilities with those set up at the end of the previous period, as to kind and amount, should be made. In addition, a certificate should be obtained from the treasurer and the bookkeeper, stating that all liabilities for the period or for any previous period have been recorded in the accounts and setting forth any contingent liabilities of the corporation which have not been entered.

Notes payable. A request should be mailed to all creditors to whom notes were issued during the year to send directly to the auditor a list of any notes (giving the date, maturity, interest rate, names of makers and endorsers, and the amount) held by them at the balance-sheet date. Any notes paid between the balance-sheet date and the date of the examination, and the checks issued therefor, should be examined. The interest-paid account should be inspected to ascertain whether any interest had been paid on notes which were not recorded.

Bank loans. A request should be made of the bank to confirm the dates, maturities, security, the endorsements, the amount of the notes, and the accrued or prepaid interest thereon as of the balance-sheet date.

Capital stock. The stock-certificate book should be examined and a listing made of all of the certificates shown as outstanding. All certificates must be accounted for.

Surplus. All entries to surplus accounting during the year should be traced, and the propriety and the authority for extraordinary entries established.

In addition to the above, the nominal accounts should be reviewed.

ANSWERS TO EXAMINATIONS OF MAY 1946

Accounting Practice—Part I

May 15, 1946, 1:30 to 6:00 p.m.

No. 1

B-V CO., INC.
WORKING PAPERS
ADJUSTMENT OF INCOME STATEMENTS
For the Three Years Ended December 31, 1942, 1943, and 1944

	Year ended December 31, 1942	1943	1944	Balance-sheet adjustment December 31, 1944	
Net sales, per problem	$150,000	$200,000	$400,000		
(1) Adjust for overstatement of sales:					
1942	(25,000)	25,000			
1943		(15,000)	15,000		
Net sales, as corrected	$125,000	$210,000	$415,000		
Cost of sales (at cost, per problem)	$ 98,500	$135,700	$267,000		
(1) Adjust for overstatement of sales:					
1942 (64% of $25,000)	(16,000)	16,000			
1943 (60% of $15,000)		(9,000)	9,000		
(2) Understatement of inventory, 1942	(8,000)	8,000			
(5b) Depreciation, 1944, overstated (10% of $10,000)			(1,000)	($ 1,000)	Depreciation reserve
Cost of sales, as corrected	$ 74,500	$150,700	$275,000		
Gross profit on sales, as corrected	$ 50,500	$ 59,300	$140,000		
Selling, administrative, and general expenses	40,000	45,000	55,000		
Net profit on operations, as corrected	$ 10,500	$ 14,300	$ 85,000		
Other income (net), per problem	$ 5,000	$ 1,000	$ 4,000		
(3) Bond premium amortization ($200 per year)	(3,900)	200	200	3,500	Unamortized bond premium
(5b) Cost of repairing storm damages		(10,000)		10,000	Plant control
(5c) Machinery discarded December 31, 1944				5,000	Plant control
Accumulated depreciation				(4,000)	Depreciation reserve
Loss			(1,000)		
Other income (net), as corrected	$ 1,100	($ 8,800)	$ 3,200		
Net income before taxes, as corrected	$ 11,600	$ 5,500	$ 88,200		
Provision for federal and state income taxes:					
1942 (25% of $11,600)	2,900				
1943 (30% of $ 5,500)		1,650			
1944 (40% of $88,200)			35,280	(3,185)	Income-tax reserve
Net income, as corrected	$ 8,700	$ 3,850	$ 52,920	$10,315	Surplus

B-V CO., INC.

Condensed Income Statements

For the Three Years Ended December 31, 1942, 1943, and 1944

	1942	1943	1944
Net sales	$125,000	$210,000	$415,000
Cost of sales	74,500	150,700	275,000
Gross profit on sales	$ 50,500	$ 59,300	$140,000
Selling, administrative, and general expenses	40,000	45,000	55,000
Net profit on operations	$ 10,500	$ 14,300	$ 85,000
Other income (net)	1,100	(8,800)	3,200
Net income before taxes on income	$ 11,600	$ 5,500	$ 88,200
Provision for federal and state income taxes	2,900	1,650	35,280
Net income	$ 8,700	$ 3,850	$ 52,920

Adjusting Entry Applicable to the Balance-Sheet of B-V Co., Inc.
As at December 31, 1944

Reserve for depreciation control		$ 5,000	
Reserve for federal and state income taxes		3,185	
Earned surplus		10,315	
Unamortized bond premium			$ 3,500
Plant control			15,000
To adjust the above amounts as at December 31, 1944, per below:			
Reserve for depreciation:			
Depreciation overstated by providing 10% on repair cost ($10,000) capitalized in error	$ 1,000		
Accumulated depreciation on machinery discarded December 31, 1944	4,000		
Total	$ 5,000		

Reserve for federal and state income taxes:

	Provision		
	Original	Corrected	Difference
1942	$ 4,125	$ 2,900	$ 1,225
1943	6,090	1,650	4,440
1944	32,800	35,280	(2,480)
Total	$43,015	$39,830	$ 3,185

Unamortized bond premium:

	Credited to income	Correct amortization	
1942	$4,000	$100	($ 3,900)
1943	—	200	200
1944	—	200	200
Total	$4,000	$500	($ 3,500)

Plant control:

Cost of repairing damages capitalized in error..	$10,000
Machinery discarded	5,000
Total	$15,000

No. 2 (Alternate for No. 3)

BUNSOM CO.

JOURNAL ENTRIES OF TRANSACTIONS FOR THE MONTH OF JANUARY, 1946

	Debit	Credit
(1)		
Materials purchased	$30,000.00	
Material price variance	600.00	
Vouchers payable		$30,600.00

To record materials purchased and resulting price variances, as shown below:

Item	Quantity (units)	Actual Cost	Standard Cost	Variance
M-a	12,000	$ 5,400	$ 6,000	$ 600
M-b	12,000	25,200	24,000	(1,200)
Totals ...		$30,600	$30,000	$ (600)

	Debit	Credit
(2)		
Materials used	27,525.00	
Material usage variance...........................	110.50	
Materials purchased		27,635.50

To record the materials used at standard cost and the material usage variance, as shown below:

M 12	Units
Finished goods transferred.......	11,000
M 11	
Work-in-process inventory January 31, 1946...............	100
Total	11,100

		Debit	Credit
M 10			
Work-in-process inventory January 1, 1946	50		
Received for process	11,050		
Cost			
M-a 11,050 units at $ .50	$ 5,525		
M-b 11,000 units at $2.00	22,000		
Total	$27,525		
Variance			
M-a 2% of $5,525 or	$ 110.50		

(3)

	Debit	Credit
Direct labor	$13,806.25	
Direct labor-time variance	1,693.75	
Direct labor-rate variance	155.00	
Vouchers payable		$15,655.00

To record direct labor costs and variances in time and rate, as follows:

Effective production of units	Units
Work in process, January 1, 1946 (80% of 50 units)	40
Received for process	11,050
Total	11,090
Work in process, January 31, 1946 (45% of 100 units)	45
Effective production	11,045

Labor time variance

Actual hrs.	3,100.00	
Standard hrs. (11,045 ÷ 4)	2,761.25	
Excess of actual	338.75 hrs. at $5.00 =	$1,693.75

Labor rate variance

Actual rate per ¼ hour	$1.2625
Standard rate per ¼ hour	1.2500
Variance per ¼ hour	$ .0125

3,100 hours at 4 ($.0125) = $ 155.00

(4)

		Debit	Credit
Manufacturing overhead		$16,590.00	
Over-all manufacturing overhead variance			90.00
Vouchers payable			16,500.00

To record the indirect labor ($1,500) manufacturing overhead ($15,000) and the overhead variance as shown below:

Effective production of units	Units
Work in process, January 1, 1946 (60% of 50 units)	30
Received for process	11,050
Total	11,080
Work in process January 31, 1946 (20% of 100 units)	20
Effective production	11,060
Over-all manufacturing cost:	
Standard (11,060 units at $1.50 each)	$16,590.00
Actual	16,500.00
Variance	$ 90.00

(5)

	Debit	Credit
Finished goods	$57,750.00	
Work in process:		
Material		$27,500.00
Direct labor		13,750.00
Manufacturing overhead		16,500.00

To record the transfer of finished goods to the warehouse, at standard costs.

Material	11,000 units at $2.50 =	$27,500
Direct labor	11,000 units at $1.25 =	13,750
Manufacturing overhead	11,000 units at $1.50 =	16,500
	11,000 units at $5.25 =	$57,750

(6)

	Debit	Credit
Cost of sales	55,125.00	
Finished goods		55,125.00

To record the cost of sales at standard costs (10,500 units at $5.25 each)

(7)

	Debit	Credit
Accounts receivable	94,500.00	
Sales		94,500.00

To record sales for month (10,500 units at $9 each)

(8)

	Debit	Credit
Selling, administrative, and general expenses..........	25,000.00	
Voucher payable		25,000.00
To record the selling, general, and administrative expenses for the month		

BUNSOM CO.

STATEMENT OF INCOME FOR THE MONTH OF JANUARY, 1946

Sales			$94,500.00
Standard cost of sales..............................			
Materials used		$27,525.00	
Direct labor		13,806.25	
Manufacturing overhead		16,590.00	
Total		$57,921.25	
Add—work-in-process inventory, January 1, 1946		67.50	
Total		$57,988.75	
Deduct—work-in-process inventory, January 31, 1946		238.75	
Standard cost of goods manufactured....		$57,750.00	
Deduct—finished-goods inventory, January 31, 1946		2,625.00	
Standard cost of sales..................			55,125.00
Gross profit on sales..............................			$39,375.00
Selling, general, and administrative expenses.........			25,000.00
Net operating profit..................................			$14,375.00
Variance:			
Deduct:			
Material:			
Price variance	$ 600.00		
Usage variance	110.50	$ 710.50	
Direct labor:			
Time variance	$1,693.75		
Rate variance	155.00	1,848.75	
Total		$ 2,559.25	
Less—manufacturing overhead variance........		90.00	2,469.25
Net profit for month of January, 1946.............			$11,905.75

NOTE: The variances may also be shown before arriving at the gross profit on sales.

BUNSOM CO.

Statement Showing Computation of Inventories

Work in process	Unit Cost	Total Cost
January 1, 1946 (complete through operation M-10):		
Material —(20% of $2.50)	$ .50	
Labor —(20% of $1.25)	.25	
Overhead—(40% of $1.50)	.60	
Standard cost of 1 unit..................	$ 1.35	
Standard cost of 50 units....................		$ 67.50
January 31, 1946 (complete through operation M-11):		
Material —(20% of $2.50)	$ .50	
Labor —(55% of $1.25)	.6875	
Overhead—(80% of $1.50)	1.20	
Standard cost of 1 unit..................	$2.3875	
Standard cost of 100 units.................		$ 238.75
Finished goods		
January 31, 1946:		
500 units at	$ 5.25	$2,625.00

No. 3 (Alternate for No. 2)

MIDDLE CITY

Work Sheet for the Year ended June 30, 1945

	Balance-Sheet, July 1, 1944		Transactions for the Year Ended June 30, 1945		Balance-Sheet, June 30, 1945	
General Fund	Assets	Liabilities, Reserves and Surplus	Debits	Credits	Assets	Liabilities, Reserves and Surplus
Cash	$50,000		(4) $165,000	(7) $162,000		
			(5) 23,500	(18) 6,000		
			(8) 1,650			
			(9) 1,000		$ 73,150	
Taxes receivable:						
Current			(3) 125,000	(4) 85,000	40,000	
Delinquent	25,000			(5) 25,000		
Long-time advance to revolving fund	15,000				15,000	
Accounts payable		$30,000	(7) 90,000	(6) 95,000		$35,000
Reserve for encumbrances		5,000	(6) 5,000	(6) 100,000		
			(6) 96,000			4,000
Due to revolving fund		5,000	(18) 6,000	(17) 3,000		2,000
Unappropriated surplus		35,000	(2) 175,000	(1) 200,000		
			(5) 1,500	(6) 1,000		
			(A) 1,250	(8) 1,650		
				(B) 5,000		64,900
Appropriated surplus—advance to revolving fund		15,000				15,000
	$90,000	$90,000				
Estimated revenues—taxes			(1) 125,000	(A) 125,000		
Estimated revenues—miscellaneous			(1) 75,000	(A) 75,000		
Appropriations			(B) 175,000	(2) 175,000		
Tax revenue			(A) 118,750	(3) 118,750		
Reserve for uncollectible taxes				(3) 6,250		6,250
Miscellaneous revenue			(A) 80,000	(4) 80,000		
Appropriation expenditures			(6) 91,000	(B) 166,000		
			(7) 72,000			
			(17) 3,000			
Appropriation encumbrances			(6) 100,000	(6) 96,000		
				(B) 4,000		
Taxes collected in advance				(9) 1,000		1,000
					$128,150	$128,150
Transportation Revolving Fund						
Cash	$10,000		(18) 6,000	(16) 4,000		
				(17) 1,800	$ 10,200	
Due from general fund	5,000		(17) 3,000	(18) 6,000	2,000	
Long-time advance from general fund		$15,000				$ 15,000
Trucks			(16) 9,000		9,000	
Accounts payable				(16) 5,000		5,000
Reserve for depreciation—trucks				(17) 1,200		1,200
	$15,000	$15,000			$21,200	$ 21,200
Special Assessment Fund						
Assessments receivable			(10) 75,000	(14) 22,500	$ 52,500	
Reserve for authorized expenditures			(C) 20,000	(10) 75,000		$ 55,000
Cash for construction			(11) 25,200	(13) 18,000	7,200	
Bonds payable			(15) 12,000	(11) 25,000		13,000
Unappropriated surplus—premium and interest			(E) 625	(11) 200		1,650
				(D) 2,075		
Encumbrances			(12) 50,000	(13) 20,000	30,000	
Reserve for encumbrances			(13) 20,000	(12) 50,000		30,000
Construction expenditures			(13) 20,000	(C) 20,000		
Contracts payable				(13) 2,000		2,000
Cash for bonds and interest			(14) 23,000	(15) 12,625	10,375	
Accrued interest on assessments			(D) 2,075	(14) 500	1,575	
Accrued interest payable			(15) 625	(E) 625		
					$101,650	$101,650

Theory of Accounts

May 16, 1946, 9:00 a.m. to 12:30 p.m.

No. 1

(a) 1. The straight-line or equal-installment method.
2. The effective-rate method.

(b) Yes.

(c)

Cash	$1,050,000	
Bonds payable		$1,000,000
Bond premium		50,000
To record the sale of bonds and the premium thereon.		

(d) The interest applicable to the period of the construction of the building on bonds sold to obtain cash for that purpose may properly be charged as a part of the construction cost. There are some accountants who do not consider this proper practice. They all agree, however, that after the period of construction, interest and amortization of bond discount should be charged to financial expense.

No. 2

(a) The authorizing resolution should include the amount of the earned surplus to be capitalized and the number of shares that are to be issued as the stock dividend.

(b)

Earned surplus	$550,000	
Capital stock—common		$500,000
Paid-in surplus		50,000
To record the issuance of the common stock dividend of 5,000 shares ($100 par, market value $110 each) as authorized by the resolution of the board of directors, ————.		

(c) In the investment account an entry should be made showing the date and the number of dividend shares received. The amount in the account applies to both the old and the new shares received, and may be allocated to all of the stock held in proportion to the number of shares of both the old and the new.

No. 3

(a) 1. Indirect materials; 2. Indirect labor; 3. Indirect manufacturing expense.

(b) 1. Factory overhead; 2. Factory burden; 3. Indirect factory expense; 4. Manufacturing expense.

(c) 1. On direct labor cost. Where labor is the principal item of cost and the rates of pay are not too divergent.
2. On the cost of material. Where materials are the principal item of cost, and the materials used in different products do not differ too much in value.
3. On direct labor plus material cost. Where both labor rates and material values differ considerably in the various products but labor and material together constitute a not too disproportionate cost.
4. On labor hours. Where labor is the principal item of cost and the rates of pay differ considerably.
5. On machine hours. Where the principal work is done by machines, not differing much in size, each calling for approximately the same amount of supervision, and the manual labor is a minor part of the manufacturing cost. In such a case the labor charges are added to the overhead, and the aggregate number of hours all the machines operate determines the rate per hour for each machine.

No. 4

(a) Capital surplus, a generic term, includes paid-in surplus, donated surplus, and revaluation surplus, or all surplus other than earned surplus.

(b) 1. Premium paid on original issue of capital stock.
2. Excess over par or stated value of capital stock arising from the reissuance, reacquisition, or retirement of shares of capital stock.
3. Acquisitions by consolidation, merger, or reorganization.
4. Donations by shareholders or others.
5. Appraisal valuations.

No. 5

(a) 1. To submit to creditors of an insolvent company for the purpose of showing what they may expect to receive in liquidation.

2. To submit to banks, or other creditors, with an application for unsecured credit.

(b) The statement of affairs shows the assets and liabilities from the viewpoint of realization and liquidation, while the balance-sheet shows the assets and liabilities from the viewpoint of a going concern.

(c) 1. Preferred; 2. Fully secured; 3. Partially secured; 4. Unsecured; 5. Contingent.

No. 6

STATEMENT SHOWING COMPUTATION, BY THE RETAIL METHOD, OF THE INVENTORY AT THE END OF THE YEAR

	Cost	Retail Selling Price
Opening inventory	$150,000	$ 295,000
Purchases during the year	400,000	690,000
Totals	$550,000	$ 985,000
Add—mark-ups, net of cancellations		15,000
Total		$ 1,000,000
Ratio of cost to retail ($550,000 ÷ $1,000,000) 55%		
Deduct—mark-downs, net of cancellations		27,500
Balance		$ 972,500
Deduct—sales during the year		702,500
Closing inventory at retail selling price		$ 270,000
Closing inventory at cost (55% of $270,000)		$ 148,500

No. 7

Cash—On hand and in banks to pay for materials, supplies, taxes, payrolls, and other costs and expenses incurred in the operation of the business	$ ....
Inventories—Cost of merchandise held for sale to our customers.	$ ....
Notes Payable—Owing to our bank for money borrowed for the peak season. This amount is payable in 60 days, when it is expected that the inventories and amounts receivable from the customers will be greatly reduced and the cash in banks increased sufficiently to pay the notes.	$ ....
Sales—Amount charged to customers for merchandise sold to them.	$ ....
Freight—Amount paid for freight on merchandise purchased from suppliers located in other cities.	$ ....

No. 8

(a) *Current Assets*

1. Petty cash.
2. Payroll.

Noncurrent Assets

3. Bond retirement.
4. Building construction.
5. Pension.

(b) "Fund" represents certain assets set aside for a specific purpose. "Reserve" represents an allocation of surplus or income for a particular purpose.

(c) Whenever it is required to accumulate a fund to provide for the expenditure for which the reserve was created. Some trust indentures covering the issuance of bonds require the creation of a reserve and a deposit of cash or securities with a trustee.

No. 9

(a) The purpose of footnotes is to furnish additional information relative to items appearing in the balance-sheet or to items which are significant, but because of their nature do not appear in the statement.

Appropriate descriptions and clarifying notes should be used for each item in the balance-sheet, in order to reduce the number of footnotes to a minimum. However, any material facts which cannot readily be disclosed in the statement proper must be shown as a footnote.

(b) 1. Statement of adjustment in property valuation. "As of January 1, 1939, the company adjusted the property values to a basis which, in the opinion of the directors, reflected current values on that date, by writing off 10 per cent of such property values with a reduction in the reserves for depreciation in the same ratio. The resulting net difference was charged to earned surplus."

2. Contingent loss not reflected in the balance-sheet.
"The company has noncancellable commitments to purchase raw materials in the amount of $100,000. The replacement cost of the materials had declined to $75,000 at the date of the balance-sheet."

3. Arrearage in dividends on preferred stock.
"Preferred stock dividends are in arrears since the organization of the company on blank date."

No. 10

December 31, 1944

Depreciation	$99,000	
Reserve for depreciation		$99,000
To record depreciation for the year ended December 31, 1944. 220,000 units at ($855,000 ÷ 1,900,000 units) 45¢ each.		

January 1, 1945

Reserve for depreciation	$75,000	
Plant account		$75,000
To record the retirement and scrapping of equipment costing $75,000.		
Plant account	$124,000	
Cash		124,000
To record the purchase of new equipment.		

December 31, 1945

Depreciation	$107,800	
Reserve for depreciation		$107,800
To record depreciation for the year ended December 31, 1945. 245,000 units at ($880,000 ÷ 2,000,000 units) 44¢ each.		

No. 11

(a) 1. Comparative balance-sheets.
2. Comparative statements of profit and loss.
3. Statement of surplus for year to date.

(b) It is suggested that the following schedules should be furnished each month to the management of a manfacturing business with net assets of approximately $1,500,000:

1. Schedule of cost of goods manufactured and sold.
2. Schedule of over-and-under absorbed overhead.
3. Schedule of general, administrative, and selling expenses.
4. Schedule of other income and other deductions.
5. Schedule of accounts receivable.
6. Schedule of accounts and notes payable.
7. Schedule of open purchase orders.
8. Schedule of open orders from customers.

No. 12

(a) Capital expenditures are those made in the acquisition of or additions to capital assets. Revenue expenditures are those made for expenses which are chargeable against income.

(b) 1. Additions and betterments.
2. Replacements and renewals.
3. Ordinary repairs and maintenance.

(c) Factory building	$200,000	
Cash		$200,000
To record the cost of the addition to the factory building constructed on leased property.		
Depreciation—factory building	$ 10,000	
Reserve for depreciation—factory building		$ 10,000
To record the depreciation for the year on the extension to the factory building at the rate of 5% per annum. This rate is based on the 20-year term of the lease upon which the extension was constructed.		

Accounting Practice—Part II

May 16, 1946, 1:30 to 6:00 p.m.

No. 1

THE ACME TRADING COMPANY WORK SHEET (not required of candidate) BALANCE-SHEET—DECEMBER 31, 1944

	Per Books		Adjustments		Adjusted Balance-Sheet		
	Debit	Credit	Debit	Credit	Debit	Credit	Remarks
Cash in banks	$151,200			(1) $15,000	$136,200		
Accounts and notes receivable	105,000			(2) 2,750	102,250		
Reserve for bad debts		$ 2,400				$ 2,400	
Inventories	182,000			(3) 6,000	176,000		(3) Includes $5,000 pledged.
Land	35,000				35,000		(4) At appraised value—July 1, 1944.
Buildings	70,000				70,000		
Reserve for depreciation		16,300				16,300	
Machinery and equipment	130,000				130,000		(4) Machine segregated for sale. Relatively immaterial. Ignore until sold.
Reserve for depreciation		39,000				39,000	
Investment in subsidiary—The Smith Co.	30,000			(5) 2,400	27,600		(5) Dividends paid $4,000
							80% = $5,000
							Earnings 1944 2,000
							From prior earnings $3,000
							80% thereof $2,400
Redemption fund for serial bonds	14,000				14,000		(6) Includes $10,000 for Jan. 2, 1945 maturities.
Unamortized discount on serial bonds payable	4,950			(7) 450	4,500		(7) Correct balance should be 45/55 of $5,500.
Notes payable—trade		10,000		(11) 1,000		11,000	
Notes payable—banks		10,500				10,500	(3) Includes $5,000 secured.
Accounts payable—trade		130,600	(11) $ 1,000			129,600	
Accrued liabilities		5,800				5,800	
Estimated federal income taxes payable		12,000				12,000	
Serial bonds payable, 4½%, Series A, due January 2, 1945		10,000	(6) 10,000				
Interest on notes receivable — collected in advance		350				350	
Serial bonds payable, 4½%, Series B to J, due at one-year intervals, beginning January 2, 1946, and ending January 2, 1954		90,000		(6) 10,000		100,000	(6) Includes $10,000 maturing Jan. 2, 1945.
Customers' advance payments for merchandise deliveries to be made in 1945		12,000				12,000	
Capital stock—common		50,000				50,000	
Capital stock—preferred		60,000				60,000	
Capital surplus		106,500	(4) 10,000 (10) 4,000	(9) 3,500		96,000	
Earned surplus:							
Balance, January 1, 1944	150,200					150,200	
Net income for year 1944		25,500	(5) 2,400 (7) 450 (9) 3,500			19,150	
Treasury stock	9,000			(10) 4,000	5,000		
	$731,150	$731,150					
Cash in special account—to finance building extension			(1) 15,000		15,000		
Notes receivable of officer payable on demand			(2) 4,000		4,000		
Accounts payable—employees				(2) 1,250		1,250	
Advances to suppliers			(3) 6,000		6,000		
Appraisal surplus				(4) 10,000		10,000	
			$56,350	$56,350	$725,550	$725,550	

NOTES: Undeclared accumulated dividends of $3,000 on preferred stock. Contingent liability as accommodation endorser on $10,000 note of The Smith Company.

THE ACME TRADING COMPANY BALANCE-SHEET—DECEMBER 31, 1944

Assets

Current assets:			
Cash in banks		$136,200	
Accounts and notes receivable	$102,250		
Less—Reserve for bad debts	2,400	99,850	
Note receivable of officer payable on demand		4,000	
Inventories—at cost or market whichever is lower, including $5,000 pledged as collateral on bank loan		176,000	
Advances to suppliers		6,000	$422,050
Cash in special account—to finance building extension			15,000
Fixed assets:			
Land, at cost plus $10,000 appreciation based on appraisal of X Engineering Co., July 1, 1944		$ 35,000	
Buildings	$ 70,000		
Less—Reserve for depreciation	16,300	53,700	
Machinery and equipment	$130,000		
Less—Reserve for depreciation	39,000	91,000	179,700
Investment in The Smith Company (80%) at cost			27,600
Unamortized discount on serial bonds payable			4,500
			$648,850

Liabilities

Current liabilities:			
Notes payable—trade		$ 11,000	
Notes payable—banks, including notes of $5,000 secured by merchandise pledged under trust receipts		10,500	
Accounts payable trade		129,600	
Accrued liabilities		5,800	
Estimated federal income taxes payable		12,000	
Accounts payable—employees		1,250	
Customers' advance payments		12,000	
Interest on notes receivable collected in advance		350	$182,500
Serial bonds, 4½%:			
Series A due January 2, 1945	$ 10,000		
Less—Redemption fund deposited with trustee	10,000		
Series B to J, due at one-year intervals, beginning January 2, 1946, and ending January 2, 1954		$ 90,000	
Less—Redemption fund deposited with trustee		4,000	86,000
Capital stock and surplus:			
Preferred stock, 5% cumulative of a par value of $100 per share, and liquidating value of $110 per share. Authorized 1,000 shares; issued and outstanding, 600 shares (Note)		$ 60,000	
Common stock, no par value. Authorized, 1,000 shares; issued and outstanding, 500 shares	$ 50,000		
Less—50 shares repurchased (cancelled in January, 1945)	5,000	45,000	
Paid-in surplus		96,000	
Appraisal surplus		10,000	
Earned surplus:			
Balance, January 1, 1944	$150,200		
Net income for the year 1944	19,150	169,350	380,350
			$648,850

NOTES: Undeclared dividends accumulated to December 31, 1944 on the preferred stock amounted to $3,000. The company was contingently liable at December 31, 1944 as an accommodation endorser to a note of its subsidiary, The Smith Company, in the amount of $10,000.

No. 2

Schedule I

MART CO., INC.

Schedule of Gross Profit Realized for the Year Ended December 31, 1945

Year	Cash Collections	Realized Gross Profit Per Cent	Realized Gross Profit Amount
1942	$ 17,000	30%	$ 5,100
1943	280,000	32	89,600
1944	305,000	34	103,700
Subtotal	$602,000		$198,400
1945	295,000	35	103,250
Total	$897,000		$301,650

Schedule II

MART CO., INC.

Statement Showing Taxable Net Income for the Year Ended December 31, 1945

Income	Sales: Installment	Sales: Regular and Cash	Total
Sales	$1,000,000	$90,000	$1,090,000
Cost of sales	650,000	60,000	710,000
Gross profit on sales	$ 350,000	$30,000	$ 380,000
Less unrealized profit on installment sales—1945: (35% of $705,000 of uncollected balances)	246,750	—	246,750
Gross profit on sales—1945	$ 103,250	$30,000	$ 133,250
Add gross profit realized on sales of prior years (Schedule I)	198,400	—	198,400
Gross profit	$ 301,650	$30,000	$ 331,650
Net capital gain:			
Gain from sale of Young Co. stock		$ 1,050	
Less net capital loss carry-over from 1944		225	
			825
Loss from sale of old machinery			(450)
Total income			$ 332,025

Deductions		
Compensation of officers	$35,000	
Interest paid	500	
Salaries and wages paid	13,500	
Depreciation	9,500	
State tax	8,000	
Personal-property tax	590	
Real-property tax	1,250	
Fire loss unrecovered by insurance	1,800	
Net operating loss deduction	12,500	
Other allowable deduction	125,000	
Bad debts—regular accounts	400	
Bad debts—installment accounts	4,195	
Loss on repossessions	8,600	
Total deductions		220,835
Net taxable income for 1945		$ 111,190

Commercial Law

May 17, 1946, 9 a.m. to 12:30 p.m.

GROUP I

No. 1

(a) A contract may be discharged (1) by performance; (2) by mutual agreement; (3) by operation of law; (4) by impossibility of performance; and (5) by material breach, at the option of the innocent party.

(b) (1) A joint contract is one made by two or more promisors, all of whom are liable in case of unexcused failure to perform, or one made to two or more promisees, who may require the performance.

(2) A several contract is where the respective parties may be separately liable or separately entitled to the whole of the same debt or performance.

(3) A joint and several contract is one where not only all the promisors are liable together but each is separately liable. Although the older view was that a contract could not create joint and several rights in the promisees, some modern authorities recognize joint and several rights in promisees.

(c) (1) A contract is entire when, by its terms, nature, and purpose, it contemplates and intends that each and all of its parts and the consideration shall be common each to the other, and interdependent.

(2) A contract is severable when the several promises are capable of and are intended to be performed independently of each other. A several contract is one which in its nature and purpose is susceptible of division and apportionment.

(d) The contract is a valid accord. In general, a payment of less than the full amount of a liquidated debt or demand does not constitute an accord and satisfaction of the debt, since the debtor by the payment is doing that which he is already legally obligated to do. The debtor in this case, however, gave a note endorsed by Carr which was the doing of something he was not obligated to do and hence constitutes a valuable consideration for the accord.

If the note is paid, the original debt is discharged. If it is not paid, Allen has alternate rights to sue on the note or on the original debt at his option.

No. 2

(a) (1) A bill of exchange is an unconditional order in writing, addressed by one person to another, signed by the person giving it, requiring the person to whom it is addressed to pay on demand or at a fixed or determinable future time, a sum certain in money to order or to bearer.

(2) Bills of exchange are either inland or foreign. An inland bill is one drawn and payable in the same state or country.

A foreign bill is one payable in a different state or country from the one in which it is drawn. The states of the United States are considered foreign to one another as to bills.

(3) The usual parties to a bill of exchange are: (a) drawer; (b) drawee; (c) acceptor; and (d) payee.

(a) the drawer, the party who makes the order;
(b) the drawee, the party to whom the order is directed;
(c) the acceptor, the drawee who assents to the order and then becomes the principal debtor on the bill; and
(d) the payee, the party in whose favor the bill is drawn.

(4) The drawee of a bill of exchange is not liable on the bill until it has been accepted by him.

The drawer is not liable until there has been a presentment to the drawee for acceptance of payment, a dishonor and notice of dishonor given to the drawer within the time specified by the Uniform Negotiable Instruments Law. In the case of a foreign bill there must also be a protest within the time specified by the U.N.I.L.

(b) No. Burt cannot maintain an action against the bank. There is no privity of contract between Burt and the bank as the contract is between the depositor Allen and the bank. Furthermore, under the U.N.I.L. a check is not an assignment of any funds in the bank.

(c) Yes. Carl can recover the amount of the note from Albert who is liable as an accommodation party.

An accommodation party is liable on the instrument to a holder for value, nothwithstanding such holder at the time of taking the instrument knew him to be only an accommodation party.

No. 3

(a) Allen was entitled to possession by virtue of right of stopping in transitu.

When the buyer of goods becomes insolvent, the unpaid seller who has parted with possession has the right of stopping them in transitu, that is to say, he may resume possession of the goods while they are in transit. The goods are still in transit when delivered to a carrier until carrier, after goods arrive at point of destination, acknowledges to buyer that he holds same as bailee for buyer.

(b) Adrian as an unpaid seller in possession of the truck, is entitled to retain possession of the goods until payment or tender of the price.

Since the goods have been sold on credit and the term of credit expired while he was still in possession of the goods, Adrian may resell, rescind, or sue for the price.

(c) Butler should not succeed. The price of a sale may be made payable in personal property. Since this was the agreement between the parties, Alex is offering performance of same.

(d) Barry may sue Albert for damages resulting from the implied warranty Albert made, that the goods at the time of sale were free from any charge or incumbrance in favor of any third person not declared or made known to the buyer at the time of the sale.

No. 4

(a) The partnership relation continues at will.

When a partnership for a fixed term is continued after the termination of such term without any express agreement, the rights and duties of the partners remain the same as they were at such termination, so far as is consistent with a partnership at will.

(b) No. The conveyance was not good.

An act of a partner which is not for the purpose of carrying on the business of the partnership in the usual way does not bind the partnership unless authorized by the other partner. Likewise, unless authorized by the other partner or unless the other partner has abandoned the business, partner Allen cannot dispose of the goodwill of the business or do any other act which would make it impossible to carry on the ordinary business of the partnership.

(c) No. Ajax does not become a partner as to (1) Xerxes and Yellow nor as to (2) third parties. Payment for service measured by share profits does not make a person a partner.

Persons who are not partners as to each other are not partners as to third persons unless there be a partnership by estoppel as to such third persons. The receipt by a person of a share of the profits of a business is prima-facie evidence that he is a partner in the business but no such inference may be drawn if such profits were received in payment of wages of an employee.

No. 5

(a) The following are some of the differences between a corporation and a partnership:

(1) A corporation is a legal entity; a partnership is not.

(2) A corporation can come into existence only by the sanction of the state; a partnership comes into existence by a contract made between the partners.

(3) The legal existence of a corporation is not affected by the death of a stockholder; a partnership, however, is dissolved by the death of a partner.

(4) A corporate shareholder does not have a legal title to the property of the corporation; a partner, however, has a legal tenancy in partnership property.

(5) In jurisdictions where there is a distinction made between law and equity a stockholder of a corporation may sue the corporation at law with respect to the corporate affairs; a partner, however, cannot sue his co-partners at law with respect to partnership affairs; he must sue for an accounting in equity.

(6) A shareholder in a corporation exerts his control of the corporation primarily through election of directors and voting on certain major questions of policy; partners, on the other hand, are normally in direct control of the management of the partnership affairs.

(7) A shareholder is not an agent of the corporation whereas a partner is an agent of the partnership.

(8) A shareholder is not personally liable for debts of the corporation; a partner is personally liable for the debts of the partnership.

(b) Yes, there is a difference.

(1) The capital of a corporation is the aggregate of the sum subscribed and paid in by the stockholders with the addition of all gains or profits realized in the use and investment of those sums less the losses which have been incurred.

(2) The capital stock is the total sum fixed by the charter as the amount paid in or to be paid in as capital upon which the corporation is to do business.

(c) Yes. Anderson is liable. A corporation cannot issue stock below the par value thereof. The receiver on behalf of the creditors may compel Anderson to pay so much of the balance due on his stock as may be necessary to pay the creditors.

(d) (1) Under the Uniform Stock Transfer Act the legal title of the shares of stock is in the purchaser. The certificate is only the indicia of ownership. Upon a delivery of the certificate with the power filled out, to the purchaser, the title passes to the purchaser.

(2) The purchaser could compel the company to make a transfer upon its books by a bill in equity against the corporation or could treat the refusal to transfer the certificate as a conversion by the corporation and sue for the value of the stock.

GROUP II

No. 6

(a) An expenditure is not deductible unless it meets the following tests:

(1) It must be an ordinary and necessary expense incurred in the taxable year (a) in carrying on any trade or business, or (b) in the case of an individual, for the production or collection of income, or (c) for the management, conservation, or maintenance of property held for the production of income.

(2) It must not be a personal expense.

(3) It must not be a capital expenditure.

(b) The two most usual methods of valuing inventories for income-tax purposes are:

(1) Cost, and

(2) Cost or market, whichever is lower.

(c) (1) $10,000. If compensation is paid to an employee of a corporation in its stock, the employee must include in gross income the fair market value of the stock at the date of receipt.

(2) The basis or cost of the stock to the president is $10,000 the fair market value at the date of receipt.

No. 7

(a) A surety is entitled to contribution from a co-surety, even though he did not know at the time of payment of the existence of the co-surety, unless the co-surety had a defense against the creditor such as that he became a surety as a result of the creditor's fraudulent misrepresentations.

(b) Allen's liability as guarantor terminated, provided the contract between the payee and the maker constituted a binding contract for an extension and provided that the payee did not in the extension agreement reserve his rights against the surety.

A guarantor or surety is released whenever the creditor and debtor without the consent of the surety and guarantor enter into a binding agreement making a material change in the terms of the original obligation unless the payee reserves his rights against the surety.

(c) The defense is not good. The liability of a surety is absolute and unconditional. He is primarily liable.

The surety assumes to perform the contract of the principal if he does not, and if the act which the surety undertakes to perform through the principal is not done then the surety is liable at once.

(d) Allen, the surety, is entitled to the chattel mortgage by right of subrogation.

Where one has been compelled to pay a debt which ought to have been paid by another, he is entitled to a cession of all the remedies which the creditor possesses against the other.

No. 8

(a) (1) An open policy of insurance is one in which the sum to be paid is not fixed, but is to be determined by the parties in the event of loss.

(2) As a general rule and apart from express stipulations to a contrary effect, a contract of insurance is consummated by and not until the unconditional acceptance of the application or proposal for such insurance and notification to the insured. Manual delivery of the policy is ordinarily unnecessary.

(3) Any act or words clearly showing an intention on the part of the insurer to be bound by a fully executed policy will constitute a sufficient delivery of the policy. Actual possession of the policy is evidential only, not essential. A policy may be delivered subject to conditions.

(b) (1) In any insurance policy the damage or losses covered depend upon what is agreed by the parties. Ordinarily, a fire-insurance policy covers all damage or loss emanating directly from the fire. This includes, in addition to damage from actual burning, damage from charring, scorching, smoke, water, or other agents used in extinguishing the fire or damage caused in removing the goods to a place of safety.

(2) (a) On an open policy without co-insurance the insurance companies' liability is the actual cash value of the insured property at the time of loss. That is the limit of the insurer's liability. The standard policy expressly so stipulates and also further limits the insurer's liability on specified risks.

(b) In case of co-insurance the insurance company is made liable only for such a proportion of the loss covered as the amount insured by it bears to the total amount of insurance.

(c) (1) A person has an insurable interest in property when he has a relationship to it such that he benefits from its continued existence or suffers a loss or liability from its destruction.

(2) In order that insurance on property shall be valid, an insurable interest must exist in the insured at the time of the loss.

It is not necessary that such an interest shall exist at the time the policy is issued, provided the parties intend that the risk shall attach only when an interest accrues to the insured.

(d) The proceeds of the life insurance belongs to Burt who had an insurable interest in the life of Allen when the policy was issued.

Where a creditor procures life insurance upon the life of his debtor he has an insurable interest in the debtor. That interest continues although the debtor paid the debt before his death. The contract of life insurance is not one for indemnity and if the creditor had an insurable interest when he took the policy he may recover although that interest has ceased.

No. 9

(a) No. The defense was not good. A common carrier, as bailee of the goods it carries, is estopped to deny the bailor's title to the goods.

(b) (1) The consignee sustains the loss.

(2) The carrier in this case has become a bailee and is not liable for the loss of the goods.

A common carrier is an insurer of the goods it carries and is excused only when the damage is caused by act of God, or public enemies. When goods reach their destination, the goods must be called for within a reasonable time. If they are not, the carrier's retention of them is as a bailee and not as a common carrier. As bailee the railroad is not an insurer of goods and can be held answerable only for negligence.

(c) (1) The carrier has a right of action for the recovery of goods or their value where they have been delivered to the wrong person.

(2) & (3) The carrier is liable to the consignor or to the consignee, whichever person is entitled to the possession of the goods, for their value even though the delivery to the wrong person was due to mistake or fraud.

(d) (1) The contract is void as it is against public policy.

(2) The carrier must rescind.

The contract is void as against public policy since a common carrier cannot discriminate in its rates between one shipper and another for the carriage of goods even though the discrimination was as a result of error or accident. Contracts which result in a discrimination in rates are in violation of the Interstate Commerce Act and are void. Under the Interstate Commerce Act the carrier has both a right and an absolute duty to recover scheduled rates regardless of contract.

No. 10

(a) (1) The mortgagor is the owner of the property on which the mortgage is placed.

(2) The mortgagee is the owner of the lien and has a security interest through that lien in the real estate.

(b) A purchase money mortgage is a mortgage given for the unpaid balance of purchase money on the sale of land.

It is given with the deed as a part of the same transaction. The mortgagee must record his mortgage before other liens are recorded in order to be protected and for that reason purchase money mortgages and deeds are recorded simultaneously.

(c) The real property itself is the primary security for the mortgage debt and always remains liable for the mortgage debt. The mortgagor remains personally liable on the bond.

No. 11

(a) (1) An executor is a person to whom the deceased has by his last will committed the execution or putting into force the purposes of the last will and testament.

(2) An administrator is a person appointed and authorized by a probate court to manage and distribute the estate of an intestate.

(3) (a) An executor derives his authority from his appointment by the testator. However, he has no power to act as executor until his appointment has been approved by the probate court and letters testamentary are issued to him.

(b) An administrator derives his authority from the probate court from the time there are issued to him letters of administration.

(4) Executors and administrators are under the control of the probate courts having jurisdiction of all matters relating to the settlement of the decedents' estates.

In different states they may have different names such as Surrogate's Court, Orphan's Court, Courts of Ordinary, and County Courts.

(b) (1) After appointment the title of the executors to personalty relates back to the date of death of the testator.

(2) An executor must use reasonable diligence to obtain possession of all the assets of the estate as soon as possible and if he fails to do so and through his negligence the estate suffers loss he is liable for them.

(c) (1) An executor's account is a brief financial statement of the manner in which the executor has performed the duties of his office in collecting the assets and making payments to those entitled thereto.

(2) It should contain a complete statement of all the assets with which the executor is charged as shown by the inventory, and any increases thereon and all debts of the estate. It should show the disposition of all assets, and should credit him with his expenses and costs, his disbursements and commissions.

No. 12

(a) An agency relationship may be created (1) by appointment; (2) by ratification; (3) by estoppel; and (4) from necessity.

(b) (1) Generally a selling agent is authorized to do whatever is reasonably necessary and wise to carry out the purpose of the agency, including power to make the usual representations and warranties and receive payment.

(2) Ordinarily he has no implied powers to mortgage, exchange, barter, or pledge the goods nor to give credit nor sell at auction.

(c) Such a power can only be conferred by the direct authority of the party to be bound, and it will only be implied in cases where the duty to be performed cannot be discharged without the exercise of such power, as in the case of a bank cashier.

(d) An agent should execute negotiable papers 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.

Auditing

May 17, 1946, 1:30 to 5:00 p.m.

No. 1

NOTE: To save space the narrative form is used in answering this question.

In general, working papers should show in the heading (1) the name of the client, (2) the account or accounts shown therein, and (3) the date or period covered. Appended to the papers would appear the name or initials of the auditor, the source of the data, and the schedule of time spent on the work. In some circumstances methods of procedure followed may be noted along with pertinent comments.

(a) *Factory buildings and reserve for depreciation.*. The working papers should show the analysis of the accounts for the period. The balances at the beginning and end should be checked against the accounts in the balance-sheet. The transactions during the year should be verified and the references to vouchers or journals entered on the papers. The basis of valuation of the building should be noted and the details of the computation of the depreciation provision should be shown.

(b) *General manager s profit-sharing bonus.* Reference should be made to the copy or a summary of the agreement and to the extracts of the minutes of the meetings of the board of directors or other authority in the permanent file. The schedule should show the computation of the bonus for the current year.

(c) *Treasury stock.* The authority to purchase, the purpose for acquiring, the cost to be paid, the value at which carried, the dates and certificate numbers of the shares acquired, retired, canceled, and resold should be shown in the working papers.

(d) *Royalty income.* The papers should show the rates and other pertinent data of all agreements, such as the sources and the basis of computing the amounts received, schedules showing such computations, and the accrual of royalty income and its subsequent receipt.

(e) *Sales and cost of sales of building lots sold by a realty company.* The papers should show the date, cost, and acreage of the original acquisition, costs of development, carrying charges, cost of the individual lots, terms of sale, mortgages received, and mortgage releases. The title to the acquired acreage and the passing of title on lots sold should be noted as well as any mortgage on the land acquired.

No. 2

(1) Are expenditures for capital assets authorized before or approved after acquisition or construction?
(2) Are actual expenditures checked against the pre-authorized estimates?
(3) Are plant ledgers maintained? Are they balanced periodically with the general ledger controls?
(4) Who has authority to scrap items? Is there a control of the sales of such items?
(5) Are retirements properly accounted for?
(6) Is there a good system in use covering small tools? Are they inventoried periodically?

No. 3

If a public accountant is extremely negligent in work done by him as a professional auditor, he may be held responsible for damages arising therefrom. He is expected to perform his work with the same degree of skill as would be expected of any other member of the profession. The contract terms with the client with respect to the scope of the work to be performed, the extent of the tests, etc., may increase or limit his responsibilities to the client.

He is expected to use reasonable care in detecting fraud and errors in the accounts and in disclosing essential facts. He is responsible to third parties for fraud, but not for negligence unless such negligence is the equivalent of fraud. However, he is not an insurer.

No. 4

(a) *Special-assessment records and related bond records of a small municipality*
(1) Ascertain whether the entries for the issue of the special-assessment bonds were properly made.
(2) Verify the footings and postings of the assessment rolls.
(3) Determine whether all collections, current and delinquent, have been properly recorded on the books of the treasurer.
(4) Determine whether the proper amounts of interest, penalties, and costs have been collected.

(5) Reconcile the open balances of uncollected current and delinquent accounts with the balances in the respective control accounts.
(6) Ascertain that the trust funds for the redemption of the bonds and payment of the interest are in agreement with the records.
(7) Ascertain that expenditures to bondholders are supported by canceled bonds and coupons.
(8) Confirm the open items by correspondence, if practicable.
(9) Ascertain whether the properties, etc., acquired because of delinquencies are properly recorded.
(10) Verify the authority for cancellations and adjustments.

(b) *Security-control records of a stock broker.*

At the close of business on the audit date, the auditor should take off the security position from the records after all transactions have been recorded.

From the cashier's records he should obtain a detailed list of securities:
(1) On hand in the company's collateral boxes (margin securities)
(2) On hand in the company's safekeeping boxes (customers' securities)
(3) Those pledged as collateral to bank and others
(4) Those which are out for transfer
(5) Those due to brokers (charged out but not delivered)
(6) Those due from brokers (charged in but not received)
(7) Those ordered out from correspondent brokers but not yet received

From the margin-clerk's records he should prepare, on separate sheets, a list of the securities which each customer is "long" or "short," as well as securities wholly owned by customers and held in safekeeping. From the customers' ledgers he should prepare, on separate sheets, a list of the securities which each customer is "long" or "short." From the master security record he should prepare, by security names, lists of customers "long" or "short," those securities, and the location of the securities, i.e., on hand, at brokers, in banks, etc. He should prepare and send out requests for confirmations of:
(1) Securities pledged as collateral to bank, or other loans, and those held in safekeeping
(2) Securities out for transfer
(3) Securities in transit
(4) Securities due to and owed by the brokerage firm

(5) Securities held for customers' accounts, including those held for safekeeping

Using the list prepared, he should count the securities in the boxes —customers' and safekeeping.

The customers' positions as shown by the master control, margin record, and ledger accounts should be checked against each other and any differences should be reconciled.

The securities on hand, at banks, at brokers, and out for transfer should be checked against the master securities record and any differences should be reconciled.

(c) *Rent-control records of a real-estate operating company.*

The records of the company generally show the location of the property, units (buildings rooms, area), whether leased, occupied, or vacant, name of tenant or lessee, term of lease, rate for term, and due date of rent. The ledgers should show the rental charges, collections, and uncollected balances. The following procedure should be followed:

(1) The rent bills should be checked with the rent rolls or rents-receivable ledger and mailed by the auditor with a request for confirmation.

(2) The accuracy of the rent rolls should be verified—

  (a) By checking with the leases, amended leases, or other agreements to determine the amount of rents, dates of occupancy, vacancies, etc.

  (b) By checking against the general-ledger control account, and the rents-receivable ledger.

  (c) By footing at the beginning of the year and applying the current changes each month during the year.

  (d) By inspection of the premises to ascertain the actual vacancies which should be compared with those shown in the rent rolls.

(3) All postings to the general-ledger control account should be checked against the footings or summaries of the sources from which the postings were made. Particular care should be taken to verify the authority and to understand any entries of unusual nature.

(4) Delinquent accounts should be examined and discussed with the manager.

No. 5

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 auditor might also audit the deposit tickets for several days prior to the close of the period and make certain that these deposits are sent directly to the bank.

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.

No. 6

The receiving record should be examined for five or six days prior to December 31st to determine that items received prior to that date have been included in the inventory or have been otherwise properly accounted for. The purchase record should then be examined to ascertain that the liability for the items received, as disclosed by the receiving record, has been recorded on the books. The entries in the purchase journal for a week or so after December 31st should be examined also to learn if any items shipped prior to the closing date could possibly have been received prior to that date. Such items should be checked against the receiving record. Care should be exercised with respect to items in transit that should be reflected with the liability thereon in the statements.

The shipping records should be examined for about a week prior to the closing date in conjunction with the return-purchases record to determine that items returned to suppliers have been properly charged against them. The return-purchases record should be examined for about five or six days prior to the closing date and by reference to the inventory and shipping records ascertain that items charged to suppliers have not been included in the inventory. The items recorded in the return-purchases record for a week or so after December 31st should be examined and by reference to the inventory it should be determined that such items have not been included therein.

The requisitions of materials issued between December 31st and the date the inventory-taking had been completed should be examined to determine that items issued before the count was made had been included in the inventory.

No. 7

"A member or an associate shall not permit his name to be used in conjunction with an estimate of earnings contingent upon future transactions in a manner which may lead to the belief that the member or associate vouches for the accuracy of the forecast."

(Rule 12. Committee on professional ethics of the American Institute of Accountants)

There can be no objection to the auditor assisting a client in estimating the results of future operations or in preparing budgets. However, he should not permit his name to be used in conjunction with the statements in a manner which might lead the reader to believe that the auditor vouched for their accuracy.

No. 8

(a) The purposes of a second bank reconciliation are to enable the auditor to verify the checks outstanding at the first reconciliation; to ascertain that there were no unrecorded checks at that date which were subsequently paid by the bank; and to discover kiting, window dressing, and other irregularities.

(b) The bank statement and canceled checks should be delivered directly by the bank to the auditor, who should check the canceled checks issued 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.

ANSWERS TO EXAMINATIONS OF NOVEMBER 1946

Accounting Practice—Part I

November 6, 1946, 1:30 to 6:00 p.m.

No. 1

NOVO KITCHEN AIDS, INC.
WORK SHEET

	Balance-Sheet April 30, 1945		Transactions and Adjusting Entries, 1945/1946		Balance-Sheet April 30, 1946		Net Assets		Reserve, Capital Stock and Surplus
	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit	(Debit) Credit
Capital stock—preferred (9,000 shares)		$ 90,000				$ 90,000			$ 90,000
Preferred stock in treasury (1,000 shares)		10,000				10,000			10,000
Preferred stock in treasury	15,000			(1) 7,500					
				(2) 2,500	$ 5,000				(5,000)
Capital stock—common (5,000 shares)		224,000		(3) 45,000		269,000			269,000
Current liabilities		388,000		(4) 9,000					
				(8) 1,500					
				(10) 4,100		402,600		$ 402,600	
Reserve for doubtful accounts		2,000		(5) 200		2,200		2,200	
Reserve for postwar rehabilitation		1,000,000		(6) 500,000		1,500,000			1,500,000
Reserve for depreciation		384,000	(8) 400	(5) 17,400		401,000		401,000	
Reserve for fire insurance		60,000	(8) 3,500	(7) 10,000		66,500			66,500
Income			(5) 17,600	(11) 750,100					
			(7) 10,000						
			(10) 4,100			718,400			718,400
Surplus		2,671,000	(9) 2,671,000						
Premium on preferred stock		50,000	(2) 2,500			47,500			47,500
Donated surplus				(9) 134,000		134,000			134,000
Surplus from resales of preferred treasury stock				(1) 2,000		8,300			8,300
				(9) 6,300					
Earned surplus			(6) 500,000	(9) 2,530,700		2,030,700			2,030,700
Preferred dividends			(3) 45,000						
			(4) 9,000		54,000				(54,000)
Sundry assets	4,864,000		(1) 9,500						
			(11) 750,100	(8) 2,400	5,621,200		$5,621,200		
Net assets								4,815,400	
	$4,879,000	$4,879,000	$4,022,700	$4,022,700	$5,680,200	$5,680,200	$5,621,200	$5,621,200	$4,815,400

NOVO KITCHEN AIDS, INC.

Transactions and Adjusting Entries

		Debit	Credit
1.	Cash	$ 9,500	
	Preferred stock in treasury..............		$ 7,500
	Surplus from resales of preferred treasury stock		2,000
	To record sale of 500 shares preferred stock in treasury @ $19 per share.		
1.	(a) Premium on preferred stock..............	2,500	
	Preferred stock in treasury..............		2,500
	To reduce remaining 500 shares in treasury to par of $10.		
2.	Preferred dividends	45,000	
	Common stock		45,000
	To record issuance of $9,000 common shares at $5 in payment of $5 dividends in arrears on preferred stock.		
3.	Preferred dividends	9,000	
	Current liabilities		9,000
	To record a $1 per share dividend declared on 9,000 shares of preferred stock, payable May 1, 1946.		
4.	Income	17,600	
	Reserve for doubtful accounts...........		200
	Reserve for depreciation..................		17,400
	To record provision for doubtful accounts and depreciation.		
5.	Earned surplus	500,000	
	Reserve for postwar rehabilitation........		500,000
	To record provision for contingencies		
6.	The extension costs of $285,000 do not affect the reserve, capital stock, and surplus section of the balance-sheet		
7.	Income	10,000	
	Reserve for fire insurance................		10,000
	To record increase of reserve		
8.	Reserve for fire insurance..................	3,500	
	Reserve for depreciation	400	
	Buildings		2,400
	Current liabilities		1,500
	To record the fire loss		
9	Surplus	2,671,000	
	Donated surplus		134,000
	Surplus from resales of preferred treasury stock		6,300
	Earned surplus		2,530,700
	To record restatement of surplus		

10.	Income	4,100	
	Current liabilities		4,100
	To charge previous year's tax deficiency to income		
11.	Sundry assets	750,100	
	Income		750,100
	To record increase in sundry assets:		

Income, per problem	$222,500
Add increase in reserve for postwar rehabilitation	500,000
	722,500
Deduct income-tax deficiency	4,100
Corrected income	718,400
Add back:	
Provision for reserves charged to income:	
Fire insurance	10,000
Depreciation	17,400
Doubtful accounts	200
Income-tax deficiency	4,100
	$750,100

Reserve, Capital Stock and Surplus Sections of Balance Sheet April 30, 1946

Reserve for fire and accident insurance			$ 66,500
Capital stock:			
Preferred, par value $10 per share			
Authorized and issued	10,000 shares	$ 100,000	
Less—in treasury	500 shares	5,000	
	9,500 shares	95,000	
Common, no par value			
Authorized 100,000 shares			
Issued 65,000 shares of a declared value of		269,000	364,000
Capital surplus:			
Premium on 9,500 preferred shares outstanding		$ 47,500	
Surplus arising from resales of preferred treasury stock		8,300	
Surplus donated		134,000	189,800
Earned surplus:			
Appropriated as reserve for postwar rehabilitation		$1,500,000	
Unappropriated		2,695,100	4,195,100
			$4,815,400

Comments on solution:

The income-tax deficiency of the previous year has been charged to income of the current year. The amount of the deficiency in relation to the amount of the income of the current year makes this treatment desirable.

The addition to the reserve for postwar rehabilitation for the current year in the amount of $500,000 has been charged to earned surplus and the accumulated reserve of $1,500,000 has been treated as appropriated earned surplus. It is not appropriate to charge income for "possible but unknown future contingencies."

The increase in the "Reserve for fire and accident insurance" has been left as a charge to income in conformity with common practice. Such a reserve created by a charge to income may properly be charged with the fire loss. An acceptable alternative treatment for the solution of this problem would be to make a correcting entry charging surplus and crediting income for the addition to the reserve. If such correction is made, the fire loss of $3,500 in the accounts is properly chargeable against income. The latter treatment should be recommended but it is not necessary to make a correcting entry when the first procedure has been followed. If the correcting entries are made charging the increase to surplus and the loss to income, the reserve should be reflected under earned surplus. The problem calls for a reserve section and where an acceptable alternative treatment permits classification of an item in a reserve section such classification should be used.

No. 2

PREP SCHOOL

Work Sheet—Year Ended June 30, 1946

GENERAL FUND

	Balances July 1, 1945	Transactions for Year Ended June 30, 1946 Dr.	Cr.	Balance Sheet June 30, 1946
Debits:				
Cash	$ 1,000	(3) $128,250	(7) $136,500	
		(4) 12,000	(18) 5,000	
		(8) 4,400		
		(12) 22,500		$26,650
Tuition receivable	12,500	(2) 142,500	(3) 128,350	
			(4) 12,500	14,150
Due from endowment fund		(1) 5,000	(12) 22,500	
		(9) 500		3,500
Investments	4,000	(11) 20,500	(8) 4,000	
Stores	15,000		(6) 1,500	13,500
Expenditures		(3) 100		
		(4) 500		
		(5) 135,000		
		(6) 1,500		
		(18) 5,000	(23) 142,100	
	$ 32,500			$ 57,800
Credits:				
Accounts payable	$ 3,500	(7) 136,500	(5) 135,000	$ 2,000
Revenues		(23) 163,900	(2) 142,500	
			(8) 400	
			(9) 500	
			(11) 20,500	
Unappropriated surplus	29,000	(23) 142,100	(1) 5,000	
			(23) 163,900	55,800
	$ 32,500			$ 57,800

Plant Fund

	Balances July 1, 1945	Transactions for Year Ended June 30, 1946 Dr.	Cr.	Balance Sheet June 30, 1946
Unexpended				
Debits:				
Cash	$ 2,000	(14)$ 50,000	(16)$ 31,500	
		(17) 47,000	(22) 1,500	
		(19) 4,500		$ 70,500
Alumni subscriptions	8,000	(13) 65,000	(17) 8,000	
			(17) 39,000	26,000
	$ 10,000			$ 96,500
Credits:				
Contracts payable—retained percentage			(16) 3,500	$ 3,500
Bonds payable—5%			(14) 50,000	50,000
Accrued interest on bonds			(14) 1,250	1,250
Accounts payable—subscription campaign	$ 1,000	(22) 1,000		
Reserve for encumbrances		(16) 35,000	(15) 70,000	35,000
Unencumbered balance	9,000	(14) 1,250	(13) 65,000	
		(15) 70,000	(19) 4,500	
		(22) 500		6,750
	$ 10,000			$ 96,500
Expended				
Debits:				
Construction in progress		(16) 35,000		$ 35,000
Educational plant	$900,000	(18) 5,000	(19) 4,000	901,000
	$900,000			$936,000
Credits:				
Financed by:				
Endowment fund	$600,000			$600,000
Tuition fund	50,000	(19) 4,000	(18) 5,000	51,000
Alumni subscriptions	200,000		(16) 35,000	235,000
Grants from state and local governments	50,000			50,000
	$900,000			$936,000

Endowment Fund

	Balances July 1, 1945	Dr.	Cr.	Balance Sheet June 30, 1946
Debits:				
Cash—current	$ 5,000	(9)$ 500	(12)$ 22,500	$ 3,500
		(11) 20,500		
Cash—principal	40,000	(9) 27,000	(10) 50,000	17,000
Investments	250,000	(10) 50,000	(9) 25,000	275,000
	$295,000			$295,500
Credits:				
Endowment fund balance	$290,000		(9) 2,000	$292,000
Due to general fund	5,000	(12) 22,500	(9) 500	
			(11) 20,500	3,500
	$295,000			$295,500

Student Loan Fund

	Balances July 1, 1945	Dr.	Cr.	Balance Sheet June 30, 1946
Debits:				
Cash	$ 1,000	(21) 4,000	(20) 3,500	$ 1,500
Student loans	3,500	(20) 3,500	(21) 3,800	3,200
	$ 4,500			$ 4,700
Credits:				
Loan fund balance	$ 4,500		(21) 200	$ 4,700

EXPLANATION OF ENTRIES:

(1) To record the amount due by endowment fund to general fund.

(2) To record tuition receivable as follows:

150 students at $1,000 each		$150,000
Less:		
6 full scholarships	$6,000	
3 partial scholarships	1,500	7,500
		$142,500

(3) To record collection of current tuition and charge off uncollectible current tuition.

(4) To record collection of tuition for prior periods and charge off uncollectible tuition.

(5) To record accounts payable for operating expenses and supplies.

(6) To adjust stores inventory to the balance at June 30, 1946.

(7) To record cash payment of accounts payable.

(8) To record sale of general fund investments and collection of accrued interest thereon.[1]

(9) To record sale of endowment fund investments and collection of accrued interest thereon.

(10) To record purchase of endowment fund investments.

(11) To record collection of interest on endowment fund investments.

(12) To record transfer of cash from endowment fund to general fund.

(13) To record subscriptions received from alumni for erection of new dormitory.

(14) To record issuance of bonds for cash and the accrual of six months' interest thereon.

(15) To record contract for construction of dormitory.

(16) To record construction in progress, payment on portion of contract, and retained percentage.

(17) To record collection of alumni subscriptions.

(18) To record payment out of general fund for construction of bleachers.

(19) To record collection of insurance on riding stable destroyed and removal of cost of asset from plant account.[2]

(20) To record student loans made.

(21) To record collection of student loans and interest thereon.

(22) To record payment of subscription campaign expenses.

(23) To close expenditures and revenue accounts in general fund to unappropriated surplus.

[1] Interest on bonds accrued prior to July 1, 1945, and collected when bonds were sold on July 1, 1945, has been credited to revenue. There is some authority for a credit to unappropriated surplus because it represents revenue of a prior period.

[2] The insurance proceeds received on destruction of the riding stable by fire were recorded in the plant fund. Since the stables will not be replaced, it is possible that the money will be returned to the general fund from which the original construction was financed. In the absence of specific action by the governing board, such a transfer is not made.

Theory of Accounts

November 7, 1946, 9:00 a.m. to 12:30 p.m.

GROUP I

No. 1

A composite rate is one based on the average life of an entire plant or a broad group of assets assembled to perform a particular service. It permits a single rate to be applied to the total investment in depreciable assets of varying useful lives.

Example:

Group	Original Cost	Salvage Value	Cost Less Salvage	Life Expectancy	Depreciation Per Year
A.........	$ 12,000	$ 1,000	$11,000	5 years	$2,200
B.........	50,000	7,000	43,000	10 years	4,300
C.........	40,000	2,500	37,500	15 years	2,500
	$102,000	$10,500	$91,500		$9,000

$$\text{Composite life} = \frac{\$\ 91,500}{\$\ \ 9,000} = 10.167 \text{ years}$$

$$\text{Composite rate} = \frac{\$\ \ 9,000}{\$102,000} = 8.82\%$$

No. 2

Control—Manufacturing Expense

*Subsidiary ledger accounts

(1) Indirect labor
(2) Superintendence
(3) Depreciation—buildings
(4) Depreciation—machinery, equipment and tools
(5) Patent expiration expense
(6) Factory supplies
(7) Insurance on factory buildings and equipment
(8) Factory rent
(9) Property taxes on factory buildings and equipment
(10) Heat, light, and power
(11) Repairs to factory buildings
(12) Repairs to machinery and equipment

Control—Selling Expense

*Subsidiary ledger accounts

(1) Salesmen's salaries
(2) Deliverers' salaries
(3) Salesmen's commissions
(4) Salesmen's travel
(5) Depreciation of delivery equipment
(6) Delivery expense
(7) Advertising expense
(8) Telephone and telegraph

Control—General Expense

*Subsidiary ledger accounts

(1) Officers' salaries
(2) Office salaries
(3) Depreciation—furniture and fixtures
(4) Office supplies
(5) Stationery and printing
(6) Insurance
(7) Office rent
(8) Bad debts
(9) Postage

*Only seven accounts required

No. 3

(a) The information for the journal entry would be obtained from the following sources:

1. General ledger of the partnership and agreement between the corporation and the partners.
   a. Items and amounts of assets of the partnership.
   b. Items and amounts of liabilities and reserves of the partnership.
2. Corporate charter.
   a. Number of shares authorized.
   b. Description of the capital stock of James & Jones, Inc.

(b) JAMES & JONES, INC. JOURNAL

January 1, 1946

Cash	$12,000	
Accounts receivable	30,000	
Inventory of merchandise	60,000	
Store fixtures and equipment	12,500	
Delivery equipment	4,000	
Office equipment	1,500	
Prepaid insurance	300	
Accounts payable		$ 15,000
Accrued wages		100
Accrued payroll taxes		200

Reserve for depreciation—store fixtures and equipment	3,000
Reserve for doubtful accounts	600
Reserve for depreciation—delivery equipment	900
Reserve for depreciation—office equipment	500
Capital stock, 10,000 shares, no par value, stated at $10 per share	100,000

To record the issuance of 10,000 shares, the entire authorized stock of the corporation, to Mr. —— James and to Mr. —— Jones, and to record the acquisition of assets as above in consideration for the stock issued and assumption of liabilities. See articles of incorporation and minutes of meetings of stockholders and directors relative to organization of James & Jones, Inc., and acquisition of assets and business.

No. 4

1. Current assets to current liabilities
2. Cash, temporary investments and receivables to current liabilities
3. Net worth to fixed assets
4. Net worth to current debt
5. Net worth to total debt
6. Average collection period for accounts receivable
7. Gross profit to net sales
8. Net profit to net sales
9. Advertising expense to net sales
10. Net income to net worth
11. Net profit to net working capital
12. Net sales to inventory

No. 5

ABC PRODUCTS
Comparative Statement of Value, at Sales Prices of Products Produced, Production Costs, and Indicated Gross Profit For the Three Months Ended March 31, 1945, and March 31, 1946

	Three months ended March 31						
	1945			1946			
	Amount	% of Prod. Costs	% of Sales Value	Amount	% of Prod. Costs	% of Sales Value	Increases (Decreases) from 1945
Value, at sales prices, of finished products produced	$450,000		100	$562,000		100	$112,000
Production costs:							
Direct material used	$112,450	29	25	$153,000	40	27	$ 40,550
Direct labor expended	225,000	57	50	164,000	43	29	(61,000)
Factory overhead	56,250	14	12.5	67,000	17	12	10,750
Total of production costs	$393,700	100	87.5	$384,000	100	68	($ 9,700)
Indicated gross profit	$ 56,300		12.5	$178,000		32	$121,700

As shown by the above statement, the indicated gross profit increased by $121,700 or from $56,300 in the three months ended March 31, 1945, to $178,000 in the three months ended March 31, 1946. This increase resulted from an increase of $112,000 in the value of finished products produced, at sales prices, plus a decrease of $9,700 in production costs.

The increase in the ratio of factory overhead to direct labor (an increase from 25% to approximately 41% resulted principally from a decrease of $61,000 in direct labor expended, and to a minor extent from the increase of $10,750 in the overhead cost.

In total the production costs *decreased* from 87.5% of sales value of finished products for the three months ended March 31, 1945, to 68.3% for the corresponding three months in 1946.

Note by Editor. Other forms of tabulation would probably be acceptable, provided that they brought out the essential facts of increase of gross profit, and gave information as to how the increase is constituted. The question does not really require the explanatory material which follows the tabulation.

GROUP II

No. 6

The accounts needed to provide control over budget operations of a city through the general accounting system are the following, all of which are required in each revenue fund:

1. *Estimated Revenues.* This account is debited at the beginning of the period with budget estimates of revenues for the ensuing period. In the preparation of any balance-sheet of the fund during the period the unrealized balance of estimated revenue is included as a resource of the fund. At the end of the fiscal period the account is closed to unappropriated surplus.

2. *Appropriations.* This account is credited at the beginning of the fiscal period with the amount appropriated in the budget. In the preparation of the balance-sheet during the fiscal period the unexpended balance of appropriations is shown as a liability of the fund, less encumbrances outstanding at that date. At the close of the fiscal period the account is closed to unappropriated surplus.

3. *Encumbrances.* The estimated costs of all orders and contracts are debited to encumbrances and credited to a reserve for encumbrances. When bills covering encumbrances are approved for

payment a reversal entry is made in the encumbrance accounts and at the same time the expenditures account is charged for the actual amount of bills and accounts payable or cash credited. In the preparation of the balance-sheet the balance of encumbrances is deducted from the appropriations account balance.

4. *Reserve for Encumbrances.* This is a contra account for encumbrances. The estimated costs of all orders and contracts are credited to it. These same costs are debited to the account when the encumbrance terminates through cancellation of orders and contracts or through receipt of the goods and services for which the orders or contracts were placed. The balance of the account representing the obligations for outstanding orders and contracts is shown in a balance-sheet as a liability of the fund.

5. *Revenue.* Realized revenues are credited to this account. In closing, this account is debited and the credit may be entered directly to unappropriated surplus or to estimated revenue.

6. *Expenditures.* This account is debited with actual expenditures. It is closed directly to unappropriated surplus or to appropriations.

7. *Unappropriated Surplus.* Estimated revenue is credited to this account and appropriations are charged to it. It is also debited or credited with other items increasing or decreasing surplus. Balances of estimated revenue and appropriations at the close of the fiscal period and of actual revenue and actual expenditure accounts are closed into it. The balance during the period indicates the estimated surplus of revenue over expenditures. The balance at the end of the year indicates actual surplus of the fund.

No. 7

1. *Reserves and Charge-offs.* Method 1 (a) is recommended. In the case of this company which has a large number of relatively small sales transactions, it is practicable to give effect currently to the probable bad-debt expense. Whenever practicable, it is advisable to accrue probable bad-debt charges and apply them in the accounting periods in which the related sales are credited. If the percentage is based on actual long-run experience the reserve balance is usually adequate to bring the accounts receivable in the balance-sheet to realizable values. However, the method does not preclude a periodic review of the accounts receivable for the purpose of estimating probable losses in relation to the reserve balance and adjustment for an inadequate or excessive reserve.

2. *Collection Expenses.* Method 2 (b) is recommended. In the case of this company, where bad-debt expense is evidently a relatively large item of expense, it is advisable to have the bad-debt expense account show the full amount of expense relating to efforts to collect and failure to collect balances receivable. The method also has the advantage of deducting anticipated collection expense in the year related revenue is taken into the income account and is consistent with an accrual basis of accounting.

3. *Recoveries.* Method 3 (c) is recommended. This method treats the recovery as a correction of a previous write-off. It produces a reserve account that reflects the net experience with bad debts. The method must be used if net losses after recoveries have been the basis for computing the precentage of sales which is used in making provision for anticipated bad debts. Method (a) might be acceptable if the provision for bad debts were based on experience with losses without considering recoveries, but in this case it would be advisable to use one account with a specific designation rather than the broad designation "other income" since the recoveries apparently are frequent.

No. 8

(a) Such intangibles may be carried continuously at cost unless and until it becomes reasonably evident that the term of existence of such intangibles has become limited, or that they have become partially or completely worthless.

(b) 1. Goodwill
2. Trade name
3. Secret process
4. Perpetual franchise
5. Organization costs
6. Subscription lists

(c) A leasehold improvement may be written off over a period less than the life of the lease if the useful life of the improvement is less than the remaining life of the lease.

(d) If the advance rentals represent the present value of periodical rentals the write-off should be such as to retain in the account at the end of any period the present value of the periodical rentals for the remaining period of the lease. If interest was not a factor in the determination of the advance rental a straight-line basis of amortization is preferable. Incurred charges should also be written off on a straight-line basis.

No. 9

(1) A deduction from an asset. This type of reserve reduces an asset to its realizable value or represents the amount of amortization.

(2) A liability. This type of reserve represents debts the amount of which may be estimated but not definitely measured.

(3) A contingent liability or a contingent reduction in the amount of an asset. This type of reserve may represent estimates of losses of varying degrees of probability and accordingly may be treated as liabilities, in a reserve section or as appropriated surplus.

(4) An appropriation of surplus. This reserve is created by a debit to earned surplus and remains as appropriated earned surplus. It serves as a restriction of dividends.

(5) Unrealized profit. This type of reserve reflects unrealized increments arising through appraisals of assets at amounts in excess of the cost or other basis conventionally used for such assets.

No. 10

In the consolidated balance-sheets the excess of the amount paid for the subsidiary's stock over the equity in net assets of the subsidiary based on its books of account at the date of purchase may be

(a) Carried as "Excess of cost of stock of subsidiary over subsidiary's book value at date of purchase."

(b) The excess may be eliminated from the consolidated balance-sheet by a charge against surplus, if such a charge is authorized by the directors of the parent company.

(c) If the excess was paid for goodwill or other specific intangibles, it may be carried accordingly.

(d) If the excess was paid because of current values of tangible assets in excess of the subsidiary's book value, the excess may be included in the total tangible assets.
It is advisable to show in a footnote to the balance-sheet, the accounting treatment of the excess.

No. 11

Current Assets:

- Cash in bank and on hand
- U. S. government securities
- Accrued interest on U. S. government securities
- Notes receivable
- Accounts receivable
  - U. S. government contracts
  - Regular accounts (less reserve for doubtful accounts)
  - Amounts due on installment accounts in 1946
  - Amounts due on installment accounts in 1947 to October 31st
- Inventories
  - Finished goods
  - Work in process
  - Raw materials (less reserve)

Current Liabilities:

- Notes payable
- Accounts payable
- Accrued payroll
- Accrued interest on bonds and notes payable
- Officers' 1946 bonus
- Provision for federal income taxes
- Preferred stock dividend payable November 1, 1946
- Customers' advances (on contracts to be completed in 1947)
- 5% 1st mortgage bonds redeemable in 1946 and redemption premium thereon
- Reserve for renegotiation of U. S. government contracts

Borderline Classifications:

1. U. S. government securities are assumed to be a temporary investment of current funds.

2. U. S. government contracts are assumed to be collectible within a year (Some authorities specify two years as an outside limit).

3. Inventory of operating parts and supplies may be shown as a current asset. This classification is frequently used on the basis that such prepaid expense is realized currently through sales of products.

4. The nature of the contingencies would determine the classification. The account might be a current liability.

5. Reserve for renegotiation of U. S. government contracts is classified as a current liability on the assumption that the contract has been completed and the amount of liability definitely determined.

No. 12

(a) Plant and equipment	$250,000	
Surplus arising from revaluation of plant and equipment		$250,000
To set up the excess of appraisal value over book value in accordance with appraisal made by the Blank Appraisal Co. as of July 1, 1945 (see their report in general files), per resolution of Board of Directors dated November 5, 1945		
(b) Depreciation of plant and equipment	$ 31,250	
Reserve for depreciation of plant and equipment		$ 31,250
To set up allowance for depreciation of plant and equipment for the year ending December 31, 1945, at a composite rate of 5% per annum calculated as follows:		

one-half of 5% of $500,000	$12,500
one-half of 5% of $750,000	18,750
	$31,250

NOTE: Full credit would probably be given if the candidate indicated that "depreciation on appreciation" has been the subject of much controversy, and if he also included an entry that credited the surplus account with an amount representing the difference between the amount of depreciation so calculated and the corresponding amount based on *cost* of the assets involved, the off-setting charge for this difference being made to "surplus arising from revaluation" or to a similar account. (See American Institute of Accountants *Accounting Research Bulletin* No. 5)

Accounting Practice—Part II

November 7, 1946, 1:30 to 6:00 p.m.

No. 1

(a) Computation of inventory loss:

Merchandise inventory at November 1, 1945 plus purchases from November 1, 1945, to February 28, 1946			$106,836.38
Unrecorded purchases on account at March 20, 1946			17,100.60
Cash purchases from March 1 to March 20, 1946			15,267.82
			$139,204.80
Less purchase returns and allowances:			
Cash receipt on March 2		$ 200.25	
Estimated allowance on claims filed—50% of $2,503.72		1,251.86	1,452.11
Beginning inventory plus net purchases			$137,752.69
Less estimated cost of sales:			
Sales from November 1, 1945, to February 28, 1946		$ 59,977.39	
Sales from March 1 to March 20, 1946:			
Accounts receivable at March 20, 1946, acknowledged	$52,876.45		
Estimated accounts receivable not acknowledged	10,000.00		
Estimated accounts receivable at March 20, 1946	$62,876.45		
Add collections March 1 to March 20, 1946	20,729.39		
	$83,605.84		
Accounts receivable, February 28, 1946	53,483.82	30,122.02	
Total sales from November 1, 1945 to March 20, 1946		$ 90,099.41	
Less gross profit—47% (see Schedule below)		42,346.72	47,752.69
Estimated merchandise inventory at March 20, 1946			$ 90,000.00
Less:			
Insurance proceeds		$ 50,000.00	
Sale of salvage		18,085.70	68,085.70
Loss on merchandise inventory			$ 21,914.30

Computation of average gross profit of prior years:

	Year Ended October 31, 1944	1945
Net sales	$160,500	$170,400
Cost of sales		
Inventory at beginning of year	$ 69,250	$ 70,485
Net purchases	89,510	74,030
	$158,760	$144,515
Inventory at end of period	70,485	57,611
	$88,275	$ 86,904
Gross profit on sales	$ 72,225	$ 83,496
Per cent of gross profit to sales	45%	49%

Average per cent of gross profit to sales—47%

(b) Journal entries to record transactions, March 1 to March 20

(1)		
Merchandise	$ 17,100.60	
Accounts payable		$ 17,100.60
To record accounts payable at March 20, 1946		
(2)		
Merchandise	15,267.82	
John Pyx, drawings	7,657.01	
Cash in bank		22,924.83
To record cash disbursements		
(3)		
Cash in bank	20,929.64	
Merchandise		200.25
Customers		20,729.39
To record cash receipts		
(4)		
Customers	20,122.02	
Fire loss	10,000.00	
Sales		30,122.02
To record sales from March 1, to March 20, 1946,		

Computed as follows:

Accounts receivable at March 20, 1946 acknowledged by customers	$52,876.45
Estimated accounts receivable not acknowledged	10,000.00

Total	$62,876.45
Collections on account, March 1 to March 20	20,729.39
	$83,605.84
Accounts receivable, February 28, 1946	53,483.82
Sales, March 1 to March 20.......	$30,122.02

(5)

Expenses	$1,000.00	
Reserve for uncollectible accounts..........		$1,000.00
To set up reserve for estimated uncollectible accounts		

(6)

Accounts payable	1,251.86	
Merchandise		1,251.86
To record estimated amount of allowance on returned merchandise		

(7)

Merchandise inventory	90,000.00	
Merchandise		90,000.00
To record estimated merchandise inventory at March 20, 1946		

(8)

Expenses	404.18	
Reserve for depreciation..................		404.18
To record depreciation as follows:		

Annual depreciation	
November 1, 1945 balance	
$10,243.26 @ 10%............	$1,024.36
Additions $300 @ 5%........	15.00
	$ 1,039.36
Monthly depreciation	$ 86.61
4-2/3 months' depreciation.....	$ 404.18

(9)

Salvaged merchandise	18,085.70	
Due from insurance company..................	50,000.00	
Fire loss	21,914.30	
Merchandise inventory		90,000.00
To record salvaged merchandise, fire loss and amount due from insurance company		

(10)

Salvaged fixtures	200.00	
Reserve for depreciation	9,076.95	
Due from insurance company	500.00	
Fire loss	766.31	
Fixtures		10,543.26
To record salvaged fixtures, fire loss and amount due from insurance company		

(11)

Expenses	147.00	
Petty cash		147.00
To record expenses paid from petty cash		

(12)

John Pyx, drawings	10,465.18	
John Pyx, capital		10,465.18
To set up drawings from November 1, 1945 to February 28, 1946		

Capital at November 1, 1945	$140,716.38
Capital at February 28, 1946	130,251.20
Drawings	$ 10,465.18

(c)

JOHN PYX, WORK SHEET

Account	Trial Balance February 28, 1946 Dr.	Trial Balance February 28, 1946 Cr.	Transactions and Adjustments March 1-20, 1946 Dr.	Transactions and Adjustments March 1-20, 1946 Cr.	Profit and Loss Nov. 1, 1945 to Mar. 20, 1946 Dr.	Profit and Loss Nov. 1, 1945 to Mar. 20, 1946 Cr.	John Pyx, Capital Dr.	John Pyx, Capital Cr.	Balance-Sheet March 20, 1946 Dr.	Balance-Sheet March 20, 1946 Cr.
Cash in bank	$ 5,285.01		(3) $20,929.64	(2) $ 22,924.83					$ 3,289.82	
Petty cash	250.00			(11) 147.00					103.00	
Customers' accounts	53,483.82		(4) 20,122.02	(3) 20,729.39					52,876.45	
Reserve for uncollectible accounts				(5) 1,000.00						$ 1,000.00
Due from insurance company			(10) 500.00							
			(9) 50,000.00						50,500.00	
Salvaged merchandise			(9) 18,085.70						18,085.70	
Fixtures	10,543.26			(10) 10,543.26						
Reserve for depreciation		$ 8,672.77	(10) 9,076.95	(8) 404.18						
Salvaged fixtures			(10) 200.00						200.00	
Accounts payable			(6) 1,251.86	(1) 17,100.60						15,848.74
Bank loan		$ 10,000.00								10,000.00
John Pyx, capital		130,251.20		(12) 10,465.18				$140,716.38		
John Pyx, drawings			(2) 7,657.01							
			(12) 10,465.18				$ 18,122.19			
Sales		59,977.39		(4) 30,122.02		$90,099.41				
Merchandise	106,836.38		(2) 15,267.82	(3) 200.25						
			(1) 17,100.60	(6) 1,251.86						
				(7) 90,000.00	$47,752.69					
Expenses	32,502.89		(11) 147.00							
			(5) 1,000.00							
			(8) 404.18		34,054.07					
Merchandise inventory, March 20, 1946			(7) 90,000.00	(9) 90,000.00						
Fire loss			(9) 21,914.30							
			(4) 10,000.00							
			(10) 766.31				32,680.61			
	$208,901.36	$208,901.36	$294,888.57	$294,888.57	$81,806.76	$90,099.41				
Net income for the period					8,292.65			8,292.65		
					$90,099.41	$90,099.41	$ 50,802.80	$149,009.03		
John Pyx, capital							98,206.23			98,206.23
							$149,009.03	$149,009.03	$125,054.97	$125,054.97

(d)

JOHN PYX
Statement of Proprietor's Equity
November 1, 1945 to March 20, 1946

Balance, November 1, 1945		$140,716.38
Add net income for period November 1, 1945 to March 20, 1946		8,292.65
		$149,009.03
Less fire loss, March 20, 1946	$32,680.61	
Drawings during November 1, 1945 to March 20, 1946	18,122.19	50,802.80
Balance, March 20, 1946		$ 98,206.23

Comments:

The solution requires asset and liability balances as at March 20, 1946, to be shown on a work sheet. Since the time of sale of the salvaged merchandise and fixtures is not stated in the problem and it is unlikely that the sales were made on the date of the fire, the amounts of salvage have been set up as "salvaged merchandise" and "salvaged fixtures."

In this solution claims against suppliers for returned merchandise have been recorded at the estimated recoverable amount and the net amount of the expected recovery has been credited to merchandise. It is stated in the problem that similar claims have been made in the past. There is no information to indicate that the amounts of gross returns have been credited to merchandise.

No. 2

X CONSTRUCTION CORPORATION
Statement of Application of Funds
Year Ended December 31, 1945

Funds provided			
From operations			
Net profit for 1945 (Shedule A)		$ 66,000	
Add:			
Addition to reserve for contingencies	$100,000		
Depreciation of plant and equipment (Schedule B)	45,000		
Amortization of bond discount	1,000		
Amortization of organization expense	6,000		
Deferred profit on contract	65,000	217,000	
		$283,000	
Deduct:			
Profit on sale of equipment	$ 42,500		
Undistributed earnings of B Company, a subsidiary, included in consolidated profit (Schedule C)	7,200	49,700	$233,300

From sale of equipment		277,500
		$510,800
Funds applied		
To purchase of additions to plant (Schedule B)		$220,000
To purchase of treasury stock		90,000
To payment of dividends		25,000
To increase insurance policy cash-surrender values (less loans)		15,050
To increase working capital:		
Increase in working capital (Schedule D)	$178,750	
Deduct postwar refund of excess-profits tax at December 31, 1944, reclassified as current asset at December 31, 1945	18,000	160,750
		$510,800

Schedule A

Net profit (before federal taxes) per books		$275,000
Deduct:		
Amortization of organization expense	$ 6,000	
Federal income and excess-profits taxes	203,000	209,000
Corrected net profit		$ 66,000

Schedule B

	Plant and Equipment	Reserve for Depreciation	Book Value
Balances, December 31, 1944	$1,050,200	$660,300	$389,900
Adjustments to restate accounts to agree with depreciated cost values established by Treasury Department as at January 1, 1945	110,150*	282,500*	172,350
Sale of equipment	354,000*	119,000*	235,000*
	$ 586,050	$258,800	$327,250
Balances, December 31, 1945	806,050	303,800	
Additions to plant and equipment and depreciation for the year	$ 220,000	$ 45,000	

* Subtract

Schedule C

Net profit of Company B	$ 20,000
Dividends paid by Company B	12,000
Profits retained by Company B	$ 8,000
X Construction Corporation's share of profits retained by Company B—90%	$ 7,200

Schedule D

		December 31		
	1944		1945	
Current assets per-balance-sheet...............		$613,750		$817,050
Deduct:				
Insurance policy cash-surrender values (less loans)	$10,000		$25,050	
Postwar refund of excess-profits tax..	18,000	28,000		25,050
Corrected current assets.......................		$585,750		$792,000
Current liabilities		508,400		535,900
Corrected working capital ....$		77,350		$256,100
Corrected working capital, December 31, 1945....................				$256,100
Corrected working capital, December 31, 1944....................				77,350
Increase in working capital......................................				$178,750

Comments:

Occasionally, in practice, insurance policy cash-surrender values are included as current assets. The treatment given in this solution is preferred.

The postwar refund of excess-profits tax was not negotiable at December 31, 1944, and therefore should not be classified as a current asset at that date. (See Accounting Research Bulletin No. 17)

Commercial Law

November 8, 1946, 9 a.m. to 12:30 p.m.

GROUP I

No. 1

(a) All profits and advantages gained by the agent in the execution of the agency belong to the principal, and it makes no difference whether the profit or advantage results from a strict performance or from a violation of the agent's duty.

(b) (1) An agent may not delegate specific duties except: (a) Where they are ministerial, (b) Where express authority to delegate is given by the principal, (c) Where implied authority to delegate is given by the principal, (d) Where necessity requires delegation, and (e) Where custom and usage permit delegation.

(2) The death of a principal terminates an agency by operation of law, except an agency coupled with an interest.

(3) An infant creating an agency makes a voidable contract which he may disaffirm.

(4) An infant may act as an agent, and the adult principal will be bound in all respects by his acts as if he were an adult agent. Infancy is a defense only to the infant.

(c) The insurance company should succeed. The authority given Harris involved the exercise of discretion by him and could not be delegated.

No. 2

(a) Yes, Carr can sue Burt for breach of the implied warranty that the seller had a right to sell the goods.

(b) Day sustains the loss. Canby can recover from Day. Section 22 (b) Uniform Sales Act states that where delivery has been delayed through the fault of either buyer or seller the goods are at the risk of the party at fault as regards any loss which might not have occurred but for such fault.

(c) Allen must obtain the negotiable bill of lading and deliver it to the carrier. Section 59 of the Uniform Sales Act, provides that if a negotiable document of title representing goods has been issued by the carrier, the carrier shall not be obliged to deliver the goods to the seller unless such document is first surrendered for cancellation.

No. 3.

(a) (1) "Treasury stock" is stock properly issued by and reacquired by a corporation. "Authorized but unissued stock" is stock which a corporation is authorized to issue under its charter but which has not been issued or sold.

(2) "Treasury stock" may be sold by the corporation for less than par. "Authorized but unissued stock" shall be issued and paid for in full at its par value, either in money, or in property, labor or services.

(b) (1) The declaration of a dividend from net earnings or surplus rests in the discretion of the board of directors and a court of equity will not interfere unless there has been an abuse of that discretion.

(2) Distribution of dividends is ordinarily within the sound discretion of the directors and a stockholder is not entitled thereto as of right until formal declaration is made, but a court of equity may compel distribution if there has been an abuse of discretion, indicated by an unreasonable accumulation, improper motives for accumulation, or other inequitable circumstances.

(c) Yes. The stockholders are liable to assessment to the extent of the unpaid balance of $25 due on each share of stock. A corporation may not issue its capital stock below the par value thereof. Upon insolvency the unpaid subscriptions may be assessed for so much as may be needed to pay the creditors not exceeding the balance due on each share.

(d) By statute in most jurisdictions, the directors of the corporation at the time of dissolution act as trustees of creditors and stockholders to settle the affairs of the corporation, unless a receiver or other person is specifically appointed by the court.

No. 4

(a) No. The note or bill itself is prima facie evidence that it is founded upon valuable consideration.

(b) No. The Uniform Negotiable Instruments Law provides that the sum payable is a sum certain within the meaning of the act although it is to be paid in installments, with a provision that upon default in payment of any installment or of interest, the whole sum shall become due, and even though it contains a provision that it shall be payable with costs of collection or an attorney's fee, in case payment shall not be made at maturity.

(c) The bank was right. Under the Uniform Negotiable Instruments Law a note made payable at a bank is treated as an order drawn on the account of the maker.

No. 5

(a) A tender is an offer or attempt to perform a contract coupled with a present ability of immediate performance. 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 running of interest, and entitles the promisor to recover costs of his defense in case he is sued thereon.

(b) Such impossibility does not discharge the promisor, even though he was not at fault, unless:
(1) the impossibility arises from a change in law;
(2) the subject matter is destroyed without fault of either party, and its continued existence is essential to the performance of the contract;
(3) the contract is for personal service and the promisor becomes incapacitated by reason of death or illness.

(c) Butler cannot maintain an action against Allen, unless the option given by Allen to Butler was supported by a valuable consideration. An offer which is not supported by a valuable consideration can be withdrawn at any time before acceptance, even though the offeror has promised to hold the offer open.

(d) The lessor was not justified in his refusal. Although the option may have been unilateral it was nevertheless supported by a valuable consideration, namely, the consideration arising out of the execution of the lease. Moreover, in most jurisdictions a promise under seal requires no consideration.

GROUP II

No. 6

(a) (1) In case of sale by sample there is

(a) An implied warranty that the bulk shall correspond with the sample in quality.

(b) The buyer shall have a reasonable opportunity of comparison except in c.o.d. transactions.

(c) If the seller is a dealer in such goods of that kind there is an implied warranty that the goods shall be free from any defects rendering them unmerchantable which would not be apparent on reasonable examination of the sample.

(2) Two of the most common documents of title are (1) bills of lading and (2) warehouse receipts.

(b) If Burt elects to sue for breach of warranty, the measure of damages is the difference between the actual value of the stock and the value it was represented to have. The book value is some evidence of this. If Burt elects to sue for deceit, the weight of authority approves the same measure of damages as for breach of warranty, but other jurisdictions measure damages by the "out-of-pocket rule"—that is, the difference between the value of the stock and the price Burt paid for it. Should Burt elect to rescind, returning the stock, he would be entitled to recover the amount he paid for it.

(c) No. Allen the seller cannot recover the price of the cotton from Burt. Where the parties purport to sell specific goods and the goods without the knowledge of the seller have wholly perished at the time the agreement was made the agreement is void.

No. 7

(a) (1) A will is an expression, in the manner required by law, for the disposition of a person's property at his death.

(2) A codicil is an addition or supplement to a will and is used either to add to, take from, or alter the provisions of the will.

(3) Wills and codicils take effect upon the death of the testator, and until that time may be altered or revoked at will, provided the intent and suitable act concur as provided by the laws of the testator's domicile.

(b) (1) Probate of a will is the process of proving the character and validity of an insrument to determine whether or not it is the will of the testator. This is done before the probate court having jurisdiction.

(2) Until a will is admitted to probate in a proper court it is wholly ineffectual as an instrument of title to the property of the deceased mentioned in the will.

(3) When a will has been admitted to probate and the statutory period for contesting the will has passed, it becomes established as the will of the deceased, and the proceedings are conclusive upon

the parties thereto and upon others who have been duly notified as to:

(a) the question of testamentary capacity,

(b) the absence of fraud or undue influence, and

(c) due execution of the instrument in accordance with the statutory requirements.

(4) The probate of a will ordinarily does not determine the validity of its provisions, or their legal effect or their construction.

(c) (1) The personal property of the testator is primarily liable for the payment of debts. This is so even though the debt may be secured by liens on real estate.

(2) Yes. A testator in his will may by specific language charge the payment of his debts upon the real estate or upon specific personal property. A mere statement in the will that the real estate shall be chargeable with debts is not sufficient to exonerate the personal property. The intention to exonerate must be clearly expressed.

(3) The claims of creditors duly proved must be paid before any distribution can be made to legatees of personal property, and if the personal property is not sufficient to satisfy claims of creditors recourse may be had to the testator's real estate.

No. 8

(a) Assuming sufficient income, federal income-tax returns must be filed for or by:

(1) The executor on behalf of John Doe, the deceased, personally.

(2) The executor for the estate of John Doe, and

(3) The trustee for the trust under the will of John Doe.

Each party named is a separate and distinct taxable entity.

(b) (1) Joint declarations may be filed by husband and wife if neither is a nonresident alien.

(2) No. A joint declaration may be filed even though one spouse has no gross income.

(3) If separate returns for the year are filed, the amounts paid on account of the estimated tax under a joint declaration for such year may be treated as payments on the tax liability of either the husband or wife or may be divided between them in any way they see fit.

(c) (1) All taxpayers are given an option to use the last-in, first-out method of valuing inventories.

(2) No. When the last-in, first-out method is used, the inventory must be taken at cost.

(3) No. An application for the change must be made to the Commissioner of Internal Revenue.

(4) The new method, once adopted, must be used for future years, unless the Commissioner authorizes or directs a change.

(d) Jones has no taxable gain on this transaction. When Jones purchased the bond he also purchased the right to exchange it for stock in the same corporation. The stock is treated as taking the place of the bond in this case.

No. 9

(a) When a surety pays the creditor, his right of contribution is not affected by the fact that the credior's claim against the principal and other sureties have been barred by the statute of limitations if the surety paying is liable to the creditor at the time he pays.

(b) Judgment for Carr. As Allen guaranteed the payment of rent by Burt under the lease he took the liability of all the conditions of that lease and the guaranty must be considered as a continuing one. Therefore, Allen the guarantor was liable.

(c) Allen can recover the $5,000 that he paid plus any expenses necessarily incurred in connection with the settlement. If a surety extinguishes a debt for less than the whole amount due, he can only recover what he actually paid as the contract between principal and surety is for indemnity only.

No. 10

(a) The railroad company sustains the loss. The shipper can recover from the company. The carrier is in effect an insurer of the goods it carries and is liable for the theft of the goods.

(b) (1) By accepting the goods for carriage C.O.D. the carrier assumes the responsibility to collect the amount due the consignor, on delivery of the goods.

(2) If the consignee refuses to accept and pay for the goods, it is generally held that the carrier fully performs his duty by notifying the consignor and holding the goods in storage subject to the consignor's order.

(3) If it delivers the goods but fails to collect the carrier is liable as for a conversion.

(4) The carrier may allow the consignor to inspect the goods before payment unless forbidden by the contract with the shipper.

(c) (1) The carrier has a right of action for the recovery of the goods or their value where they have been delivered to the wrong person.

The carrier by such delivery is liable to the consignor or the person entitled to possession of the goods for their value even though the delivery to the wrong person was due to mistake or fraud.

(2) A carrier is liable for damage caused by delivery of the goods at the wrong place. If the owner accepts the goods he releases the carrier from liability for damages occurring thereafter, but not from liability for damages already sustained.

No. 11

(a) No. One partner cannot, unless expressly authorized by all the partners, submit a partnership liability to arbitration.

(b) Judgment for Allen's children.
Allen's interest was (2) personal property.
Wife did not have dower right in the real estate.

A partnership interest in realty is personal property, and the partner's share upon distribution is personal property. Therefore, Allen's share would be outright by reason of his bequest to his children as personal property. The widow has no dower in personal property.

(c) In the absence of express agreement the personal representative of the last surviving partner has the right to wind up the partnership affairs. The adminstrator of White's estate would be entitled to the possession of all partnership property for the purpose of winding up.

No. 12

(a) No. When a check is certified a substituted contract is entered into under which the absolute liability of the bank is substituted in place of the drawer of the check.

(b) (1) A person is deemed to be an indorser when he places his signature upon an instrument otherwise than as maker, drawer, or acceptor unless he clearly indicates by appropriate words his intention to be bound in some other capacity.

(2) The following warranties are implied to all subsequent holders in due course by one who indorses without qualifications:

(a) That the instrument is genuine and in all respects what it purports to be;

(b) That he has good title to it;

(c) That all prior parties had capacity to contract;

(d) That the instrument is at the time of his endorsement valid and subsisting;

(e) That on due presentment, the instrument will be accepted or paid, or both as the case may be according to its tenor;

(f) That if the instrument is dishonored and the necessary proceedings on dishonor are taken, he will pay the amount thereof to the holder or to a subsequent indorser who may be compelled to pay.

(c) (1) A holder in due course is a holder who has taken the instrument under the following conditions:

(a) That it is complete and regular upon its face;

(b) That he became the holder of it before it was overdue, and without notice that it had been previously dishonored, if such were the fact.

(c) That he took it in good faith and for value.

(d) That at the time it was negotiated to him he had no notice of any infirmity in the instrument or defect in the title of the person negotiating it.

(2) A holder in due course holds the instrument free from any defect of title of prior parties and free from defenses available to prior parties among themselves, and may enforce payment of the instrument for the full amount thereof against all parties liable thereon.

Auditing

November 8, 1946, 1:30 to 5:00 p.m.

No. 1

(a) Oct. 31.	Purchases	$26,540	
	Vouchers payable		$26,540

To record the following purchases of merchandise on which title had passed at October 31, 1946, but which were not recorded until November, 1946:

Date of Invoice	Date Merchandise Received	Amount
October 30	October 31	$ 3,120
October 28	October 30	5,350
November 1	October 30	4,500
October 26	November 5	6,040
October 28	November 4	7,530
		$26,540

Nov. 1	Vouchers payable	26,540	
	Purchases		26,540

To reverse entry made on October 31, 1946, for purchases of merchandise on which title had passed but which were not recorded in the voucher register until November, 1946.

(b) The physical inventory taken at October 30, 1946, should be increased as follows to reflect the correct amount at October 31, 1946:

Date of Invoice	Date Merchandise Received	Inventory Amount
October 26	November 5	$ 3,975*
October 30	October 31	3,120
October 26	November 5	6,040*
October 28	November 4	7,530*
		$20,665

* Should be shown as merchandise in transit.

It is assumed that the merchandise billed on the first invoice listed was shipped on October 26, the date of the invoice.

No. 2

(a) Adjusting journal entries as at June 30, 1945:

(1)

Reserve for depreciation—equipment	$ 3,000	
Equipment		$2,700
Profit and loss on sale of equipment		300

To record adjustment for sale of Monotype Machine for $1,300 cash on February 10, 1945:

Original cost	$4,000
Depreciation to date of sale	3,000
	$1,000
Sales price	1,300
Profit	$ 300

(2)

Profit and loss on sale of equipment	30	
Reserve for depreciation—equipment	45	
Other income	15	
Equipment		90

To record adjustment for sale of 2 HP motor for $15 cash on March 3, 1945:

Original Cost	$90
Depreciation to date of sale	45
	$45
Sales price	15
Loss	$30

(3)

Machinery repairs—sorter (entry of March 14, 1945)	60	
Factory expenses—lubrication (entry of April 1, 1945)	85	
Factory supplies—ink (entry of April 9, 1945)	150	
Machinery repairs—painting (entry of May 4, 1945)	12	
Equipment		307

To remove from equipment account various items capitalized in error.

(4)

Reserve for depreciation—equipment	40	
Equipment		40

To adjust credit to equipment account, May 17, with respect to the amount of accumulated reserve on old shelves sold.

(5)

			Debit	Credit
Profit and loss on sale of equipment			128	
Reserve for depreciation—equipment			220	
Equipment				348

To record adjustment for sale of old shop lights on June 8, 1945:

Cost		$ 400	
Depreciation to date of sale		220	
		$ 180	
Sales price	$65		
Less commission	13	52	
Loss		$ 128	

(6)

Reserve for reconversion	$1,000	
Equipment		$1,000

To transfer to former account the amount of engineer's fee charged to equipment in error on June 15, 1945.

(7)

Reserve for reconversion	3,600	
Equipment		3,600

To transfer to former account the charge of June 30, 1945, representing estimated loss in profit during engineer's reconversion survey.

Other adjustments as of June 30, 1945:

The footing of the debit column is overstated by $2,985—
Correct amount is $750,665

The footing of the credit column is understated by $15—
Correct amount is $ 1,515

(b) Debits in equipment account at June 30, 1945		$750,665
Credits in equipment account at June 30, 1945		1,515
Balance in equipment account before adjustments		$749,150
Deduct adjustments 1	$2,700	
2	90	
3	307	
4	40	
5	348	
6	1,000	
7	3,600	8,085
Correct balance in equipment account at June 30, 1945		$741,065

NOTE: The use of one equipment account for the various classes of items which have been entered therein is subject to criticism but no attempt has been made to reclassify the items in appropriate accounts because of the lack of information as to the content of the balance at January 1, 1945.

No. 3.

(a)

1. Certificates may have been surrendered in exchange for others without attaching the surrendered certificates to the stub book.
2. The excess certificates may have been issued under proper authority for services or for property and not recorded in the financial books.
3. They may have been issued improperly in exchange for cash, services or property, or without consideration. The impropriety might result from oversight or from fraudulent design.
4. The error may have occurred by reason of which an item which should have been posted to the capital stock account was not in fact so posted.
5. An error may have occurred in entering on the certificate stub the number of shares issued.
6. Additional stock may have been issued near the end of 1945 but the cash received not recorded until 1946.

(b)

1. Make a quick inspection of open stubs to determine whether they provide a ready clue to the reason for difference, e.g., one certificate issued for 10,000 shares. If so, investigate the facts regarding its issue.
2. If a quick inspection fails to provide a clue, refer to a list of stockholders supporting the entries in the cash receipts book for the 72,000 shares originally sold. Check this list item by item against stubs for shares originally issued and mark the stubs so checked. Then check returned certificates attached to stubs against new stubs issued in exchange for those certificates, marking the new stubs. Prepare a list of unmarked stubs. This should total 10,000 shares and serve to identify the outstanding certificates with respect to which shares are not recorded in the general ledger.
3. If errors are found in the number of shares issued as shown by stubs in the stock certificate book after comparison with the cash receipts entries it may be necessary to circularize the original stockholdders to determine how many shares were actually issued.

   The cash receipts book and general journal for the first few days of 1946 should be examined for entries which may have been for stock issued late in 1945.

4. If it is found that excess shares have been issued, inquiry should be made of responsible officers with respect to the circumstances in which they were issued. The answers obtained should be substantiated by appropriate evidence, e.g., resolutions of Board, etc.

No. 4

The answer to this question is predicated on these assumptions:

1. Inventories and receivables are assumed to be material items.
2. It is assumed that the report is not to accompany financial statements to be filed with the Securities and Exchange Commission as a part of a registration statement.
3. It is assumed that the organization is not large enough to have an effective system of internal control.
4. It is assumed that an expanded scope of audit was followed because no reliance was placed on internal control.

(a) The report set forth in this question is deficient both in substance and in form.

The report is not dated or signed.

The reference to the examination of the report of Canadian subsidiary is not sufficient to relate that examination or the figures shown in the report of the Chartered Accountants to the consolidated financial statements.

The second paragraph indicates omissions of required audit procedures as to inventories and accounts receivable without any statement of the auditor's disapproval. The sentence covering the inclusion of liabilities is unnecessary if the auditor satisfied himself as to the correctness of the accounting records. In the absence of such assurance the auditor should have indicated a reservation in positive terms.

The declaration as to accounting principles and procedures followed should, in accordance with present standards of reporting, have been associated with the opinion. Moreover, by the use of the words "commonly accepted" a less definite meaning is implied than if "commonly" were omitted. If the use of this word and of the phrase "for the industry" was intended to weaken the general expression or to denote a reservation, that intention should have been expressed in more positive terms. If the auditor was satisfied as to the acceptability of the principles and procedures employed, the weakening word and phrase should have been omitted. The statement as to consistency of accounting principles and practices should, in any event, have been made to include consistency as between years and not solely the year itself.

Because of the limitations of financial statements of corporations in showing financial conditions and results of operations "correctly," the standard opinion form uses the adverb "fairly" instead of "correctly."

The auditor did nothing to satisfy himself as to the existence of the inventory or as to the basis of pricing, or as to mathematical computation, except for the summary. He did not confirm accounts receivable nor apparently even substitute some less acceptable procedure. A reservation with respect to these omissions of procedures involving material items would negate an opinion on the fairness of the financial statements. Therefore, no opinion should have been offered.

(b) The following form of report would be appropriate under the circumstances described:

(Date)

To the Board of Directors of
The ABC Corporation:

We have examined the consolidated balance-sheet of the ABC Corporation and its subsidiary as at March 31, 1946, and the consolidated statements of profit and loss and surplus for the year then ended, have reviewed the accounting procedures of the corporation and, without making a detailed audit of the transactions, have examined or tested the accounting records of the corporation and other supporting evidence by methods and to the extent we deemed appropriate, except that we did not verify inventories either as to quantity, price, or mathematical accuracy of detail, nor did we confirm accounts receivable balances. Otherwise, our examination was made in accordance with generally accepted auditing standards applicable in the circumstances and included all other procedures which we considered necessary.

We have examined and accepted the report of Chartered Accountants covering their audit of the corporation's subsidiary, a Canadian corporation. We have satisfied ourselves that the financial statements shown therein have been included properly in the consolidated financial statements. The net assets of the Canadian corporation represent less than ___ per cent of the consolidated net assets.

Our examination disclosed no irregularities nor violation of accepted accounting principles and procedures. However, by reason of the omission of accepted auditing procedures with relation to inventories, and accounts receivable, we are unable to offer an opinion as to the fairness of the consolidated financial statements.

(Signature)

No. 5

1. Credit balances should be studied to determine whether they should be treated as deductions from accounts receivable or should be included as liabilities.
2. The maturity dates of accounts receivable should be studied. Those maturing later than one year from the date of the balance-sheet are generally segregated and not shown as current assets.
3. Accounts receivable from stockholders, directors, officers, and employees, unless for ordinary and current trade purchases of merchandise, should be shown separately.
4. Deposits as security or guarantees or any other similar extraordinary items should be shown separately.
5. Accounts receivable from affiliated concerns, even though arising from transactions in the ordinary course of business, should be shown separately. Accounts with affiliated companies may be shown as current assets, investments, or otherwise as the circumstances justify. They may properly be included as current assets only if the debtor company has a satisfactory margin of current assets over current liabilities including such accounts.
6. Accounts receivable that have been hypothecated or assigned should be so shown on the balance-sheet.
7. Accounts receivable for merchandise out on consignment should be excluded from the schedule of accounts receivable. The merchandise represented thereby should be included in the inventory at its proper valuation.

No. 6

1. The auditor should satisfy himself with respect to the adequacy and effectiveness of the system of internal control over the issue and return of containers and the accounting therefor.

2. He should see to it that the amount billed customers for containers is not credited to sales, but to a liability account with an appropriate caption such as "Deposits on Returnable Containers."
3. He should satisfy himself that the total of accounts receivable, as shown on the balance-sheet, does not contain debit balances representing containers out less than three months. Such balances should have been offset against the "Deposits on Returnable Containers" account, or whatever other account has received credit for the containers at the time of billing.
4. He should satisfy himself that the "Deposits on Returnable Containers" account at the balance-sheet date represents only deposits actually paid on containers held less than three months and that it does not contain credit balances representing the price billed for containers out over three months. Such balances should have been credited in proper proportions to the "Container Inventory" account and to the "Profit on Container Sales" account.
5. He should verify by inspection or test inspection the inventory of containers on hand in the client's plant at the balance-sheet date.
6. He should satisfy himself that the container inventory at the balance-sheet date is valued at a figure not in excess of cost, and that the containers represented thereby are only those in the client's plant and those in the hands of customers less than three months. In this connection he should satisfy himself that containers sold, destroyed, broken or discarded have been removed from the account.

No. 7

1. The auditor should require that the cashier witness his count. He should obtain a receipt from the cashier for the return of the fund after completion of the count.
2. The auditor should count the cash and prepare a descriptive list thereof. Rolls of coin are seldom opened and counted in detail in the absence of any suspicion of irregularity.
3. Petty cash vouchers, representing amounts expended from the fund since the date of the last reimbursement, should be examined critically and listed. The auditor should satisfy himself that they appear to be in order and that they bear the approval of a responsible officer. The auditor should see that a journal entry is made reducing the amount of the petty cash fund and charging the various expense accounts affected.
4. Checks on hand and included as part of the balance of the fund should be examined critically and listed. The auditor should sat-

isfy himself that none of them represents unauthorized advances or borrowings from the fund. In case of doubt, the items concerned should be reviewed with a responsible officer. The auditor should see that an entry is made transferring the amount of advances, I.O.U's, post-dated checks, etc., to accounts receivable or notes receivable accounts. Checks not post-dated should be traced through to deposit in the bank, and the auditor should see that these are included among the deposits shown in a bank statement obtained as of a later date.

5. The amount of cash, vouchers, checks, etc., examined and listed by the auditor should be totaled and the auditor should see that this total is $2,000. Any overage or shortage should be adjusted through an account usually designated "cash over and under."
6. The auditor should satisfy himself that the petty cashier does not have access to other liquid funds from which a shortage in the petty cash fund might have been reimbursed. Should such other funds be found to exist, they should be counted by the auditor and proved to whatever controls may exist before the petty cash fund is returned to the cashier.
7. The auditor should reexamine the petty cash at a later date and compare the composition of the fund with that at January 1st to see that no shortage exists which was temporarily covered at the earlier date.

No. 8

It is generally accepted as unethical practice for an accountant:

1. To advertise his professional attainments or services.
2. To directly or indirectly solicit the clients, or encroach improperly upon the practice of another public accountant.
3. To violate the confidential relationship between himself and his client.
4. To report to third parties as to the financial affairs of a client with respect to whom the auditor does not occupy an independent position.
5. To receive fees or commissions on work recommended or turned over to the laity; to allow participation in the fees or profits of professional work to the laity.
6. To engage in any business or occupation conjointly with that of a public accountant, which is incompatible or inconsistent therewith.
7. To offer employment to an employee of another public accountant without first informing such accountant.

ANSWERS TO EXAMINATIONS OF MAY 1947

Accounting Practice—Part I

May 14, 1947, 1:30 to 6:00 p.m.

No. 1

A COMPANY AND SUBSIDIARY, B COMPANY
CONSOLIDATING WORK SHEET
Year Ended December 31, 1945

Debits	Trial Balances A Company	Trial Balances B Company	Eliminations	Consolidated Income Statement	Consolidated Surplus	Minority Interest	Consolidated Balance Sheet
Cash	$ 545,200	$ 267,300					$ 812,500
Receivables, customers	187,000	375,400					562,400
War bonds	1,575,300	556,000					2,131,300
Inventories	398,200	146,800	(4) $ 12,900				532,100
Investment, B Company							
Bonds	198,000		(2) 18,000				180,000TB
Capital stock	300,000		(1) 283,500				16,500 G
Advances	226,600		(5) 226,600				
Investment, A Company Bonds		30,000					30,000TB
Fixed assets	2,311,000	714,700	(8) 20,000				3,005,700
Unamortized bond discount		2,700	(2) 2,430				270
Goodwill		90,000					90,000
Cost of sales	3,280,500	1,676,100	(3) 258,000	$4,695,100			
			(4) 3,500				
Selling and administrative expense	333,000	261,000		594,000			
Depreciation expense	184,000	42,600	(8) 600	226,000			
Interest expense	24,000	19,700	(5) 11,700	23,900			
			(6) 8,100				
Bond discount amortized		300	(2) 270	30			
Amortization of premium on B Company bonds owned	2,000		(2) 2,000				
Provision for income taxes	600,000	420,000		1,020,000			
Dividends paid	100,000	20,000	(7) 16,200		$100,000	$ 3,800	
	$10,264,800	$4,622,600	$863,800	$6,559,030	$100,000	$ 3,800	$7,360,770
Credits							
Accounts payable	$ 79,200	$ 69,500					$ 148,700
Accrued income taxes	624,800	431,400					1,056,200
Other accrued expense	10,000	4,000					14,000
Advances from A Company		226,600	(5) $226,600				
Reserve for bad debts	2,500	3,200					5,700
Reserve for depreciation	1,420,600	302,300	(8) 3,600				1,719,300
Reserve for postwar adjustments	1,000,000	445,000					1,445,000
First-mortgage 3% bonds	800,000						800,000
First-mortgage 4% bonds		200,000					200,000
Capital stock—A Company	1,000,000						1,000,000
Capital stock—B Company		200,000	(1) 162,000			$38,000	
Paid-in surplus	50,200						50,200

A COMPANY AND SUBSIDIARY, B COMPANY
CONSOLIDATING WORK SHEET
Year Ended December 31, 1945

Earned surplus—A Company	424,700		(1)	61,722		$323,278		
			(2)	22,700				
			(8)	17,000				
Earned surplus—B Company		90,200	(1)	59,778			14,022	
			(4)	16,400				
Sales	4,797,300	2,644,500	(3)	258,000	$7,183,800			
Interest—war bonds	20,400	5,000			25,400			
Interest—intercompany bonds	7,200	900	(6)	8,100				
Interest—advances to B Company	11,700		(5)	11,700				
Dividends received	16,200		(7)	16,200				
	$10,264,800	$4,622,600		$863,800	$7,209,200			
Less profit and loss debits					6,559,030			
					650,170			
Less minority interest in income of B Company—19% of $234,200 (book income of $230,000 plus excess of intercompany profit in inventory at December 31, 1944 over intercompany profit in inventory at December 31, 1945. See elimination 4)					44,498		44,498	
Consolidated net income for year ended December 31, 1945					$605,672	605,672		
						928,950	96,520	
Less surplus debits						100,000		
Consolidated earned surplus at December 31, 1945						$828,950		828,950
Less minority interest debits							3,800	
Minority interest at December 31, 1945							$92,720	92,720
								$7,360,770

TB—indicates treasury bonds G—indicates goodwill from consolidation

A COMPANY AND SUBSIDIARY, B COMPANY

ELIMINATIONS

(1) To eliminate 81% of B Company capital stock and surplus:

81% of $200,000 capital stock	$162,000
81% of $150,000 surplus at January 1, 1937	121,500
	$283,500
81% of $73,800 surplus at December 31, 1944 (book amount of $90,200 less intercompany profit in inventory of $16,400—see elimination 4)	$ 59,778
A Company's share of decrease in surplus from January 1, 1937 to December 31, 1944 not reflected on A Company's books	61,722
	$121,500

(2) To eliminate premium and discount on intercompany bonds:

90% of unamortized bond discount of $2,700	$ 2,430
90% of amortized bond discount of $300	270
Unamortized bond premium on books of A Company	18,000
Amortization of bond premium by A Company	2,000
Reduction in consolidated earned surplus	$ 22,700

(3) To eliminate intercompany purchases and sales

(4) To eliminate intercompany profit in opening and closing inventory of A Company:

	Cost to A Company	Eliminate B Company profit thereon—20%
Inventory, December 31, 1944	$82,000	$ 16,400
Inventory, December 31, 1945	64,500	12,900
Reduction in cost of sales		$ 3,500

(5) To eliminate intercompany advances and interest thereon

(6) To eliminate intercompany bond interest

(7) To eliminate intercompany dividends

(8) To eliminate intercompany profit in fixed assets:

Profit on sale of building by A Company on January 1, 1940—reduce fixed assets	$ 20,000
Depreciation for current year to be reduced by 3% of $20,000	600
Reserve for depreciation to be reduced by 18% (6 years at 3% per year) of $20,000	3,600
Earned surplus at December 31, 1944 to be reduced by 85% 28⅓ years remaining life of building from December 31, 1944 at 3% per year) of $20,000	17,000

Comments:

Alternative procedures in eliminating intercompany profits in inventory commonly found in practice are:

1. Eliminate the entire intercompany profit in the inventory against consolidated earned surplus without any reduction in the minority interest. (See *Contemporary Accounting,* Chapter 5, page 6, and Kester, *Advanced Accounting,* Fourth Edition, page 610.)
2. Eliminate the parent company's portion of the intercompany profit in the inventory against consolidated earned surplus and reflect in minority interest the minority's share of the profit. (See Finney, *Principles of Accounting,* Advanced, Third Edition, page 275.)

The procedure which eliminates the intercompany profit from consolidated earned surplus and minority interest is considered preferable by the editor of The Students' Department and is used in this solution. (See Moonitz, *The Entity Theory of Consolidated Statements,* page 86.)

No. 2

FARM EQUIPMENT COMPANY

TRANSACTIONS

June 1, to August 31, 1936

(1)

Cash receipts and disbursements per summary in problem

(2)

Accounts receivable	$ 9,500	
Sales		$ 9,500
To record sales on account from June 1 to June 16, 1946.		

(3)

6% mortgage due January 1, 1948	10,000	
Loss on sale of land and building	5,000	
Land and building		15,000
To record assumption of mortgage by purchaser of land and building and record loss on sale.		

(4)

Loss on sale of furniture, fixtures, trucks, etc.	9,950	
Furniture, fixtures, trucks, etc.		9,950
To record loss on sale of furniture, fixtures, trucks, etc.		

(5)

Loss on uncollectible accounts	14,550	
Accounts receivable		14,550
To record loss on uncollectible accounts.		

STATEMENT OF LOSS ON REALIZATION AND EXPENSES OF LIQUIDATION

June 1 to August 31, 1946

Sales of merchandise		$ 97,700
Less cost of merchandise sold		120,250
Loss on sale of inventory of merchandise		$ 22,550
Loss on sale of land and building		5,000
Loss on sale of furniture, fixtures, trucks, etc.		9,950
Loss on uncollectible accounts		14,550
Loss on realization of assets		$ 52,050
Expenses of liquidation:		
Auctioneer's commission and expenses	$2,850	
Interest on mortgage	50	
Officers and office salaries	5,100	
Salary of manager-bookkeeper	2,400	
Collection agency expenses	375	
Legal fees and expenses re liquidation	675	11,450
Loss on realization and expenses of liquidation		$ 63,500

CASH AVAILABLE FOR DISTRIBUTION AS LIQUIDATING DIVIDEND

August 31, 1946

Cash balance, August 31, 1946	$151,200
Number of shares outstanding	4,200
Liquidating dividend per share	$ 36

Stockholder	Number of Shares Owned	Amount Payable To Stockholders
A	1,600	$ 57,600
B	1,200	43,200
C	900	32,400
D	360	12,960
E	140	5,040
	4,200	$151,200

FARM EQUIPMENT COMPANY
WORK SHEET

	Balance-Sheet May 31, 1946		Transactions June 1, to August 31, 1946		Profit and Loss		Surplus		Balance-Sheet	
Cash	$ 36,750		(1) $142,200	(1) $ 27,750					$151,200	
Accounts receivable	33,500		(2) 9,500	(1) 23,500						
				(1) 1,250						
				(1) 3,700						
				(5) 14,550						
Inventory of merchandise	120,250				$120,250					
Furniture, fixtures, trucks, etc., less reserve	20,500			(1) 8,250						
				(1) 2,300						
				(4) 9,950						
Land and building, less reserve	30,000			(1) 15,000						
				(3) 15,000						
Accounts payable, including taxes		$ 15,600	(1) 15,600							
Accrued interest on mortgage		250	(1) 250							
Accrued payroll		450	(1) 450							
6% mortgage due January 1, 1948		10,000	(3) 10,000							
Capital stock (par $50)		210,000								$210,000
Surplus		4,700						$ 4,700		
	$241,000	$241,000								
Sales				(1) 5,850		$ 97,700				
				(1) 47,350						
				(1) 31,500						
				(1) 3,500						
				(2) 9,500						
Auctioneer's commission and expenses			(1) 2,850		2,850					
Interest on mortgage			(1) 50		50					
Officers and office salaries			(1) 5,100		5,100					
Salary of manager-bookkeeper			(1) 400		2,400					
			(1) 2,000							
Collection agency expenses			(1) 375		375					
Legal fees and expenses re liquidation			(1) 675		675					
Loss on sale of land and building			(3) 5,000		5,000					
Loss on sale of furniture, fixtures, trucks, etc			(4) 9,950		9,950					
Loss on uncollectible accounts			(5) 14,550		14,550					
			$218,950	$218,950	$161,200	$ 97,700				
Loss on realization and liquidation						63,500	$63,500			
					$161,200	$161,200	$63,500	$ 4,700		
Deficit, August 31, 1946								58,800	58,800	
							$63,500	$63,500	$210,000	$210,000

Theory of Accounts

May 15, 1947, 9:00 a.m. to 12:30 p.m.

GROUP I

No. 1

(a) Transactions which require the inclusion of unearned income on the balance-sheet are:
   1. Installment sales on which a portion of the profit is unrealized at the balance-sheet date.
   2. Collections of rent, interest, royalty payments, etc., which are applicable to future accounting periods.

(b) An unearned income account should be shown as a liability under the caption of deferred credits or current liabilities.

(c) The balance of an unearned income account should be reduced by periodic transfers to income as portions thereof are earned.

No. 2

1. Dividends should be recorded as soon as they have been declared by the board of directors.
2. No liability should be set up for purchase commitments unless a liability arises upon cancellation of the commitment by the prospective purchaser; in such a case the liability should be set up when it arises, i.e., at the time of cancellation of the contract to purchase.
3. A liability for goods purchased on credit should be recorded when title passes to the purchaser. If the terms of purchase are f.o.b. destination, title passes when the material purchased arrives; if f.o.b. shipping point, title passes when shipment is made by the vendor.
4. Officers' salaries should be recorded when they become due at the end of a pay period. Accrual of unpaid amounts should be recorded in preparing financial statements dated other than at the end of a pay period.
5. A special bonus to employees should be recorded when approved by the board of directors or person having authority to approve, if the bonus is for a period of time and that period has ended at the date of approval; if the period for which the bonus is applicable has not ended but a part of it has expired, it would

be appropriate to accrue a pro rata part of the bonus at the time of approval and make additional accruals of pro rata amounts at the end of each pay period.

No. 3

(a) Some accountants make no distinction between prepaid expenses and deferred charges and use the terms interchangeably to describe a variety of prepayments of expenses applicable to future accounting periods and postponements of extraordinary items which are set up as assets but will be charged to expense in future accounting periods. If a distinction is made it is generally based on the length of time over which the items will be charged to expense, short-term items being classified as prepaid expenses and long-term items being classified as deferred charges. Some accountants insist that a cost which does not provide a right to receive future service from an outside party but which will benefit future accounting periods should be labeled a deferred charge, whereas a cost which carries with it the right to future service from an outside party or a cost of inventoriable supplies should be labeled a prepaid expense.

(b) It is common practice to show prepaid expenses and deferred charges under a common heading for example, "prepaid expenses and deferred charges" as the last asset group of the balance-sheet. The practice of showing the short-term prepaid expenses as current assets is increasing.

No. 4

Journal Entries

PLAN 1

(a) Cash	$ 940,000	
Unamortized bond discount....................	60,000	
Bonds payable		$1,000,000
To record the issuance of $1,000,000 par value of 5%, 1st mortgage, 20-year bonds, due December 31, 1966, for cash at 94.		
(b) Bond discount expense	250	
Unamortized bond discount		250
To charge to expense the pro rata portion of discount on 5%, 1st mortgage, 20-year bonds, due December 31, 1966, for the month of..........., 19.....		

(c) Bonds payable	1,000,000	
Cash		1,000,000
To record payment, in cash, at par of the entire issue of 5%, 1st mortgage, 20-year bonds, due December 31, 1966.		

PLAN 2

(a) Cash	$1,000,000	
Bonds payable		$1,000,000
To record the issuance of $1,000,000 par value of 5%, 1st mortgage, 20-year bonds, due December 31, 1966, for cash at par.		
(b) Bond premium expense..................................	250	
Bond premium accrued..................................		250
To charge to expense the pro rata portion of premium payable at maturity on 5%, 1st mortgage, 20-year bonds due December 31, 1966, for the month of..........., 19.....		
(c) Bonds payable	1,000,000	
Bond premium accrued	60,000	
Cash		1,060,000
To record payment, in cash, at 106, of the entire issue of 5%, 1st mortgage, 20-year bonds, due December 31, 1966.		

No. 5

1. Capital surplus should be shown in the proprietary section immediately following capital stock.
2. Merchandise out on consignment should be shown among current assets under the heading of inventories.
3. Pension fund on deposit with a trustee should be shown among non-currrent assets under a separate heading or grouped with other similar funds and deposits.
4. Reserve for depreciation of plant and equipment should be deducted from the plant and equipment account.
5. Materials in transit should be shown among current assets under the heading of inventories.
6. Although it is common practice to show a self-insurance reserve on the liability side immediately preceding capital stock and surplus, it is better practice to show it as a segregation of earned surplus.
7. Reserve for doubtful accounts receivable should be deducted from accounts receivable.
8. Merchandise held on consignment should not appear on the consignee's balance-sheet except possibly as a footnote.

9. Intangible assets should be itemized in a section for intangible assets. They are occasionally shown in the fixed asset section.

10. The nature of the contingent liabilities and the amount, if determinable, should be shown in a footnote on the balance-sheet. If a reserve for contingencies is recorded it should be shown as a segregation of earned surplus.

GROUP II

No. 6

(a) 1. The inventory of raw materials would be overstated by the amount of the trade discount.

2. The accounts payable would be overstated by the amount of the trade discount.

3. If the accounts payable are paid, less trade discount, in advance of sale of corresponding goods, and the related trade discount is credited to income, the surplus would be overstated by the amount of such trade discount.

4. If the inventory is sold prior to payment of the corresponding accounts payable, and the related trade discount is included as a part of cost of goods sold, the surplus would be understated by the amount of such trade discount.

5. If the income for the period is incorrect, the liability for income taxes would be incorrect to the extent that the determination was based on incorrect data.

(b) 1. If an offsetting credit equal to the amount of the trade discount is not made to cost of goods sold in the accounting period when the goods are sold, the cost of goods sold would be overstated and the net income understated.

2. Overstatement or understatement of net income would result under the conditions outlined in answers 3, 4, and 5 above.

NOTE: The errors resulting from the indicated treatment of trade discounts would also result from a similar treatment of cash discounts, but since the amounts involved are small it is common practice to disregard such errors and treat cash discounts in the manner indicated in the question.

No. 7

(a) Inventory of merchandise may be subjected to the "gross-profit test."

(b)

Net sales	$100,000
Less estimated gross profit based on average of gross profit of profit of two or more prior accounting periods, for example, 24%	24,000
Cost of goods sold	$ 76,000
Inventory at beginning of period	$ 12,000
Purchases	80,000
	$ 92,000
Less cost of goods sold (above)	76,000
Estimated inventory at end of period	$ 16,000

The calculated inventory of $16,000 may be compared with an amount obtained by actual count to determine the accuracy of the count or whether all merchandise is accounted for. The method is also used to determine the inventory of merchandise lost by theft or destroyed by fire or other casualty if perpetual inventory records are not available.

No. 8

Under the last-in, first-out method the dollar amount of merchandise on hand at the end of any given period represents the cost of a quantity of merchandise equal to that on hand at the time of adoption of the method, at its inventory valuation at that time, plus increases since the date of adoption of the method, if there are such increased amounts held, at the cost in the earliest periods of acquisition of such increases.

In contrast, in using the first-in, first-out method, the cost of merchandise in inventory is computed at the cost of the most recent acquisitions.

No. 9

(a) Working capital is the excess of current assets over current liabilities.

(b) The "working capital ratio" is the ratio of current assets to current liabilities. It is commonly calculated by dividing the total of current assets by the total of current liabilities. The ratio is ordinarily stated in relation to 1. If the result of dividing current assets by current liabilities is 3, the working capital ratio would be stated as "3 to 1."

No. 10

(a) No.

(b) The sinking fund reserve is set aside out of surplus. It is not a charge against income. In arriving at net income a cost or an expense item for depreciation should have been deducted. On the other hand, sinking fund reserve charges are ordinarily made against surplus.

No. 11

(a) Consolidated financial statements are ordinarily prepared in cases where one business organization (usually a corporation) holds control of one or more other such organizations or where two or more business organizations are controlled by a single individual or group. The operations of the businesses should be similar. It is not considered appropriate to prepare consolidated statements for two or more businesses which are in entirely different fields such as a manufacturing concern and a bank.

(b) The purpose of preparing consolidated financial statements is that of showing the financial position and results of operation of two or more business organizations, which are under single control, as if they were a single enterprise.

No. 12

(a) The name of the partnership.
The names of the partners.
The amount of capital contributed by each partner.
The fiscal year of the partnership.
The methods of determining and dividing profits and losses.
Interest, if any, on partners' capital or overdrafts.
The accounting treatment of amounts withdrawn by partners.
The methods of accounting to be followed in case of liquidation of the partnership.

(b) The excess of the partner's withdrawals over his share of profits should be charged to his capital account.

Accounting Practice—Part II

May 15, 1947, 1:30 to 6:00 p.m.

No. 1

CONSTRUCTION CORPORATION

BALANCE SHEET

December 31, 1944

Assets

Current assets			
Cash			
In bank	$ 210,100.00		
On hand	10,000.00	$ 220,100.00	
Accounts receivable			
Contracts billed (including percentage retained of $110,000)	$ 425,000.00		
Contracts not billed	37,000.00	462,000.00	
Prepaid insurance		31,000.00	713,100.00
Postwar excess profits tax refund			32,000.00
Advance payments on machinery and equipment			40,000.00
Investment in subsidiary company			
Capital stock		$ 100,000.00	
Advances		9,666.67	109,666.67
Plant and equipment			
Land		$ 60,000.00	
Buildings	$ 240,000.00		
Machinery and equipment (including $110,000 completed, billed but not delivered)	1,555,000.00		
	$1,795,000.00		
Less: Reserve for depreciation	700,000.00	1,095,000.00	1,155,000.00
			$2,049,766.67

Liabilities and Capital

Current liabilities		
Notes payable to banks	$ 40,000.00	
Accounts payable—trade	290,000.00	
Estimated federal income and excess-profits taxes payable	301,466.67	
Sundry taxes payable	25,000.00	
Accrued expenses	22,500.00	$ 678,966.67

Long-term liabilities		
Purchase money mortgages due June 30, 1946		200,000.00
		878,966.67
Capital		
Capital stock	$ 125,000.00	
Paid-in surplus	275,000.00	
Earned surplus	770,800.00	1,170,800.00
		$2,049,766.67

CONSTRUCTION CORPORATION

Adjusting Journal Entries

(1)

Contract sales—billed revenues	$1,540,000.00	
Cost of contracts completed		$ 814,000.00
Cost of contracts in progress		305,000.00
Earned surplus, January 1, 1944		421,000.00

To record gross profit earned prior to January 1, 1944:

Portion of contract price earned prior to January 1, 1944:

Contract A—85% of $1,200,000		$1,020,000.00
Contract B—40% of $1,300,000		520,000.00
		1,540,000.00
Contract costs to January 1, 1944		
Contract A	$814,000	
Contract B	305,000	1,119,000.00
Profit		$ 421,000.00

(2)

Earned receivables—unbilled	37,000.00	
Contract sales—unbilled revenues		37,000.00

To record unbilled revenues as follows:

Total contract sales earned:

Contract A	100% of	$1,200,000..	$1,200,000.00
Contract B	54% of	1,300,000..	702,000.00
Contract C	35% of	900,000..	315,000.00
Contract D	100% of	500,000..	500,000.00
Contract E	100% of	450,000..	450,000.00
Contract F	100% of	240,000..	240,000.00
			$3,407,000.00
Amount in contract sales—billed revenues account			$3,370,000.00
Contract sales earned, but unbilled			$ 37,000.00

(3)

Cost of contracts in progress		38,333.33	
Advances to subsidiary company (Jones Sand Co., Inc.)			38,333.33
To credit 50 per cent of gross profit on Contract C after rent allowance to Jones Sand Co., Inc., as rent on equipment used:			
Portion of contract price earned 35% of $900,000	$ 315,000.00		
Cost incurred	200,000.00		
Profit before rent allowance	115,000.00		
Rent allowance—⅓	$ 38,333.33		

(4)

Earned surplus, January 1, 1944		$ 168,400.00	
Provision for federal income taxes			$ 16,933.33
Estimated federal income and excess-profits taxes payable			151,466.67
To set up correct federal income tax liability.			
Applicable to income earned prior to January 1, 1944—40% of $421,000	$ 168,400.00		
Applicable to income earned during 1944—40% of $332,666.67 (see below)	133,066.67		
Total tax liability	301,466.67		
Amount previously recorded	150,000.00		
Increase in tax liability	$ 151,466.67		
Provision for federal taxes on 1944 income per books	$ 150,000.00		
Correct provision for taxes on 1944 income	133,066.67		
Adjustment to provision for federal income taxes	$ 16,933.33		
Income for 1944 before federal income taxes			
Income credits from work sheet	$1,867,000.00		
Income debits from work sheet	1,534,333.33		
	$ 332,666.67		

(5)

Machinery and equipment		180,000.00	
Advance payment on machinery and equipment		40,000.00	
Advance purchases			220,000.00
To close advance purchases account and charge accounts as follows:			
Machinery and equipment:			
Cash advanced for machinery received	$ 70,000.00		
Machinery completed and billed by vendor but not delivered	110,000.00		
	180,000.00		
Advance payment for machines not received	40,000.00		
	$ 220,000.00		

Notations on Solution

In conformity with the provisions of Accounting Research Bulletin No. 30, prepaid insurance is listed as a current asset.

It is assumed that title has passed to the vendee for the machinery in hands of vendor which has been completed and billed.

CONSTRUCTION CORPORATION
Work Trial Balance
Year Ended December 31, 1944

	Trial Balance Dr.	Trial Balance Cr.	Adjusting Entries Dr.	Adjusting Entries Cr.	Income Statement Dr.	Income Statement Cr.	Surplus Statement Dr.	Surplus Statement Cr.	Balance-Sheet Dr.	Balance-Sheet Cr.
Cash	$ 210,100	$	$	$	$	$	$	$	$ 210,100.00	$
Imprest work funds.............	10,000								10,000.00	
Earned receivables—billings based on engineers' and architects' certificates	315,000								315,000.00	
Earned receivables—unbilled......			(2) 37,000.00						37,000.00	
Retained percentages receivable...	110,000								110,000.00	
Postwar excess-profits credit......	32,000								32,000.00	
Advance purchases	220,000			(5) 220,000.00						
Prepaid insurance	31,000								31,000.00	
Advance payments on machinery and equipment			(5) 40,000.00						40,000.00	
Investment in subsidiary company (Jones Sand Co., Inc.)........	100,000								100,000.00	
Advances to subsidiary company (Jones Sand Co., Inc.)........	48,000			(3) 38,333.33					9,666.67	
Land	60,000								60,000.00	
Buildings	240,000								240,000.00	
Machinery and equipment.........	1,375,000		(5) 180,000.00						1,555,000.00	
Reserve for depreciation — buildings, machinery and equipment		700,000								$700,000.00
Notes payable to banks..........		40,000								40,000.00
Accounts payable—trade		290,000								290,000.00
Estimated federal income and excess-profits taxes payable.......		150,000		(4) 151,466.67						301,466.67
Accrued taxes—other than federal taxes on income...............		25,000								25,000.00
Accrued expenses		22,500								22,500.00
Purchase money mortgages payable June 30, 1946................		200,000								200,000.00
Common capital stock...........		125,000								125,000.00
Capital surplus		275,000								275,000.00
Earned surplus, January 1, 1944..		318,600						318,600		
Profit earned on contracts prior to January 1, 1944.............				(1) 421,000.00				421,000		
Federal income tax on income earned prior to January 1, 1944			(4) 168,400.00				168,400			
Contract sales—billed revenues...		3,370,000	(1) 1,540,000.00			1,830,000				
Contract sales—unbilled revenues.				(2) 37,000.00		37,000				
Cost of contracts in progress.....	612,000		(3) 38,333.33	(1) 305,000.00	345,333.33					
Cost of contracts completed......	1,828,000			(1) 814,000.00	1,014,000.00					
Administrative and general expenses	175,000				175,000.00					
					1,534,333.33	1,867,000				
Provision for federal income taxes	150,000			(4) 16,933.33	133,066.67					
	$5,516,100	$5,516,100	$2,003,733.33	$2,003,733.33	1,667,400.00	1,867,000				
Net income					199,600.00			199,600		
					$1,867,000.00	$1,867,000	168,400	939,200		
Surplus, December 31, 1944......							770,800			770,800.00
							$939,200	$939,200	$2,749,766.67	$2,749,766.67

No. 2

CITY OF FULTON

ASSESSMENT FUND—PAVING OF FIRST STREET

(a) *Journal Entries*

(1)

Improvements authorized	$100,000	
Reserve for authorized expenditures		$100,000

To record approval by legislative body of paving of First Street at a cost of $100,000—60% to be paid by city and 40% by property owners.

(2)

Encumbrances	95,000	
Reserve for encumbrances		95,000

To record award of contract for paving of First Street at $95,000 to A.B.C. Construction Co.

(3)

Assessments receivable	36,100	
Governmental unit's share of cost	58,900	
Improvements authorized		95,000

To record levy of assessments and city's share of cost of paving First Street: Assessments:

On privately owned property (40% of 90% of $95,000)	$34,200
On foreclosed property (40% of 5% of $95,000)	1,900
Total assessments	$36,100

City's share:

60% of $95,000	$57,000
40% of cost on property devoted to public use (40% of 5% of $95,000)	1,900
	$58,900

(4)

Cash for construction	50,000	
Certificates of indebtedness		50,000

To record issuance of short-term certificates for paving First Street.

(5)

Cash for construction	45,000	
Due to Assessment Revolving Fund		45,000

To record advance from Assessment Revolving Fund for paving First Street.

(6)

Cash for payment of certificates and advances	58,900	
Governmental unit's share of cost		58,900

To record receipt of proceeds of bonds issued to pay city's share of cost of paving First Street.

(7)

Construction expenditures	95,000	
Reserve for encumbrances	95,000	
Encumbrances		95,000
Contracts payable		95,000

To record completion of contract for paving First Street and approval for payment to A.B.C. Construction Co.

(8)

Contracts payable	95,000	
Cash for Construction		95,000

To record payment to A.B.C. Construction Co. for completed contract for paving First Street.

(9)

Certificates of indebtedness	50,000	
Cash for payment of certificates and advances		50,000

To record payment of certificates of indebtedness issued for paving First Street.

(10)

Due to Assessment Revolving Fund	45,000	
Cash for payment of certificates and advances		8,900
Assessments receivable assigned		36,100

To record repayment to Assessment Revolving Fund as follows:

Cash	$ 8,900
Assessments assigned	36,100
	$45,000

(11)

Cash from collection of assigned assessments	36,100	
Assessments receivable		36,100

To record collection of assessments for paving First Street.

(12)

Assessments receivable assigned	36,100	
Cash from collection of assigned assessments		36,100

To record remittance to Assessment Revolving Fund of collections on assessments assigned to it.

(13)

Reserve for authorized expenditures	5,000	
Improvements authorized		5,000

To close out unencumbered balance of authorization for paving First Street.

(14)

Reserve for authorized expenditures	95,000	
Construction expenditures		95,000

To close actual expenditures into authorization for paving First Street.

Comments:

It is assumed that the property acquired by the city through foreclosure of tax liens is charged on the assessment roll in the same manner as privately owned property. If the property is resold by the city, the assessments will be paid by the purchaser. If the property is retained, the city will pay these assessments from the general fund.

CITY OF FULTON
SPECIAL ASSESSMENT ROLL—FIRST STREET IMPROVEMENT

Name and Address of Property Owner	Legal Description of Property			Frontage in Feet	Total Assessed	Payments		
	Lot	Block	Subdivision			Date	Principal	Interest
R. R. White 34 First Street	7	3	Hilltop	150	$ 750	4/30/46 4/30/47	$150 150	$22.50 18.00
F. O. Spalding 26 First Street	10-11	3	Hilltop	300	1500	4/30/46 4/30/47	300 300	45.00 36.00

JOURNAL ENTRIES TO ADJUST BOOKS OF
X MACHINE COMPANY

(1)

Sales	$ 8,000	
General Manufacturing Company		$ 8,000

To correct for fictitious charge per special master's report.

(2)

Sales	1,000	
General Manufacturing Company		1,000

To record allowance for defective merchandise per special master's report.

(3)

Sales	5,000	
Y Assembly Company		5,000

To adjust sales to Y Assembly Company from $55,000 to $50,000.

JOURNAL ENTRIES TO ADJUST BOOKS OF Y ASSEMBLY COMPANY

(1)

Expenses		$ 200	
General Manufacturing Company "Advances"			$ 200
To record Y Assembly Company's share of expenses charged to General Manufacturing Company as follows:			
Legal	$ 100		
Advertising	100		
	$ 200		

(2)

Cost of sales	325	
General Manufacturing Company "Advances"		325

To record Y Assembly Company's share of payroll charged to General Manufacturing Company.

(3)

Cost of sales	3,000	
Gain on sale of business property		3,000

To correct for gain on sale of business property credited to cost of sales.

(4)

General Manufacturing Company "Advances"	25,000	
Reserve for depreciation—machinery	625	
Depreciation of machinery rented to General Manufacturing Company	625	
Machinery		25,000
Machinery rentals		625
Cost of sales		625

To charge General Manufacturing Company for proceeds of machinery sold, to record machine rental, and to record as separate expense the depreciation of machinery previously charged to cost of sales.

(5)

Cost of sales	10,000	
X Machine Company		10,000

To adjust purchases from X Machine Company from $40,000 to $50,000.

(6)

Sales	15,000	
General Manufacturing Company		15,000

To adjust sales to General Manufacturing Company from $85,000 to $70,000.

(7)

Y, Capital	2,000	
Loan by Y (bad debt)		2,000

To charge loan made by Y from funds of Y Assembly Company, now worthless, to Y's capital account.

JOURNAL ENTRIES TO ADJUST BOOKS OF GENERAL MANUFACTURING COMPANY

(1)

Cost of sales	$ 1,000	
X Machine Company		$ 1,000

To reduce allowance for defective merchandise from $2,000 to $1,000 per special master's report.

(2)

Expense	125	
Cost of sales	21,345	
Y Assembly Company "Advances"		21,470

To adjust "Advances" account for payments made by X Assembly Company for General Manufacturing Company as follows:

To be charged to expense:	
Legal	$ 100
Advertising	25
	$ 125
To be charged to cost of sales:	
Freight	$ 430
Supplies	10,050
Payroll	10,865
	$21,345

(3)

Gain on sale of business property	3,000	
Y Assembly Company "Advances"		3,000

To adjust for amount due by Assembly Company on sale of machinery incorrectly recorded as gain on sale of business property.

(4)

Cost of sales	5,000	
Y Assembly Company		5,000

To adjust purchases from Y Assembly Company from $70,000 to $65,000.

X Machine Company, Y Assembly Company and General Manufacturing Company
PROFIT AND LOSS WORK SHEET
Year Ended December 31, 1945

	Per Books	Adjusting Entries Dr.	Adjusting Entries Cr.	Corrected
X Machine Company				
Sales	$265,000	(1) $ 8,000	$	$251,000
		(2) 1,000		
		(3) 5,000		
Cost of sales	154,000			154,000
Gross profit	111,000			97,000
Expenses	78,000			78,000
Net profit from operations	33,000			19,000
Gain on sale of business property	3,500			3,500
Net profit	$ 36,500			$22,500
Y Assembly Company				
Sales	$540,000	(6) 15,000		$525,000
Cost of sales	372,000	(2) 325	(4) 625	384,700
		(3) 3,000		
		(5) 10,000		
Gross profit	168,000			140,300
Expenses	93,000	(1) 200		93,200
Net profit from operations	75,000			47,100
Gain on sale of business property			(3) 3,000	3,000
Machinery rentals			(4) 625	625
				50,725
Depreciation of rented machinery		(4) 625		625
Loan by Y (bad debt)	2,000		(7) 2,000	
Net profit	$ 73,000			$ 50,100
General Manufacturing Company				
Sales	$870,000			$870,000
Cost of sales	525,000	(1) 1,000		552,345
		(2) 21,345		
		(4) 5,000		
Gross profit	345,000			317,655
Expenses	210,000	(2) 125		210,125
Net profit from operations	135,000			107,530
Gain on sale of business property	3,000	(3) 3,000		
Net profit	$168,000			$107,530

RECONCILIATION OF RECIPROCAL ACCOUNTS

	Due from Y Assembly Company Dr.	Due from Y Assembly Company Cr.	Due to X Machine Company Dr.	Due to X Machine Company Cr.
Charges by X Machine Company	$ 55,000			
Credits by Y Assembly Company				$ 40,000
Adjusting entry No. 3 on X Machine Company books		$ 5,000		
Adjusting entry No. 5 on Y Assembly books				10,000
Balances, adjusted		50,000	$ 50,000	
	$ 55,000	$ 55,000	$ 50,000	$ 50,000

	Due from General Manufacturing Company Dr.	Cr.	Due to X Machine Company Dr.	Cr.
Charges by X Machine Company	$145,000			
Credits by General Manufacturing Company				$135,000
Adjusting entries on X Machine Company books				
No. 1		$ 8,000		
No. 2		1,000		
Adjusting entry No. 1 on General Manufacturing Company books				1,000
Balances, adjusted		136,000	$136,000	
	$145,000	$145,000	$136,000	$136,000

	Due from General Manufacturing Company Dr.	Cr.	Due to Y Assembly Company Dr.	Cr.
Charges by Y Assembly Company for sales	$ 85,000			
Credits by General Manufacturing Company for purchases				$ 65,000
Adjusting entry No. 6 on books of Y Assembly Company		$ 15,000		
Adjusting entry No. 4 on books of General Manufacturing Company				5,000
Balances, adjusted		70,000	$ 70,000	
	$ 85,000	$ 85,000	$ 70,000	$ 70,000

	General Manufacturing Company Advances Dr.	Cr.	Y Assembly Company Advances Dr.	Cr.
Charges on books of Y Assembly Company	$ 26,995			
Credits on books of General Manufacturing Company				$ 27,000
Adjusting entries on books of Y Assembly Company				
No. 1		$ 200		
No. 2		325		
No. 4	25,000			
Adjusting entries on books of General Manufacturing Company				
No. 2				21,470
No. 3				3,000
Balances, adjusted		51,470	$ 51,470	
	$ 51,995	$ 51,995	$ 51,470	$ 51,470

Comments:

No adjustment to "cost of sales" is necessary on the books of General Manufacturing Company for depreciation of machinery recorded in error since the amount recorded is equal to the amount of unrecorded machine rental charged by Y Assembly Company.

SUMMARY OF INCOME TAX DATA

Income to be reported for tax purposes is as follows:

	X	Y
Net profit of X Machine Company	$ 19,000	
Net profit of Y Assembly Company		$ 47,100
Gain on sale of business property	3,500	3,000
Share of profit of General Manufacturing Company, a partnership		
X — 40%	43,012	
Y — 60%		64,518
Rental income $625 less depreciation of machinery of $625		None
Non-business bad debt to be treated as short-term capital loss (deduction will be limited to $1,000 unless there are capital gains not mentioned in problem; carry-over of $1,000 to 1946		1,000

Note:

No information is available on whether the business property sold by X Machine Company was held over six months. If it was held more than six months, only one half of the gain would be included in determining taxable income.

It is assumed that the loan by Y was a non-business bad debt.

Commercial Law

May 16, 1947, 9 a.m. to 12:30 p.m.

GROUP I

No. 1

(a) As a general rule fraud does not render a contract void, but merely voidable at the option of the party injured.

(b) If the defrauded party elects to affirm the contract, he may bring an action in deceit for any damage he has suffered, set up the fraud in reduction of the demand if sued on the contract, or, if it would be to his advantage, enforce against the fraudulent person the kind of bargain which he represented that he was making. If, on the other hand, the defrauded party elects to rescind the contract, he waives his right to sue for deceit, but has a right to remedies which will restore the situation which the parties occupied before the contract was entered into, including a right to sue to recover what he has parted with, to sue in equity to have the contract avoided judicially, or to resist an action at law on the contract or a suit in equity for specific performance.

(c) If there has been repudiation or a material breach of a contract by one party, the other party may elect to rescind the contract, thereby discharging himself from the obligation of further performance, and to bring an action for restitution, either in quantum meruit to recover the value of the performance rendered by him or in equity to recover property parted with. If he chooses not to rescind, he may sue for damages sustained by reason of the breach of contract, or, in appropriate cases, to compel specific performance of the contract by the other party.

(d) *An accord* is an agreement between two persons to give and accept something in satisfaction of a right of action which one has against the other. *Satisfaction* is the performance of such substituted agreement. Together they are called accord and satisfaction.

(e) The lessor was not justified in his refusal. Although the option may have been unilateral it was, nevertheless, supported by a valuable consideration, namely, the consideration arising out of the execution of the lease. Moreover, the presence of a seal upon the lease gives rise to a prima facie presumption of consideration.

No. 2

(a) The essentials are:

1. It must be in writing and signed by the maker or drawer;
2. Must contain an unconditional promise or order to pay a sum certain in money;
3. Must be payable on demand, or at a fixed or determinable future time;
4. Must be payable to order or to bearer; and
5. Where the instrument is addressed to a drawee, he must be named or otherwise indicated therein with reasonable certainty.

(b) The note is negotiable. According to section 5 of the Uniform Negotiable Instruments Law, a provision which gives the holder an election to require something to be done in lieu of the payment of money does not affect the negotiable character of the instrument. The holder has a right to demand money, and the note therefore meets the requirement that it must contain an unconditional promise to pay a sum certain in money.

(c) A person who endorses without qualification warrants:

1. That the instrument is genuine and in all respects what it purports to be;
2. That he has good title to it;
3. That all prior parties had capacity to contract;
4. That the instrument is at the time of his endorsement valid and subsisting.

   In addition, he engages that on due presentment it shall be accepted or paid, and that if it be dishonored he will pay the amount thereof to the holder, or to any subsequent endorser who may be compelled to pay it.

   The person who makes a qualified endorsement warrants the matters mentioned in 1, 2, and 3 above, and
5. That he has no knowledge of any fact which would impair the validity of the instrument or render it valueless.

(d) In the following cases title passes by operation of law, without either assignment, endorsement, or delivery:

1. On the death of the holder and qualification of a personal representative, title vests in his personal representative.
2. In case of the bankruptcy of the holder, title vests in the trustee.

3. Upon the death of a joint payee or endorsee, the title vests at once in the survivor or survivors.

(e) Interest runs from the date of issue of the instrument. Section 17, subdivision 2 of the Uniform Negotiable Instruments Law provides that where an instrument provides for the payment of interest without specifying the date from which interest is to run, the interest runs from the date of instrument, and if the instrument is undated, from the issue thereof.

(f) C can maintain an action against A on the note but can recover only according to the original tenor, namely, $1,000 (unless C can show that A was guilty of negligence in the writing of the instrument, in which case A may be estopped by reason of his own negligence from setting up the fraudulent alteration which his negligence made possible). Section 124 of the Uniform Negotiable Instruments Law provides that, 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. Section 125 provides that any alteration which changes the sum payable is a material alteration.

No. 3.

(a) 1. A de facto corporation is an association which assumes to be and acts as a corporation and which resulted from a bona fide attempt to organize a corporation under a valid law, although a legal corporation was not created because of some error in the proceedings or failure to comply with the conditions specified by law.

2. (a) A de facto corporation is a reality and has a substantial legal existence and the general rule is that it may function to the same extent and in the same manner as if it were a corporation de jure.

   (b) Its existence may be terminated only in a direct proceeding by the state for that purpose.

   (c) It has corporate existence even against the state on collateral attack and against individuals or other corporations whether they attack its right to corporate existence collaterally or directly.

(b) 1. The corporation may not properly endorse the note. An accommodation endorsement by a corporation is an ultra vires act, beyond the scope of its corporate powers.

2. The bank was not a holder in due course as it received the instrument with actual knowledge of the infirmity in the endorsement.

3. The bank cannot recover upon the endorsement. Only a holder in due course can recover against a corporation upon such an endorsement.

(c) 1. The contract was not within the powers of the companies.

2. A corporation cannot enter into a partnership with another corporation or person. A corporation can be bound only by the acts of its board of directors acting as a board. In a partnership, each partner may bind the other by acts within the actual or apparent scope of his authority. In partnership, there is individual liability of the partners. In a corporation, the stockholders are not liable beyond their subscriptions for the debts of the corporation.

No. 4

(a) A factor is a person who, in pursuance of his usual business and for a compensation, is employed by another to sell property for him, and is vested with the possession or control of the property. Factors are commonly called commission merchants. The term is also applied to one who is empowered to purchase, as well as to sell, goods.

(b) A factor is said to act under a del credere commission, where, in consideration of an increased commission, he guarantees the payment to the principal of all debts that become due through his agency.

(c) The prevailing rule in the United States is that he is liable absolutely as a principal, and that, if the debt is not paid when due, an action will lie against him at once for the amount. As he is liable as principal, his contract is not within the statute of frauds and need not be in writing.

(d) The authority and power of an agent entrusted with the general management of some particular business is prima facie coextensive with the business delegated to his care, and includes authorization to do whatever is necessary and usual to carry into effect the principal power or powers, and whatever is within the scope of the authority usually confided to an agent employed in that capacity.

(e) An agent can delegate his authority in the following situations:

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 interests of the principal, as when the agent cannot lawfully perform the transaction in person or the nature or place of the business makes it impracticable for the agent to perform it.
3. When the usage of trade sanctions the appointment of sub-agents.

(f) Green Co. can hold Allen liable. An agent of an undisclosed principal always risks being held personally liable at the election of the person dealing with him.

(g) Title is vested in John Jones individually and not in the corporation. The words "President of the Jones Company" are merely descriptive.

No. 5

(a) A "net operating loss," which is the amount (with adjustments) by which the taxpayer's deductions exceed his gross income, may be carried back to be included (after some adjustments) in the deductions for the two preceding taxable years and carried forward to be included (after some adjustments) in the deductions for the two succeeding taxable years. There can, of course, be no further carry-back or carry-over after the loss has once been absorbed.

(b) There can be no carry-back to any year beginning prior to January 1, 1941. Subject to this exception, a net operating loss must first be carried back and applied against the income of the second preceding taxable year. If the loss is not entirely absorbed by the income of that year, there can be a carry-back of the balance to the first preceding taxable year. If such balance is not entirely absorbed by the income of that year, there can be a carry-over of the unabsorbed portion to the first succeeding taxable year. If any part of the loss is still unabsorbed, there can also be a carry-over to the second succeeding taxable year.
The law does not offer any choice of order. A net operating loss must be carried back and then forward in the manner previously described.

(c) The taxpayer may carry back the net operating loss of 1944 ($5,000) to reduce the net income of 1942 ($3,000) to zero and to reduce the net income of 1943 ($10,000) to $8,000. It may carry back the net operating loss of 1945 ($14,000) to 1943 to eliminate the net income of $8,000 remaining after the application of the 1944 net operating loss. The balance of the 1945 net operating loss ($6,000) may be carried forward for two years and applied against the net income, if any, of those years.

(d) As the term "constructive receipt" implies, the income in question is not reduced to the possession of the taxpayer, but nevertheless is so much within his control and disposition as to be treated, for tax purposes, as having been received.

(e) Jones should report this income for the year 1945. Interest credited on a savings bank deposit is a common example of income constructively received.

No. 6 **GROUP II**

(a) The Bankruptcy Act provides that "proof of claim" shall consist of a statement under oath, in writing and signed by the creditor, setting forth the claim; the consideration therefor; and whether any and, if so, what securities are held therefor; and whether any and, if so, what payments have been made thereon; and that the claim is justly owing from the bankrupt to the creditor.

1. A proof of claim for purpose of allowance must be filed by the claimant in the court of bankruptcy where proceedings are pending or before the referee, if the case has been referred.
2. It must be filed within the statutory period of limitation which is within six months after the first date set for the first meeting of creditors. (There are a few minor exceptions.)
3. Proof of claim must be filed for the purpose of allowance, to establish claimant's rights as a creditor of the bankrupt estate and to participate in voting for trustee and other rights of a bona fide creditor.
4. Claims which are not filed within six months after the first date set for the first meeting of creditors shall not be allowed.
5. The statutory period is six months (with exceptions for claims of the government, insane persons and infants).

(b) Some debts have priority.

(c) The debts to have priority in advance of payment of dividends to creditors and to be paid in full out of the bankrupt estate shall be, and the order of payment, are:

1. Costs and expenses of administration of bankrupt estate subsequent to filing the petition in bankruptcy.
2. Wages, not to exceed $600 to each claimant, which have been earned within three months before commencement of proceeding due to workmen, servants, clerks, or salesmen on salary or commission basis, whole or part-time employees of the bankrupt.
3. Costs and expenses of creditors in defeating confirmation of an arrangement or wage-earner plan or the bankrupt's discharge.
4. Taxes due and owing by the bankrupt to the United States or any state or subdivision thereof.
5. Debts having priority under federal laws and rent due to a landlord who is entitled to priority by applicable state law for premises occupied by bankrupt and which accrued within three months before date of bankruptcy.

(d) 1. The receiver may not employ a public accountant.

2. An order of Bankruptcy Court employing the accountant is required.
3. The compensation for the accountant's services is fixed by the court order employing him.

   General Order 45 in Bankruptcy provides that:

   "No auctioneer or accountant shall be employed by a receiver, trustee or debtor in possession except on order of the court expressly fixing the amount of compensation or the rate or measure thereof. The compensation of appraisers shall be provided in like manner in the order appointing them."

No. 7

(a) Section 8(3) of the Uniform Partnership Act, which is in effect in half of the states, expressly provides that a partnership may acquire and hold real estate in its firm name. At common law, although a partnership may own the equitable title or even deal in real estate, it cannot hold the legal title thereto in its firm name, since a partnership is not recognized by the law as a legal entity. The title should be taken in the names of the individuals composing the firm, and deeds of conveyance should be signed by the individuals.

(b) The rule means that realty purchased with partnership funds for partnership purposes is, as between the real and personal representatives of the partners, treated as personalty, and the rules relating to the descent of real estate do not apply. This rule of equitable conversion has been adopted in equity to aid in the payment of the partnership debts and in adjusting equities between the partners. Its application is limited to cases where such payment and adjustments are necessary.

(c) When a firm is dissolved by the act of the partners or by the retirement of one partner, it is necessary, in order to terminate the power of the former partners to bind each other, to give actual notice of such dissolution or retirement to all persons who have previously given credit to the firm in money, goods, or services, and notice by publication to the general public. When a dormant partner retires, he need give no notice to relieve himself from future liability.

(d) In the absence of an agreement to the contrary a partner is not entitled to compensation for services rendered the firm. This is so even though one partner has been more active than his co-partners in the partnership business.

(e) The death of a partner works a dissolution of the partnership with the right in the survivor, Burt, to wind up its affairs. After the payment of partnership liabilities of $8,000, a sum of $22,000 remains. Out of this sum of $22,000, Burt should pay Allen's personal representative his capital contribution and should also pay himself his capital contribution. The profit, if any, remaining should be divided equally in the absence of any agreement as to the division of profits. If a loss has been sustained, the loss should be borne by each in the same manner in which profits would be divided.

No. 8

(a) The statute of frauds applicable to contracts to sell or sales of goods (section 4 of the Uniform Sales Act) provides that a contract to sell or a sale of goods shall not be enforceable by action if the articles dealt with are of the value of $500 or more (the limit fixed by the local statute in certain states varies from this amount); unless

1. The buyer accepts part of the articles so sold, and actually receives the same; or
2. The buyer gives something in earnest to bind the bargain, or in part payment; or

3. A memorandum in writing of the bargain is signed by the party to be charged, or his agent in that behalf.

(b) If the goods are to be manufactured by the seller especially for the buyer, and are not suitable for sale to others in the ordinary course of the seller's business, the statute of frauds does not apply.

(c) The memorandum must indicate with reasonable certainty the subject matter to which the contract relates, who are the parties to the contract, and the terms and conditions of the promises involved to which the party to be charged binds himself. It must be signed by the party to be charged or his agent. The memorandum need not state matters not affecting the terms to which the party to be charged binds himself, such as already executed consideration or the acceptance which converted his written offer into a contract.

(d) No special form or single writing of the memorandum is required, so long as the writing in question shows the required terms of the bargain and is properly signed by the party to be charged or his agent.

(e) Under section 20(4) of the Uniform Sales Act the purchaser obtains the property in the goods. Although the bill of exchange has not been honored, he received the bill of lading endorsed by the consignee without notice of the facts making the transfer wrongful and he parted with value therefor.

No. 9

(a) 1. Generally, contracts of fire insurance or liability and indemnity insurance are not assignable before loss without the consent of the insurer because they are regarded as personal contracts. Such policies usually contain express provisions prohibiting assignment except with the consent of the insurer. According to the prevailing modern view, and in the absence of contrary provisions in the policy, a life insurance policy is assignable.

2. A contract of liability or indemnity insurance is regarded as personal because each party depends upon the character, credit, and conduct of the other. The contract is not attached to and does not accompany a transfer of the property covered. It is customary, however, for companies to consent to the assignment of the policy when the property covered is transferred. The relation of the parties to a life insurance contract is not usually regarded as personal so as to prohibit

assignment of the policy in the absence of contrary provisions in the policy.

(b) The fire insurance policy is not assignable by the seller to the buyer of the property without the consent of the insurer, which, when given, turns it into a novation, the assignee being substituted for the original insured. By the better opinion such assignee then takes such rights as are given by the terms of the contract, freed from any defenses available against the assignors.

(c) 1. General creditors of the insured have no rights whatsoever in the latter's insurance on property prior to the happening of a loss.

2. After a loss has occurred, the claim of the insured becomes a mere chose in action, which is subject, like any other chose, to be seized for the satisfaction of his creditors. But by the weight of authority, the proceeds of insurance upon exempted property are also exempt.

(d) 1. All rights possessed by the insured, when adjudged a bankrupt, in policies with a cash surrender value payable to himself or to his estate, if not exempt, pass at once as assets to his trustee in bankruptcy, subject to the privilege of the bankrupt to retain the policies free from the claims of the creditors upon paying or securing to the trustee the cash value thereof.

2. When an unexempt policy possessed by the bankrupt is payable to a third party beneficiary with power reserved to change the beneficiary, it is now 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. 10

(a) A bailment differs from a sale in that there is no transfer of title in a bailment, and bailment requires the return of the identical thing delivered in the same or in an altered form. If title is retained and possession of the property transferred with the requirement of redelivery in the same or in altered form, the transaction is a bailment. If there is a transfer of title, with or without possession, the transaction is a sale.

(b) The following principles are generally common to bailments:

1. There must be a delivery, actual or constructive.
2. There must be a voluntary acceptance by the bailee, except in bailments created through operation of law.
3. There must be competent parties.
4. The right of property remains in the bailor, and he may maintain an action to protect it.
5. The bailee is estopped from disputing that the bailor had title at the time the goods were delivered.
6. The bailor must not expose the bailee to danger without warning.
7. The bailee must exercise good faith at all times and exercise the degree of care which is determined by, and commensurate with, the particular class to which the bailment belongs.
8. The bailee must deliver up the property in proper condition at the termination of the bailment, or excuse his inability to do so.

(c) The modern classification of bailments is as follows:

1. Those for the sole benefit of the party on the bailor's side.
2. Those for the sole benefit of the party on the bailee's side.
3. Those for the benefit of both parties.

Bailments are sometimes classified with respect to the liability of the bailee as ordinary or exceptional bailments. Exceptional bailments are those which affect the public interest in such a way that the law has imposed on the bailee a different liability from that in ordinary bailments. Exceptional bailments usually include those involving common carriers, innkeepers and certain public agencies.

(d) Daniels cannot set up his title through Burt since Burt as bailee never acquired the title to the goods and could therefore not transfer the title to Daniels. A bailee acquires only the possession of the goods, the title remaining in the bailor.

(e) According to the weight of authority, Allen can recover. While there has been considerable conflict among the decisions, the present trend of cases is to hold that the negligence of the bailee, or the bailee's servant cannot be imputed to the bailor as there is no relationship of master and servant or principal and agent between the bailor and bailee. Since the servants of Burt and Carr were jointly negligent, the servants and Burt and Carr are joint tort feasors and are therefore jointly as well as severally liable.

No. 11

(a) The usual parts of a deed are the *premises* and the *habendum clause*. The *premises* includes the name and address of the parties; the date (frequently the date is placed at the end of the deed instead of here); the recital of consideration; the granting clause containing words of conveyance; a description of the land conveyed; and any exceptions or encumbrances, such as easements or liens, subject to which, the conveyance is made. The *habendum clause* defines the extent of the interest of the transferee.

(b) 1. The *granting clause* in a deed must contain words indicating an intention to convey. The usual words of conveyance are "give, grant, bargain, and sell" or "grant and release." However, any words which clearly indicate the intention to transfer ownership are sufficient.

2. The *habendum clause* in a deed is usually introduced by the words "to have and to hold" and defines the extent of the interest of the transferee.

(c) Deeds take effect on delivery, or, as is required in many states, on delivery by the grantor and acceptance by the grantee. Delivery means on indication by the grantor that the instrument shall be legally operative; manual transfer of the instrument is not necessary and does not constitute delivery if the transfer is not with such intention. As to third parties without notice, however, deeds do not become effective until they are recorded, as provided by recording statutes of the various states.

(d) 1. The five usual covenants in a deed are:

(a) that the grantor is lawfully seized;

(b) that he has good right to convey;

(c) that the land is free from encumbrances, except those named in the deed;

(d) that the grantee shall quietly enjoy the land conveyed;

(e) that the grantor will warrant and defend the title against all lawful claims.

2. The first three are personal covenants and in most states do not run with the land.

3. The last two covenants run with the land and the right to sue on them passes to any subsequent grantee.

(e) A warranty deed is a deed containing covenants by the grantor respecting the title to the lands conveyed.
A quitclaim deed is a deed which does not contain any covenants of title and conveys to the grantee only the interest that the grantor had.

(f) The usual covenants in a warranty deed are:

1. *Covenant of seizing or title;* that is, the grantor that he is the owner and has the right to convey.
2. *Covenants against encumbrances;* that the grantor warrants that there are no outstanding interests in the land in a third person which will operate to decrease the value of the land.
3. *Covenant of quiet enjoyment;* that the grantor warrants that the grantee shall not be disturbed in his possession of the premises conveyed, by the grantor or any one claiming under his or paramount title.

No. 12

(a) The word "certify," as applied to bank checks, indicates the act of an authorized officer of the bank in recognizing and accepting the check of a depositor as an appropriation of the amount specified on the check to the payee named therein, by means of writing or printing appropriate words on the check and signing his name, and then passing the check from the custody of the bank.

(b) 1. The certification was unlawful. It is provided by federal statute that it shall be unlawful for any officer of any Federal Reserve Bank, or member bank (National Bank) to certify any check drawn upon such bank unless the person drawing the check has on deposit with such bank, at the time such check is certified, an amount of money not less than the amount specified in such check.

2. The cashier is guilty of a misdemeanor for which he is subject to a fine or imprisonment. The cashier is also liable to the bank for the amount of the loss. By statute any officer who shall certify a check before the amount thereof shall have been regularly deposited in the bank by the drawer thereof shall be guilty of a misdemeanor and on conviction shall be fined not more than $5,000 or imprisoned not more than five years, or both.

3. The check is a valid obligation of the bank. The statute provides that any check so certified shall be a good and valid obligation against such bank.

(c) 1. The director cannot recover on the note. A note given on account of such service is without a valid consideration.

2. The contract between the firm and the director was against public policy and void.

3. The director's act was unlawful in that he violated the federal banking laws. Under the United States banking laws any officer, director, employee, or attorney of a national bank who stipulates for or receives or consents to receive any fee, commission, gift, or thing of value from any person, firm, or corporation for procuring for such firm any loan or purchase or discount of any paper, note, draft, check, or bill of exchange shall be guilty of a misdemeanor subject to imprisonment or a fine of not more than $5,000 or both.

Auditing

May 16, 1947, 1:30 to 5:00 p.m.

No. 1

Audit procedures applicable to stocks, bonds, and mortgages:

1. Prepare, or have the client prepare, schedules for each of the three types of investments, showing appropriate details such as:
   (a) stocks—stock certificate number, name of issuing company, class of stock, number of shares, date acquired, par value, cost, current market value, dividends collected, dividends receivable.
   (b) bonds—bond number, name of issuing company, description of bond, number of bonds and denominations, date due, date acquired, cost, current market value, interest collected, interest accrued.
   (c) mortgages—name of mortgagor, face amount, balance due, interest rate, date of mortgage, date due, description of collateral, interest collected, interest accrued.
2. Established control over securities and notes until after the cash count has been completed.
3. Examine the stocks, bonds, and mortgages. The security custodian should be present at the time of examination.
4. Verify ownership of the securities. The securities should either be in the name of the client or properly endorsed or assigned.
5. Obtain written confirmation of all securities not in possession of the client at time of examination. The securities may not be in possession of client because they may be pledged as collateral, in the hands of brokers, in transit to brokers, or out for collection.
6. Check all purchases and sales during the current audit period against broker's advices, cash receipts and disbursement records, and to the minutes of the board of directors for proper authorization.
7. Compare the totals of the detailed lists with the control account balances.
8. If the examination of securities is made after the balance sheet date, all interim transactions must be reviewed and reconciliations made with the balances at the balance sheet date.

Audit procedures applicable to stocks:

1. Compare dividends received with record of dividend payments by corporations. Cash dividends should be traced to the cash receipts record and stock dividends to journal entries. The total of dividends received should be reconciled with the dividend income account.
2. Obtain market values of stocks and provide an adequate reserve for price declines of material amounts on temporary investments. Permanent investments need not be written down unless it appears that a permanent change in value has occurred.

Audit procedures applicable to bonds:

1. Compare interest collections with the amounts scheduled to be collected. The total of the interest earned (interest collected less accrued interest purchased and plus accrued interest receivable) should agree with the bond interest income account.
2. Check the accrued interest on the bonds at the end of the period and see that the proper entry was made for the accrual.
3. Obtain market values of the bonds and provide an adequate reserve for price declines of material amounts on temporary investments. Verify the correctness of the amortization of discount or premium on long-term investments.
4. Examine interest coupons on the bonds to see that all immatured coupons remain attached.

Audit procedures applicable to mortgages:

1. Examine the mortgage papers for names of mortgagor and mortgagee, signature of mortgagor, and evidence of recording in the public records. If it is a purchased mortgage, see that the assignment is properly recorded.
2. Confirm the existence of the mortgages and the balances due by communication with the mortgagors.
3. Determine the existence of the property mortgaged. If the property mortgaged is improved, inspect the insurance policies to determine whether adequate coverage is carried. Inspect tax receipts to determine whether property taxes are paid to the current date.
4. If sinking fund deposits are required, confirm the existence of the fund and determine whether all requirements are being fulfilled.
5. Trace the credits to principal during the current period to the cash records.

6. Compare the interest collections scheduled to be received with those recorded in the cash records. The interest earned during the period (interest collected less accrued interest purchased and plus accrued interest receivable) should agree with the mortgage interest income account.
7. Check the accrued interest on the mortgages at the end of the period and see that the proper entry was made for the accrual.

No. 2

The additional audit procedures to be performed at December 31, 1946, are as follows:

1. Determine the effectiveness of existing systems of internal audit and control of sales and collections on account to determine the extent of detailed work to be done at December 31.
2. The accounts receivable control account for the month of December should be analyzed and footed. The postings to the control account for the month of December should be checked. Additional checking of footings and postings may be required if system of internal control is not adequate.
3. Test the footings of the sales and cash receipts records.
4. Accounts written off as bad debts should be checked for authorized approvals.
5. Make test checks of the December cash receipts to individual accounts.
6. Allowances and returns (including those entered in January, 1947) should be reviewed for reasonableness and tests should be made to supporting records for authorizations.
7. Scrutinize the control account and a few of the larger individual accounts for possible cash charges, which, if found, should be thoroughly investigated.
8. The shipping records for the last few days of December should be checked against the sales records to determine that all sales were recorded in the proper period. This will also serve as a test check of the support for sales entries.
9. Trial balance tapes at December 31, 1946 should be footed and checked for agreement with the total of the control account. Unusually large account should be investigated. If there is a substantial number of new accounts, consideration should be given to the circularization of these on the same basis as was used on November 30.

No. 3.

A QUESTIONNAIRE FOR EVALUATION OF INTERNAL CONTROL COVERING CASH RECEIPTS OF A LARGE MANUFACTURING COMPANY

Ques. No.	Question	Answer		Comments
		Yes	No.	
1.	Are cash receipts centralized in as few hands as possible?			
2.	Are accountabilities fixed each time the cash changes hands, from the time of its initial receipt to acceptance by the bank as a deposit?			
3.	Are the day's receipts deposited intact on at least the following business day?			
4.	Do those handling cash have access to receivable records or to the mailing of statements, and do those persons handling receivable records have any access to the cash?			
5.	Are negotiable assets other than currency, checks or drafts in custody of an employee independent of the cashier?			
6.	If cash is received for cash sales, are sales invoices independently prepared and reconciled to cash collections?			
7.	Are cash registers used?			
8.	Are numbered receipts given each time cash is received on account?			
9.	Is the bank statement received and reconciled by an independent person?			
10.	Is fidelity insurance carried? Does it cover any of the employees referred to in this section of the questionnaire? Does the fidelity bond have any reference to character and to frequency of audit by outside accountants?			

Ques. No.	*Question*	*Answer*		*Comments*
		Yes	*No*	
11.	Is the mail opened by someone other than the cashier or the accounts receivable bookkeeper?			
12.	Does the person opening the mail prepare a record of the money and checks received, and is this record given to someone other than the cashier for independent verification of the amount recorded and deposited?			
13.	Is a duplicate deposit ticket, after authentication by the bank, received by an employee independent of the cashier and of the person who makes the deposit? If so, are such authenticated deposit tickets compared with: (a) record of incoming remittances? (b) the cash book?			
14.	Are notices of collection or other items subsequently charged back by the bank (because of insufficient funds, etc.) sent to an employee other than the cashier?			
15.	Are all bank accounts authorized by the Board of Directors?			
16.	Where branch offices make collections are such collections deposited locally in a bank account subject only to home office withdrawals?			
17.	Are unsatisfactory remittances (e.g. those drawn with excessive discount deductions, etc.) under adequate control if not deposited promptly?			

No. 4

(a)

HANAN & SON, INC.

Date of count.......................

Inventory Tag No. 251

Description..............................

Stock No................ Size..........

Quantity.........................

Counted by...
(*Employee*)

Remarks:

Upper half of Tag—Will be left with Merchandise

— —
(*Perforated*)

Date of count.......................

Inventory Tag No. 251

Description..............................

Stock No........................ Size..........

Quantity ....

Count checked by..
(*Employee*)

Count checked by..
(*Auditor*)

Remarks:

Lower half of Tag—This will be detached and picked up by the independent auditors

The reverse side of the lower half of the tag would be as follows:

Date	Received After Count	Issued After Count	Initialed

(b) Memorandum covering use of inventory tag:

1. All tags and attached stubs should be prenumbered, tag and corresponding stub bearing the same number.
2. They should be issued by the general supervisor direct to department supervisors in blocks of consecutive numbers, according to the needs of each. The general supervisor should keep an official record of the disposition made of the tags (complete with stubs) issued, possibly requiring the respective department supervisors to initial in such record for the tags received by them.
3. Each department supervisor should maintain control over all tags furnished by him to his subordinates. A formal record will be required for this purpose so that the depart-

ment supervisor is kept informed during the course of the inventory taking who is in possession of certain tags and in order that any discrepancies which may later transpire may be more easily traced.

4. The tags should be used consecutively and, when tag and corresponding stub have been duly filled in and initialed, they should be firmly attached (by string or otherwise) to the relative merchandise. A careful check should be made to see that all merchandise is tagged.
5. The clerk making original count may be accompanied by his checker or the two may work independently; in any event, the checker should follow closely behind the counter in order that any errors may be caught and corrected as quickly as possible. The checker should not initial in the space provided in the lower section of tag unless he is in agreement with the original count or is definitely assured that the revised data he has reported is correct.
6. The condition of the merchandise should be noted in the "remarks" section of the tag.
7. Voided and unused tags must be returned to the department supervisors who, in turn, must hand them over to the general supervisor.
8. As indicated on the specimen tag submitted herewith, the upper and lower halves of the tags should remain attached pending check by the independent auditors. They will not be detached until after the close of the balance sheet date.
9. Quantities of merchandise placed in stock or taken out of stock between the time of count and the balance sheet date should be noted on the reverse side of the lower half of the tag.
10. If perpetual inventory records are in use the quantity of each item as shown on the inventory tag should be checked for agreement with the corresponding perpetual inventory record and appropriate adjustments made to the perpetual inventory records.

No. 5

The rules of the American Institute of Accountants, and of many state societies, provide that professional service shall not be rendered or offered for a fee which is contingent upon the findings or results of such services. The purpose of such a rule is to avoid situations in which an auditor might be influenced in his report by the contingent nature of the fee. Even if an accountant's independence is not actually impaired by a contingent fee arrangement, his impartiality may easily be questioned because of the position in which he has placed himself. Professional service should be based on the value of the service and not on the amount recovered or received by the client.

The rule against contingent fees does not apply to cases involving federal, state or other taxes in which the findings are those of the tax authorities and not those of the accountant. The independence of the accountant is not involved in such situations. Contingent fees are permitted in the legal profession and by the Treasury Department (if reasonable and disclosed). The justification is that such an arrangement makes possible professional services to citizens who cannot afford to pay unless their cause succeeds.

No. 6

BURNEY CORPORATION
ADJUSTING JOURNAL ENTRIES
December 31, 1946

Organization expenses		$ 24,500	
Unamortized bond discount		2,270	
Amortized bond discount		130	
Land		247,000	
Salaries		9,700	
Bond interest		1,500	
Property taxes		2,200	
Building		555,000	
Fixed properties			$842,300
To close the fixed properties account and set up appropriate accounts for the costs incurred.			
Organization expense:			
June 8 Organization fees paid to state	$ 1,500		
June 30 Corporate organization costs	3,000		
Dec. 12 Stock bonus to promoters, 2,000 shares of $10 par value each	20,000		
	$ 24,500		
Unamortized bond discount:			
Total discount to be amortized over period of 10 years from June 16, 1946	$ 2,400		
Less amortization for current year—6½ months @ $20 per month	130		
	$ 2,270		

Land:

June 16	Land site and old building........	$240,000
July 2	Title clearance fees..............	2,800
Aug. 28	Cost of razing old building........	4,200
		$247,000

Miscellaneous income	200	
Land		200
To credit land with sale of scrap on old building.		
Bond interest	125	
Bond interest payable.............................		125
To record bond interest accrued from December 15, to December 31, 1946.		

Comment:

Costs incurred prior to the beginning of operations may be capitalized rather than charged to expense. If the capitalization theory is followed, the bond interest and amortized bond discount to December 15, 1946 would be included as part of the building cost. The property taxes to December 15, 1946 would be included as part of the land cost. There is some support for charging executive salaries to organization expense.

No. 7

Leasehold

1. Examine the signed copy of the lease and make extracts therefrom for the working papers (permanent file), noting especially such matters as annual rental, date of expiration, renewal clause, if any, disposition of buildings upon expiration of the lease, sub-leasing privileges, etc.
2. Examine the paid vouchers, checks or other evidences that payments under the lease are up to date and that other provisions are being fulfilled.
3. Make sure that the cost of the building and other structures is being depreciated over the original life of the lease of 40 years. Recognition should be given to the scrap value of the building and removal costs if the building is to be removed at expiration of lease and the amounts involved are estimated to be substantial.

Sub-lease:

1. Examine the signed copy of the lease and make necessary extracts for the working papers.

2. Determine that the collections of rental from the sub-lease are up to date and have been properly recorded.
3. Examine expense charges incurred by Everlast on account of sub-lease.

No. 8

Audit procedures applicable to Town of Oakville and Oakville Sports Center:

1. Review the system of internal audit and control to determine the extent of detailed checking required.
2. Check to see that funds have actually been appropriated to cover the expenditures and that expenditures were charged against the proper appropriation.
3. Test original vouchers for proper authorization, for evidence of supplies received or services rendered, and for correctness of quantities, prices and extensions.
4. Compare checks or warrants issued for agreement with supporting vouchers as to name of payee, date, and amount.
5. See that transfers between funds, if any, have been duly authorized.
6. Check the minutes of meetings of the governing body for authorization of important disbursements, such as capital outlay.

Audit procedures applicable to Town of Oakville:

1. Refer to the town charter, the statutes and the ordinances, in order to ascertain in whom or in what body authority is vested for appropriating legal funds and making expenditures. Note should be made especially as to what town officers or committees are authorized by law or ordinance to approve expenditures. The budget and minutes should be examined.

Audit procedures applicable to Oakville Sports Center:

1. Public funds received from the town should be checked to see that they have been expended as provided for in budget appropriations of Sports Center and Town.
2. Check official papers regarding private funds to determine whether or not any restrictions were placed upon their use, and, if so, determine whether any violations have been committed by the Sports Center in expending them.

ANSWERS TO EXAMINATIONS OF NOVEMBER 1947

Accounting Practice—Part I

November 12, 1947, 1:30 to 6:00 p.m.

No. 1

ARNOLD, BATES AND CASS

STATEMENT OF CASH

Balance, June 30, 1947			$ 52,000
Receipts, July 1, 1947 to September 30, 1947, inclusive:			
Accounts receivable		$ 78,000	
Notes receivable		2,500	
Interest accrued on notes receivable		50	
Merchandise sold		96,000	
Cash surrender value of Cass' life insurance policy		1,000	
Refund of unapplied discount on bank loan		150	177,700
			$229,700
Disbursements, July 1, 1947 to September 30, 1947, inclusive:			
Liabilities paid:			
Accounts payable	$ 47,000		
Notes payable to bank	30,000		
Accrued liabilities	5,000	$ 82,000	
Expenses of liquidation		28,000	110,000
Balance, September 30, 1947			119,700
Less amount estimated to be required to complete liquidation			10,000
Balance, September 30, 1947, available for distribution to partners			$109,700

ARNOLD, BATES AND CASS

STATEMENT OF PARTNERS' CAPITAL ACCOUNTS

January 1 to June 30, 1947

	Arnold	Bates	Cass	Total
Balances, January 1, 1947	$217,000	$131,000	$ 22,300	$370,300
Add:				
Interest on above balances at six per cent for six months	6,510	3,930	669	11,109
Salaries for six months	2,500	6,000	12,500	21,000
	$226,010	$140,930	$ 35,469	$402,409
Deduct:				
Withdrawals	$ 12,380	$ 2,300	$ 5,239	$ 19,919
Loss for six months ended June 30, 1947 (schedule below)	27,630	27,630	27,630	82,890
	$ 40,010	$ 29,930	$ 32,869	$102,809
Balances, June 30, 1947	$186,000	$111,000	$ 2,600	$299,600

STATEMENT OF LOSS FOR SIX MONTHS
Ended June 30, 1947

Loss before deducting partners' salaries and interest on investments	$ 50,781
Partners' salaries	21,000
Interest on investments	11,109
Loss to be charged to partners equally	$ 82,890

ARNOLD, BATES AND CASS

Balance Sheet as of September 30, 1947

(after giving effect to distribution of cash
to partners in the amount of $109,700)

Assets

Cash		$ 10,000
Accounts receivable	$ 28,000	
Less reserve for bad debts	4,600	23,400
Notes receivable		3,100
Accrued interest on notes receivable		50
Merchandise at cost		55,000
Prepaid expenses		1,850
Furniture and equipment at cost	$ 37,000	
Less reserve for depreciation	15,000	22,000
		$115,400

Liabilities

Partnership liabilities		None

Net Worth

Arnold, Capital	$ 72,900	
Bates, Capital	72,900	
	145,800	
Less debit balance Cass' account	30,400	$115,400

No. 1 *(continued)*

ARNOLD, BATES AND CASS
STATEMENT OF DISTRIBUTION TO PARTNERS
September 30, 1947

		Partners' Loans		Other	Partner's Capital		
	Assets	Arnold	Bates	Liabilities	Arnold	Bates	Cass
Balances, June 30, 1947	$467,100	$ 30,000	$ 30,000	$107,500	$186,000	$111,000	$ 2,600
Deduct:							
Expenses of liquidation paid	28,000						
Loss on disposal of assets							
Merchandise	12,000						
Land and building	9,000						
Write-off of goodwill	50,000						
Total losses and expenses to September 30, 1947	99,000				33,000	33,000	33,000
Liabilities paid	82,000			82,000			
	$181,000						
Balances, September 30, 1947 before distribution to partners	$286,100	$ 30,000	$ 30,000	$ 25,500	$153,000	$ 78,000	$ 30,400*
Allocation of debit balance in Cass' account					15,200	15,200	30,400
	$286,100	$ 30,000	$ 30,000	$ 25,500	$137,800	$ 62,800	
Deduct:							
Estimated additional expenses of liquidation	10,000						
Contingent loss, assuming complete loss on remaining assets	105,400						
	$115,400				57,700	57,700	
	$170,700	$ 30,000	$ 30,000	$ 25,500	$ 80,100	$ 5,100	
Deduct:							
Real estate transferred to Arnold	$ 50,000	$ 24,500	$	$ 25,500	$		
Cash surrender values of life insurance policies transferred to Arnold and Bates	11,000	5,500	5,000		500		
	$ 61,000	$ 30,000	$ 5,000	$ 25,500	$ 500		
Cash distributed	$109,700		$ 25,000		$ 79,600	$ 5,100	
Balances, September 30, 1947 before distributions to partners	$286,100	$ 30,000	$ 30,000	$ 25,500	$153,000	$ 78,000	$ 30,400*
Deduct distributions:							
Cash	$109,700	$	$ 25,000	$	$ 79,600	$ 5,100	
Real estate	50,000	24,500		25,500			
Cash surrender value of life insurance policies	11,000	5,500	5,000		500		
	$170,700	$ 30,000	$ 30,000	$ 25,500	$ 80,100	$ 5,100	
Balances, September 30, 1947 after distributions to partners	$115,400				$ 72,900	$ 72,900	$ 30,400*

* Debit

No. 2 (Alternate for No. 3)

(a)

STATEMENT TO SHOW AT WHAT PRICE PER POUND
YIP SHOULD BE SOLD

	Pounds	Cost
Raw materials:		
A @ $2.000 per pound	30,000	$60,000.00
B @ .025 per pound	50,000	1,250.00
C @ .500 per pound	20,000	10,000.00
Combined	100,000	$71,250.00
Mixing, blending and cooking		16,090.00
Shrinkage	40,000	
Cost to point of split-off	60,000	$87,340.00
Less amount transferred to pre-Zip	20,000	29,113.33
Yip produced	40,000	$58,226.67
Additional costs applicable to Yip		4,660.00
Total	40,000	$62,886.67
Manufacturing cost per pound		$ 1.572167

Manufacturing cost per pound = .32175 of list price (Schedule A-1)

List price per pound then $= \frac{\$1.572167}{.32175} = \$4.8862999$ or $4.89

Net selling price per pound = $4.8862999 x .585 = $2.8584854 or $2.86

(b)

STATEMENT TO SHOW AT WHAT PRICE PER GALLON
ZIP SHOULD BE SOLD

	Pounds	Cost
Cost of pre-Zip (from preceding statement)	20,000	$29,113.33
Additional costs:		
Electrolysis and filtering to drums		6,920.00
Waste	5,000	
Total	15,000	$36,033.33
	Gallons	
At 7.5 pounds per gallon 15,000 pounds is equivalent to	2,000	
Cost to manufacture per gallon		$18.016667

Manufacturing cost per gallon = .32175 of list price (Schedule A-1)

List price per gallon $= \frac{\$18.016667}{.32175} = \$55.995857$ or $56.00

Net selling price per gallon = $55.995857 x .585 = $32.7575763 or $32.76

(c)

STATEMENT OF INCOME FROM SALE OF YIP AND ZIP
on the basis of processing 100,000 pounds of raw material

	YIP (Price per lb. $2.86)	ZIP (Price per gal. $32.76)	Combined
Sales	$114,400.00	$ 65,520.00	$179,920.00
Cost of sales	62,886.67	36,033.33	98,920.00
Gross profit	$ 51,513.33	$ 29,486.67	$ 81,000.00
Selling, administrative and general expenses, including provision for income taxes	28,600.00	16,380.00	44,980.00
Net profit	$ 22,913.33	$ 13,106.67	$ 36,020.00

	YIP (Price per lb. $2.8584854)	ZIP (Price per gal. $32.7575763)	Combined
Sales	$114,339.42	$ 65,515.15	$179,854.57
Cost of sales	62,886.67	36,033.33	98,920.00
Gross profit	$ 51,452.75	$ 29,481.82	$ 80,934.57
Selling, administrative and general expenses, including provision for income taxes	28,584.85	16,378.79	44,963.64
Net profit	$ 22,867.90	$ 13,103.03	$ 35,970.93

SCHEDULE A-1

Computation of Basis for Determining Net Selling Price

If list price =		1.00000
Less 35% thereof		.35000
Balance =		.65000
Less 10% thereof		.06500
Then net selling price =		.58500
Less:		
Expenses — 25% thereof	.14625	
Net profit — 20% thereof	.11700	.26325
Balance = Cost to manufacture		.32175

Conversions

Raw material B:
2,000 pounds = 1 ton
1 ton costs \$50.00
∴ 1 pound costs \$ .025

Raw material C:
8 pounds = 1 gallon
1 gallon costs \$4.00
∴ 1 pound costs \$ .50

No. 3 (Alternate for No. 2)

TOWN OF G. WATER DEPARTMENT
WORK SHEET
Year Ended September 30, 1947

	Trial Balance October 1, 1946		Transactions Year Ended September 30, 1947		Trial Balance September 30, 1947	
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Cash	$ 153,678	$	(3)$880,954 (9) 5,642	(14)$295,190 (15) 145,269 (18) 90,000 (19) 401,624 (20) 2,122	$ 106,069	$
Sinking fund cash	207,843		(18) 90,000 (21) 324,200 (22) 63,751	(10) 570,000 (13) 79,000	36,794	
Accounts receivable	327,926		(1) 832,952 (2) 90,951 (4) 35,234	(3) 880,954 (5) 12,840	393,269	
Stores inventory	136,052		(6) 63,172	(11) 61,299	137,925	
Supplies	20,737		(8) 1,046	(12) 6,474	15,309	
Sinking fund investments	962,500		(10) 570,000	(21) 324,200	1,208,300	
Plant and property	17,212,767		(15) 145,269		17,358,036	
Accounts payable		33,996	(19) 401,624	(6) 63,172 (7) 357,378 (8) 1,046		53,968
Accrued interest payable		87,676	(14) 295,190	(16) 293,261		85,747
Accrued liabilities		2,122	(20) 2,122			
Bonds payable		6,747,000	(13) 79,000			6,668,000
Reserve for depreciation of plant and property		96,130		(23) 24,854		120,984
Reserve for retirement of bonds		41,333		(17) 79,250		120,583
Reserve for service connection replacements		7,491		(24) 3,000		10,491
Operating surplus		465,775	(15) 145,269 (17) 79,250 (18) 90,000 (24) 3,000	(9) 5,642 (23) 24,854		178,752
Sinking fund reserve		1,170,343	(13) 79,000	(18) 90,000		1,181,343
Capital surplus		10,369,637	(23) 24,854	(13) 79,000 (15) 145,269		10,569,052
Water sales				(1) 832,952		832,952
Other revenue				(2) 90,951		90,951
Other income				(4) 35,234		35,234
Uncollectible accounts of prior years			(5) 12,840		12,840	
Administration expenses			(7) 139,303		139,303	
Production expense			(7) 41,976		41,976	
Distribution expense			(7) 176,099		176,099	
Stores used			(11) 61,299		61,299	
Supplies used			(12) 6,474		6,474	
Interest expense			(16) 293,261		293,261	
Interest income from sinking fund				(22) 63,751		63,751
Depreciation on plant and property			(23) 24,854		24,854	
Profit on operations						
	$19,021,503	$19,021,503			$20,011,808	$20,011,808

	Operating Fund				Sinking Fund		Capital Fund	
	Assets	Liabilities	Expense	Income	Assets	Liabilities	Assets	Liabilities
Cash	$106,069	$	$	$	$	$	$	$
Sinking fund cash					36,794			
Accounts receivable	393,269							
Stores inventory	137,925							
Supplies	15,309							
Sinking fund investments					1,208,300			
Plant and property							17,358,036	
Accounts payable		53,968						
Accrued interest payable		85,747						
Accrued liabilities								
Bonds payable								6,668,000
Reserve for depreciation of plant and property								120,984
Reserve for retirement of bonds		120,583						
Reserve for service connection replacements		10,491						
Operating surplus		178,752						
Sinking fund reserve						1,181,343		
Capital surplus								10,569,052
Water sales				832,952				
Other revenue				90,951				
Other income				35,234				
Uncollectible accounts of prior years			12,840					
Administration expenses			139,303					
Production expense			41,976					
Distribution expense			176,099					
Stores used			61,299					
Supplies used			6,474					
Interest expense			293,261					
Interest income from sinking fund						63,751		
Depreciation on plant and property			24,854					
Profit on operations		203,031	203,031					
	$652,572	$ 652,572	$959,137	$959,137	$ 1,245,094	$ 1,245,094	$17,358,036	$17,358,036

COMMENTS: A question may be raised as to the purpose of the "reserve for bond retirement" account since there also is a "sinking fund reserve" account. Contributions to the sinking fund have been charged to "operating surplus" of the operating fund and a further charge establishing a "reserve for retirement of bonds" seems to serve only as a provision for future contributions to the sinking fund. The above solution adopts this interpretation.

Theory of Accounts

November 13, 1947, 9:00 a.m. to 12:30 p.m.

GROUP I

No. 1

(a) 4.
(b) 2.
(c) 3.
(d) 5.
(e) 4.

No. 2

(a) The bonus or consideration paid by the D Company to the B Company should be written off over the periods benefited. In this case the write off may be made over the thirty-one years from January 1, 1946 to December 31, 1976 or over the thirty years from January 1, 1947 to December 31, 1976. The use of the thirty year period can be justified since the purpose of the expenditure is the acquisition of a site for a building which will be used throughout this period.

Inclusion of the subsequent period of twenty years in the period of amortization is not acceptable because the option to extend the lease may not be exercised.

(b) The original cost of the building should be written off over the period of thirty years, from January 1, 1947 to December 31, 1976 the remaining period of the lease. Since no assurance is available that the D Company will exercise its option to extend the lease at that time, and since it must be assumed that the building will revert to the owner of the property upon the termination of the lease, its useful life to the D Company will be estimated as thirty years.

(c) The cost of building improvements should be written off over their useful life or over the period from the date when they were effected to December 31, 1976, whichever is shorter. Here again the original termination date of the lease should be the latest one to be used in determining the length of the period over which such expenditures should be amortized.

(d) Machinery installed on January 1, 1947 in the D Company's building erected on its leased site should be written off on the basis of an average service life of twenty years.

No. 3

Proposal (c) is recommended. A sinking fund for long-term bonds whether it consists of cash, securities or both, is restricted as to its use and not available for payment of current liabilities. It should therefore be excluded from current assets. However, the sinking fund cash and securities do constitute assets which the company can use to pay specified non-current liabilities, and it is appropriate to include such cash and securities as non-current assets in the balance-sheet. Cash and securities belonging to such a sinking fund as this should be recorded separately in the accounts from other cash or securities, the use of which has not been restricted either by action of the board of directors or by the terms of an agreement which involves creditors of the company.

No. 4

(a) The cost of the first installation of a machine should be charged to an asset account if the machine is a fixed asset of the concern which incurs the cost. The installation cost relating to relocating a machine should be charged to expense.

(b) Inward transportation charges relating to the acquisition of a fixed asset should be charged to an asset account. If they relate to materials, merchandise or supplies to be used up in current operation of the business, they may be charged to the related asset accounts and absorbed in operating costs as rapidly as the items to which they are related are so absorbed, or, if such procedure is not practical, they may be charged directly to expense accounts.

(c) Judgment must be exercised in matching charges for revision of layout against current and future revenue. Charges for rearranging the shop are preferably entered as expense. If the revision involves charges for new machinery, improvements or substantial replacements of parts, such charges should be capitalized by debits to asset or related reserve accounts. Significant charges in a revision to improve efficiency and lower product costs in future periods may temporarily be capitalized through a deferred charge account.

(d) Taxes paid as part of the purchase price of land should be capitalized. Taxes paid on land which is being held in anticipation of use in the future may be charged to an asset account; taxes on land which is used in current operations are current expenses. Taxes on timber land, for example, are frequently capitalized until the cutting operations are commenced.

No. 5

(a) On the consolidated balance-sheet the profit to S on materials sold to P would be eliminated from the cost of the new construction and from consolidated surplus.

On the consolidated income statement, sales would be reduced by the full amount of S's sales to P and consolidated purchases would be reduced by the cost of the materials transferred to P for construction purposes. The net result would be a decrease in consolidated profit by the amount of the profit originally made on sales of S to P.

(b) In preparing consolidated statements for subsequent years, a further adjustment for depreciation is required. Since the sales and purchases of S were closed to its surplus account at the end of the year in which they were made, the consolidated statements should reflect the original elimination as a debit to consolidated surplus and a credit to fixed assets or reserve for intercompany profit in fixed assets. In addition, since depreciation on the books of P will be based on the cost to it of the fixed assets including profit of S, an adjustment is required to eliminate the portion of the depreciation charges which represent a write-off of profit on sales of S to P reflected in the asset account. The elimination which is applicable to the current year reduces the depreciation charge and the credit to reserve for depreciation for the current year; that applicable to prior years increases surplus and reduces the reserve for depreciation.

GROUP II

No. 6

Under a by-product system of accounting the net market value of the short lengths as they leave the furniture department would be credited to that department and charged to the toy department.

Under a joint-product system of accounting the cost of the hardware would be allocated to the two departments on an equitable basis. A quantity basis such as square feet might be developed by tests and used. Since the market value of the short lengths in relation to the market value of the longer lengths may be less than proportionate to relative square feet, an arbitrary allocation may be used giving consideration to relative values.

The by-product basis is satisfactory for products of minor importance. The joint-product system is superior if the operations of the toy department play a significant part in the determination of total profits. On the basis of the information available in the question, this method is the better cost procedure. Irrespective of the method of allocation employed, the arbitrary nature of the allocation must be recognized in interpreting the profits of the respective departments.

No. 7

Land	$100,000	
Donated surplus		$100,000

To record the receipt of a gift of land adjoining the present plant site. The value used is the fair market value which value is also the latest assessed value of the property. The value is in accordance with the direction of the Board of Directors of the A Corporation as shown by minutes of a meeting of the board held on ...., 1947.

No. 8

(1) Charge all costs and expenses to the income account in the months incurred. Since the costs and expenses incidental to the introduction of new models are incurred annually, this method would satisfactorily present income by years if the amounts expended are fairly uniform. As of the end of a particular year or other fiscal period, the net worth might be materially understated using this method.

(2) Charge the costs and expenses of the change-over period to a model development account and amortize the account on the basis of a conservative estimate of the number of models to be produced and sold. This method results in a closer application of costs and expenses against the related revenues. It is to be preferred in accounts for internal management and control and for cost accounting. It affects the annual financial statements only if the period of production of a model continues after the close of the annual accounting period of the corporation. The model development account may be shown in the balance-sheet as a classification of inventory costs or as a prepaid expense.

No. 9

I would uphold neither the controller nor the treasurer. The wording of the question indicates that Rex Corporation paid $200,000 to the vendor (the mortgagor). The treatments of the controller and treasurer indicates only a payment of $75,000.

Since the Rex Corporation bought the property "subject to a mortgage" it assumed no direct liability for the mortgage. In such a purchase it is proper to reflect the transaction on the balance-sheet as the investment in an equity in real estate with full, parenthetical disclosure of the contingent liability which must be paid to hold the property in case of foreclosure by the mortgagee. The balance-sheet liability of $125,000 would be proper if at the balance-sheet date it was apparent that the company would have to pay the mortgagee because of or to avoid foreclosure.

No. 10

(a) A portion of the salaries of a company's president, general manager, and controller may properly be included in the cost of construction of the new plant undertaken by the company's own organization if a portion of their time is devoted to such a project.

Some accountants apportion general overhead including officers' salaries to all activities of the business in accordance with a uniform procedure, while others contend that only additional overhead necessitated by the construction should be applied against the new construction.

(b) The portion of officers' salaries properly allocable to the cost of the new plant construction should be based on the amount of time each devoted to such projects. If no careful record of the amount of time each devoted to the new plant construction is kept, the salaries may be allocated in accordance with a careful estimate of the time required by such projects.

No. 11

(a) The lease should be valued at $450,000 in computing the amount to be paid to liquidate the interest of the withdrawing partner. This would provide for payment to the withdrawing partner of the amount which he would have received if the entire lease had been sold at the time of his withdrawal from the firm and his share of the proceeds paid over to him. If no value is included for the lease, the remaining partner or partners would be in the position of acquiring 40% of an asset worth $450,000 at no cost to them; they would realize $450,000 for themselves by selling the asset on January 1, 1948, whereas they would have been entitled to receive only $270,000 for their share of it immediately prior to the withdrawal of the outgoing partner.

(b) The books of account of the partnership have been correctly kept with respect to the lease. The current accounting of the partnership is for purposes of a going business expected to continue for a long period of time, in contrast with the computation for purposes of settlement which requires treatment which is equitable at a given date or point of time. Current accounting is intended to account for funds received and uses of those funds, rather than to provide valuations of assets (except to some extent and at some dates with regard to current assets). Since no funds had been used to acquire the lease, up to December 31, 1947, it was not necessary to state any amount for it in the assets of the partnership up to that date.

No. 12

(a) Either of the two following methods is acceptable:

1. The portion of the current provision for income taxes which is attributable to such item may be applied as a reduction of the credit to surplus and taken up as a credit in the income statement, specifically disclosed and appropriately described, either as a deduction from the aggregate current provision for income taxes or as a separate credit. The recommendation assumes that adequate provision for the entire income tax liability has been made in the income statement.

2. The amount of income taxes shown in the statement of income may reflect the actual taxes believed to be payable under the applicable 'tax laws with footnote disclosure, referenced to both the income and surplus statements, of the tax effect of the item credited to surplus.

Accounting Research Bulletin No. 23 recommends the first method as a means of establishing a normal relationship of the income tax expense to the income shown in the income statement. The Student's Department prefers the second method because it emphasizes the facts as to income tax expense and because it is not the general practice to allocate other items of expense on a hypothetical basis of what they would have been disregarding actual transactions.

(b) Either of the two following methods is acceptable:

1. Assuming that provision has been made in the income statement for the net estimated tax liability, the amount of the reduction in taxes may be credited against the charge to surplus and included as a charge in the income statement, specifically disclosed and appropriately described, either as an addition to the current provision for income taxes or as a separate charge.

2. The amount of income taxes shown in the statement of income may reflect the actual taxes believed to be payable under the applicable tax laws with footnote disclosure, referenced to both the income and surplus statements, of the tax effect of the item credited to surplus.

Accounting Research Bulletin No. 23 recommends the first method. The Student's Department prefers method (2) for the reasons stated in (a) above.

(c) Either of the two following methods is acceptable:

1. Corrections of income tax accruals, representing either additions to, or reductions of tax provisions, may be included in the statement of income. If the amount of a correction is material it may be shown separately from the current provision for income taxes.

2. Corrections of income tax accruals, if the amounts are so material and significant in relation to the net income of the period as to produce misleading inferences of the income statement, may be treated as direct charges or credits to surplus with an indication as to the period or periods to which they relate.

Accounting Research Bulletin No. 32 recommends the first method with separate disclosure of material amounts. The Bulletin states that the charges and credits may be made directly to surplus (second method) if misleading inferences might be drawn from their inclusion in the income statement. The writer prefers the first method because he believes it desirable to reflect all revenue and expense in the income statement with a sectional segregation of operating and non-operating items.

NOTATION:

The following references present a fairly complete statement of views relating to the question:

Contemporary Accounting, Chapters 3, 4, and 38.

Accounting Research Bulletin, Nos. 8, 23, and 32.

Accounting Practice—Part II

November 13, 1947, 1:30 to 6:00 p.m.

No. 1

(a)

X Bank Loan Account

Sept 1-15, 1947	Advanced by bank on 360,000 lbs.		$52,800
	Remitted to bank on 190,625 lbs. @ $ .1475....		28,117
Sept. 15, 1947	Balance due bank on 169,375 lbs.		$24,683
Sept. 16-30, 1947	Advanced by bank on 126,000 lbs.		18,510
	295,375		$43,193
	Remitted to bank on 171,875 lbs. @ $ .1457....		25,042
Sept. 30, 1947	Balance due bank on 123,500 lbs.		$18,151
Oct. 1-15, 1947	Advanced by bank on 135,000 lbs.		20,025
	258,500 lbs.		$38,176
	Remitted to bank on 114,583 lbs. @ $ .1470....		16,844
Oct. 15, 1947	Balance due bank on 143,917 lbs.		$21,332
Oct. 16-31, 1947	Advanced by bank on 85,000 lbs.		12,450
	228,917 lbs.		$33,782
	Remitted to bank on 156,250 lbs. @ $ .1482....		23,156
Oct. 31, 1947	Balance due bank on 72,667 lbs.		$10,626

(b)

Statement in Pounds of
Materials Covered by Trust Receipts
October 31, 1947

	Quantities Purchased	Quantities Paid for	Balance
Sept. 1-15, 1947	360,000	190,625	169,375
Sept. 16-30, 1947	126,000	171,875	123,500
Oct. 1-15, 1947	135,000	114,583	143,917
Oct. 16-31, 1947	85,000	156,250	72,667

Computation of Quantities Paid for

Sept. 1-15, 1947	Remittances based on 183,000 lbs. of sales = 183,000 ÷ .96 = 190,625 lbs.
Sept. 16-30, 1947	Remittances based on 165,000 lbs. of sales = 165,000 ÷ .96 = 171,875 lbs.
Oct. 1-15, 1947	Remittances based on 110,000 lbs. of sales = 110,000 ÷ .96 = 114,583 lbs.
Oct. 16-31, 1947	Remittances based on 150,000 lbs. of sales = 150,000 ÷ .96 = 156,250 lbs.

Computation of Remittance Rate

Sept. 1-15, 1947	Rate given		= $ .1475
Sept. 16-30, 1947	Rate based on Sept. 15 balances... =	$ 24,683	= $ .1457
		169,375	
Oct. 1-15, 1947	Rate based on Sept. 30 balances... =	$ 18,151	= $ .1470
		123,500	
Oct. 16-31, 1947	Rate based on Oct. 15 balances.... =	$ 21,332	= $ .1482
		143,917	
Oct. 31, 1947	Rate .... =	$ 10,626	= $ .1462
		72,667	

(c)

Assigned Accounts Receivable

	Sales		Collections		Balance	
	Pounds	Amount	Pounds	Amount	Pounds	Amount
Sept. 1-15, 1947......	250,000	$ 42,040	183,000	$ 30,875	67,000	$ 11,165
Sept. 16-30, 1947.....	150,000	25,000	165,000	27,500	52,000	8,665
Oct. 1-15, 1947.......	150,000	25,125	110,000	18,425	92,000	15,365
Oct. 16-31, 1947......	75,000	12,525	150,000	25,100	17,000	2,790
	625,000	$104,690	608,000	$101,900	17,000	$ 2,790

(d)

Inventory of Product
October 31, 1947

Purchases of raw material....................................	706,000 lbs.
Less inventory of raw material, October 31, 1947.............	23,708 lbs.
Material converted	682,292 lbs.
Finished product manufactured:	
682,292 lbs. × .96 = ...	655,000 lbs.
Finished product sold and shipped...........................	625,000 lbs.
Inventory of finished product, October 31, 1947...............	30,000 lbs.

No. 2

(a)

(1)

Account Sales

Of shipment of gas burners
Received from the Winston Company, to be sold for its account and risk
Rendered by Holmes Plumbing Co.

Sales—13 gas burners @ $185.00..............................		$2,405.00
Charges:		
Freight and cartage on 18 burners received..........	$ 36.00	
Commission—25% of $2,405.00......................	601.25	637.25
Net proceeds—check enclosed		$1,767.75

Received		18	gas burners
Sold	13		
Returned	2	15	" "
On hand, September 30, 1947		3	" "

(2)

Account Sales

Of shipment of gas burners
Received from the Winston Company, to be sold for its account and risk
Rendered by Lundeen Heating Equipment Co.

3 burners sold @ \$250.00		\$ 750.00
Less charges:		
Inward transportation on 6 burners	\$ 18.00	
Commission—25% of \$750.00	187.50	205.50
Net proceeds—check enclosed		\$ 544.50

Received		6	gas burners
Sold	3		
Returned	1	4	" "
On hand, September 30, 1947		2	" "

(3)

Account Sales

Of shipment of 12 gas burners
Received from the Winston Company, to be sold for its account and risk
Rendered by Quincy Furnace Co.

Sales during September, 1947		
9 burners @ \$200.00		\$1,800.00
Charges during September, 1947		
Cost of repairing defective burner	\$ 6.00	
Commission on \$1,800 @ 25%	450.00	456.00
Net proceeds—check enclosed		\$1,344.00

Received	12	burners
Sold	9	"
On hand, September 30, 1947	3	"

THE WINSTON COMPANY

Adjusting Journal Entries

September 30, 1947

(1)

		Debit	Credit
Sales		$7,200.00	
Accounts receivable			$7,200.00
To reverse entries erroneously made by recording consignments out as sales as follows:			
Holmes Plumbing Company	$3,600.00		
Lundeen Heating Equipment Company	1,200.00		
Quincy Furnace Company	2,400.00		
	$7,200.00		

(2)

		Debit	Credit
Consignments out		3,600.00	
Manufacturing			3,600.00
To record consignments out at manufacturing cost of $100 per burner as follows:			
Holmes Plumbing Company	$1,800.00		
Lundeen Heating Equipment Company	600.00		
Quincy Furnace Company	1,200.00		
	$3,600.00		

(3)

		Debit	Credit
Manufacturing		40.00	
Accounts receivable			40.00
To correct error made on September 20, 1947 in charging Holmes Plumbing Company for charges on two defective burners returned as follows:			
Freight on return	$ 22.00		
Repair of burners	18.00		
	$ 40.00		

(4)

	Debit	Credit
Manufacturing	28.00	
Accounts receivable		28.00
To correct error made on September 15, 1947 in charging Lundeen Heating Equipment Company with freight on return of defective burner.		

(5)

	Debit	Credit
Accrued liabilities	450.00	
Accounts receivable		450.00
To correct error made on September 30, 1947 in which commissions allowed Quincy Furnace Company were charged to accounts receivable and set up in accrued liabilities.		

(6)

Consignments out		36.00	
Accounts receivable			36.00
To transfer freight paid on shipment to Quincy Furnace Company to "consignments out."			

(7)

Accounts receivable		200.00	
Sales returns and allowances			200.00
To reverse entry made in error on September 15, 1947 for return by Lundeen Heating Equipment Company of one defective burner.			

(8)

Manufacturing		307.00	
Consignments out			307.00
To record return of defective burners as follows:			
Holmes Plumbing Company			
2 burners @ $100 plus $2 freight paid by consignee	$ 204.00		
Lundeen Heating Equipment Company			
1 burner @ $100 plus $3 freight paid by consignee	103.00		
	$ 307.00		

(9)

Consignments out		307.00	
Manufacturing			300.00
Selling expense			7.00
To record shipment on September 27, 1947 of burners on consignment as follows:			
Holmes Plumbing Company			
2 burners	$ 204.00		
Lundeen Heating Equipment Company			
1 burner	103.00		
	$ 307.00		

(10)

Account receivable		3,656.25	
Cash			3,656.25
To reverse entries of September 30, 1947 for collection of cash from consignees since cash was not received until October, 1947, as follows:			
Holmes Plumbing Company	$1,767.75		
Lundeen Heating Equipment Company	544.50		
Quincy Furnace Company	1,344.00		
	$3,656.25		

(11)

Accounts receivable	$3,656.25	
Consignments out	54.00	
Selling expense	1,300.75	
Manufacturing	2,506.00	
Sales		$4,955.00
Consignments out		2,562.00

To record sales of burners made in September, 1947 by consignees, per account sales received.

Charge consignments out:

Freight charges paid by	
Holmes Plumbing Company	$ 36.00
Lundeen Heating Equipment Company	18.00
	$ 54.00

Charge selling expense:

Commissions to	
Holmes Plumbing Company	$ 601.25
Lundeen Heating Equipment Company	187.50
Quincy Furnace Company	450.00
	$1,238.75
Freight charges on burners sold	
Holmes Plumbing Company	
13 burners @ $2	26.00
Lundeen Heating Equipment Company	
3 burners @ $3	9.00
Quincy Furnace Company	
9 burners @ $3	27.00
	$1,300.75

Charge manufacturing:

25 burners @ $100	$2,500.00
Repairs on one defective burner	6.00
	$2,506.00

Credit sales:

Holmes Plumbing Company	$2,405.00
Lundeen Heating Equipment Company	750.00
Quincy Furnace Company	1,800.00
	$4,955.00

Credit consignments out:

25 burners @ $100	$2,500.00
Freight charged to selling expense	62.00
	$2,562.00

(c)

THE WINSTON COMPANY

Balance Sheet

September 30, 1947

Assets

Current:		
Cash		$ 55,253.75
Accounts receivable	$241,722.50	
Less reserve for bad debts	9,398.00	232,324.50
Inventories:		
Finished burners (including burners on consignment in amount of $1,128.00)	$ 22,328.00	
Work in process, materials and supplies	42,271.00	64,599.00
Prepaid expenses		3,007.00
Total current assets		$355,184.25
Property and Equipment	$128,762.00	
Less reserve for depreciation	27,632.00	101,130.00
		$456,314.25

Liabilities

Current:		
Accounts payable		$ 31,742.00
Accrued liabilities		138,348.00
Total current liabilities		170,090.00

Capital

Capital stock	$100,000.00	
Earned surplus	186,224.25	286,224.25
		$456,314.25

(d)

THE WINSTON COMPANY

INCOME STATEMENT

for the year ended September 30, 1947

Sales		$641,702.00
Less returns and allowances		2,448.00
Net sales		$639,254.00
Cost of sales		128,365.00
Gross profit		$510,889.00
Expenses:		
Selling expenses	$140,930.75	
Administration expenses	89,423.00	230,353.75
Net profit on operation		$280,535.25
Other deductions, net of other income		3,289.00
		$277,246.25
Less provision for income taxes		110,000.00
Net income for the year		$167,246.25

(b)

THE WISTON COMPANY
WORK SHEET
Year Ended September 30, 1947

	Trial Balance Dr.	Trial Balance Cr.	Adjusting Entries Dr.	Adjusting Entries Cr.	Income Statement Dr.	Income Statement Cr.	Surplus Statement Cr.	Balance Sheet Dr.	Balance Sheet Cr.
Cash	$ 58,910.00	$	$	(10)$ 3,656.25	$	$	$	$ 55,253.75	$
Accounts receivable	241,964.00		(7) 200.00	(1) 7,200.00				241,722.50	
			(10) 3,656.25	(3) 40.00					
			(11) 3,656.25	(4) 28.00					
				(5) 450.00					
				(6) 36.00					
Inventories—burners	21,200.00							21,200.00	
Inventories—work in process, materials and supplies	42,271.00							42,271.00	
Prepaid expenses	3,007.00							3,007.00	
Plant	128,762.00							128,762.00	
Accounts payable		31,742.00							31,742.00
Accrued liabilities		138,798.00	(5) 450.00						138,348.00
Capital stock		100,000.00							100,000.00
Earned surplus		18,978.00					18,978.00		
Sales		643,947.00	(1) 7,200.00	(11) 4,955.00		641,702.00			
Sales returns and allowances	2,648.00			(7) 200.00	2,448.00				
Manufacturing	129,384.00		(3) 40.00	(2) 3,600.00	128,365.00				
			(4) 28.00	(9) 300.00					
			(8) 307.00						
			(11) 2,506.00						
Selling expense	139,637.00		(11) 1,300.75	(9) 7.00	140,930.75				
Administrative expense	89,423.00				89,423.00				
Reserve for bad debts		9,398.00							9,398.00
Reserve for depreciation		27,632.00							27,632.00
Non-operating income		318.00				318.00			
Non-operating expense	3,607.00				3,607.00				
Provision for income taxes	110,000.00				110,000.00				
	$970,813.00	$970,813.00							
Consignments out			(2) 3,600.00	(8) 307.00				1,128.00	
			(6) 36.00	(11) 2,562.00					
			(9) 307.00						
			(11) 54.00						
			$ 23,341.25	$ 23,341.25	$474,773.75	$642,020.00			
Net income for the year					167,246.25		167,246.25		
					$642,020.00	$642,020.00			
Earned surplus, September 30, 1947							$186,224.25		186,224.25
								$493,344.25	$493,344.25

Commercial Law

November 14, 1947, 9:00 a.m. to 12:30 p.m.

No. 1

(a) The partnership capital is the aggregate of the sums of money or other property contributed by its members to establish or continue the partnership business, while the partnership property embraces everything that the firm owns, including its capital and all the property subsequently acquired in partnership transactions.

(b) Partnership liability begins when the partnership is actually formed, although articles of partnership are not executed until later. A partnership liability may be imposed upon a person under principles of estoppel, where he holds himself out, or permits himself to be held out, as a partner in an enterprise.

(c) Under the Uniform Partnership Act, which is in effect in 25 states, an incoming partner is liable to the extent of firm assets for debts and engagements of the firm created prior to his admission. In common-law jurisdictions, he is not liable unless he assumes such obligations. The manner in which such assumption must be made differs in different jurisdictions; some holding that, in order to render such incoming partner liable to previous creditors, they must be parties to the agreement by which such debts are assumed, while others hold that such partner is liable to the creditors on his agreement to assume, although they were not parties thereto.

(d) Every partner, whether having an active part in the management of the business or not, has a right to be informed particularly as to all the firm's operations; and for this purpose he may, in the absence of express agreement to the contrary, inspect, examine and make extracts from all the books of the firm.

(e) A general partner is one who is liable for all firm debts. A special partner is one whose liability for firm debts is limited to a defined amount. Special partners exist only by statutes relating to limited partnerships.

(f) A special partner will be held liable as a general partner by any of the following acts; taking an active part in the business or interfering in the management of the business; in most states, by any alteration in any of the matters stated in the certificate; or failure to comply with, or the violation of, any of the requirements of the statute. In some states, the withdrawal by the special partners of any part of the sum contributed by them, either as dividends, profits, or otherwise, at any time during the continuance of the partnership renders them liable as general partners; but in most states such withdrawal merely renders the special partners liable to restore the sums withdrawn, with interest.

(g) Lee's liability to the creditors of the old firm of Jock and Kilroy is limited to satisfaction out of the partnership assets of the new firm of Jock, Kilroy and Lee, namely, the $6,000. Jock and Kilroy are liable for the claims of creditors of the old firm. Lee, Jock and Kilroy are liable to creditors since Lee's admission into the firm.

No. 2

(a) The words "value received" are not essential to the validity of a note or bill. The term is inserted to show that the instrument is founded upon sufficient consideration; but the note or bill itself imports a consideration, and its mere production is prima facie evidence thereof; in certain cases, however, statutes require that the nature of the consideration be stated in the instrument.

(b) Generally, such persons have no power to bind the estates which they represent by negotiable paper, and if they attempt to issue such paper in their representative capacity, they are held personally liable thereon; the matter descriptive of their representative character being treated as surplusage. Where any person is under obligation to endorse in a representative capacity, he may negative personal liability by endorsing without recourse or in terms which clearly indicate an intention to bind only the principal or estate.

(c) Every person negotiating an instrument by delivery or by a qualified endorsement, warrants—

1. that the instrument is genuine and in all respects what it purports to be;
2. that he has good title to it;

3. that all prior parties had capacity to contract (this warranty does not apply to persons negotiating public or corporation securities other than bills and notes);
4. that he has no knowledge of any fact which would impair the validity of the instrument or render it valueless;

but when the negotiation is by delivery only, the warranty extends in favor of no holder other than the immediate transferee.

(d) When 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 endorsers. 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.

(e) Any alteration which changes:
1. the date;
2. the sum payable, either for principal or interest;
3. the time or place of payment;
4. the number or the relations of the parties;
5. the medium or currency in which payment is to be made;

or which adds a place of payment where no place of payment is specified, or any other change or addition which alters the effect of the instrument in any respect, is a material alteration.

(f) It is not a negotiable instrument. A negotiable promissory note must contain an unconditional promise to pay. A promise to pay out of a particular fund is conditioned upon there being moneys available in that fund and is therefore not an unconditional promise.

(g) The Uniform Negotiable Instruments Law requires the holder of the note to serve a notice of dishonor upon the endorser, his agent or personal representative, within the time provided in the Act. The Act, however, excuses the failure to serve the notice in accordance with the provisions thereof when such service cannot be made after the exercise of due diligence. In this case the facts are sufficient to support a finding that the holder did exercise due diligence by serving it upon the executor named in the will, even though it appeared later that the executor had renounced and another had been appointed substitute administrator.

No. 3

(a) Consideration in the law of contracts may be defined as an act, or a forbearance, or the creation, modification or destruction of a legal relation, or a return promise, bargained for and given in exchange for a promise. Consideration may be given to the promisor or to some other person. It may be given by the promisee or by some other person.

(b) Consideration is sometimes classified as good or valuable. Valuable consideration is that which is sufficient to support an executory contract. It is defined in the answer to 3(a) above. Good consideration has no place in the law of executory contracts, but is of importance in executed transfers of property, especially in the law of fraudulent conveyances. Love and affection based on kinship by blood or marriage is called good consideration.

(c) A valuable consideration is essential to the validity of every simple contract, whether it is required to be in writing or not, except that want of consideration does not avoid a negotiable instrument in the hands of a bona fide purchaser for value.

(d) The delivery of the debtor's unsecured and unendorsed negotiable note or check will discharge a contract to pay money only when it is clearly accepted by the party entitled in discharge of his right absolutely. In most states it is presumed, in the absence of expressions to the contrary, that such payment is conditional, and that, if the instrument is not paid when due, the payee reverts to his original rights, either to performance of the contract or satisfaction for its breach.

(e) A part payment of the debt, or interest thereon, a written acknowledgment of it, or a written promise to pay it is sufficient to revive a barred debt. In some jurisdictions an oral promise is held sufficient.

(f) X is entitled to a judgment on the counterclaim for $2,000 less the damages caused to Y by the substitution of pine flooring instead of oak flooring. Where a party to a contract has substantially performed the contract he is entitled to recover on the contract with a deduction for so much as has not been performed in accordance with the contract.

No. 4

(a) 1. The relation of the bank and the depositor in an ordinary deposit and checking account is that of debtor and creditor.

2. The relation is that of bailee and bailor. A "special deposit" implies the custody of property without the authority in the custodian to use it, and the right of the owner to receive back the identical thing deposited.

3. Title to deposits in (1) is vested in the bank. Title to deposits in (2) is vested in the depositor. Ordinary deposits are not the property of the depositors but of the bank receiving them; the relation of the bank and depositor being that of debtor and creditor, the deposits are the assets of the bank. Special deposits are the property of the bailor who retains title, the bank merely holding possession as bailee.

4. In an ordinary deposit and checking account the general rule is that the bank and depositor have mutual rights of set-off in their accounts. Where a depositor is indebted to a bank he is entitled to set-off this indebtedness against his credit balance in the bank even though the bank is insolvent. On the other hand a bank may look to the credit balance in its hands for repayment of any matured indebtedness to it by the depositor.

5. In the absence of express authority, a bank has no right of set-off against the depositor's credit balance until such debt matures and becomes due. A bank cannot withhold payment of a fund on deposit or refuse payment of a check on the ground that it holds a note which will mature at some future date for payment for which it seeks to hold the deposit.

(b) 1. A bank is under obligation to honor its depositors' checks to the extent of the depositors' respective credit balances. A refusal to pay without good and sufficient reason will warrant recovery of damages.

2. Banks are under no obligation to payees to pay checks, being only answerable to the depositors for refusal to pay.

(c) Banks cannot charge against depositors' accounts money paid on forged checks or on checks to which the bank obtained title by forged endorsement as they are authorized by the depositor to pay only checks properly signed and endorsed.

No. 5

(a) An act of bankruptcy is an act committed by a debtor which will render him liable to be proceeded against in involuntary bankruptcy by his creditors and will warrant the court's adjudging him bankrupt on a proper petition in their behalf.

(b) The statute declares that an act of bankruptcy shall be deemed to have been committed by a person who has:

1. Conveyed, transferred, concealed, removed, or permitted to be concealed or removed any part of his property, with intent to hinder, delay, or defraud his creditors, or any of them;
2. Transferred, while insolvent, any portion of his property to one or more of his creditors with intent to prefer such creditors over his other creditors;
3. Suffered or permitted, while insolvent, any creditor to obtain a lien upon any of his property through legal proceedings and not having vacated or discharged such lien within thirty days from the date thereof or at least five days before the date set for any sale or other disposition of such property;
4. Made a general assignment for the benefit of his creditors;
5. While insolvent, or unable to pay his debts as they mature, procured, permitted or suffered voluntarily or involuntarily the appointment of a receiver or trustee to take charge of his property;
6. Admitted in writing his inability to pay his debts and his willingness to be adjudged a bankrupt.

(c) Insolvency is not always a necessary ingredient or element in the commission of an act of bankruptcy; that depends upon the wording of the statute with reference to the particular act of bankruptcy alleged, and it will be construed with reasonable strictness.

(d) 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.

(e) The statute provides that in all cases of mutual debts or mutual credits between the estate of a bankrupt and a creditor the account shall be stated and one debt set-off against the other, and the balance only shall be allowed or paid. But the creditor's claim must be of a nature to be provable in bankruptcy and must not have been purchased by or transferred to him after the filing of the petition or within four months before such filing, with a view to such use and with knowledge or notice that such bankrupt was insolvent or had committed an act of bankruptcy. In addition, the creditor must not have received or acquired preferences, liens, conveyances, transfers, assignments, or encumbrances which are void or voidable under the Bankruptcy Act, unless he shall surrender them.

(f) A set-off cannot ordinarily be allowed where the debt in question is due from the bankrupt jointly with others, or where others are jointly interested with the creditor in the claim offered for set-off.

(g) A bank which has a provable claim against a bankrupt may set-off the amount thereof against money of the bankrupt which it holds at the commencement of the bankruptcy proceedings in a general deposit account, but not where the deposit was for safekeeping only, or was made and accepted for a special and designated purpose.

No. 6

(a) 1. When the mortgagor insures his own interest for his separate benefit, the mortgagee takes no greater rights than any other unsecured creditor in the proceeds. When the mortgagor insures for the benefit of the mortgagee, or is under a contract duty so to do, insurance money payable under a policy procured by the mortgagor must be applied to the payment of the mortgage debt.

2. When the mortgagee insures his interest on his sole account, money paid by the insurer will not inure to the benefit of the mortgagor. When the mortgagee insures under a provision that the premiums paid shall be added to the mortgage

debt, insurance money received will reduce the debt pro tanto.

(b) After fire loss, insurance proceeds are payable to the person insured who bears the risk of loss, in accordance with his insurable interest. The general view is that the vendee is entitled to the proceeds, since it is upon him that the loss falls, but in those jurisdictions in which the vendor bears the risk of loss, he is entitled to retain the insurance money. The vendor takes no benefit under a policy procured independently by the vendee after the contract of sale.

(c) Since the interests of a life tenant and a remainderman are separate, insurance procured separately by either will not inure to the benefit of the other. However, if the life tenant insures the courts are quick to find an intention to act as agent for the remainderman in protecting the latter's interest as well as his own. In such case the life tenant is required to hold the excess above his interest as trustee for the remainderman.

(d) The right of action is in the insured's personal representative, who holds the proceeds for the person, whether heir or devisee, who was entitled to receive the property destroyed.

(e) The insured must generally do two things. He must give notice of loss to the insurer within the time specified in the policy, or if no time is specified, within a reasonable time. He must also file proof of loss within the time prescribed by the policy (generally 60 days).

(f) 1. Notice of loss is held to be "immediate," within the requirement of a standard policy, when it is given as soon after the fire as is reasonably possible under existing circumstances, in the exercise of due diligence.
   2. Proofs of loss satisfactory to the insurer are required to be given, but the insurer must be satisfied when the insured has done all in his power to furnish the information stipulated for in the policy. It is the duty of the dissatisfied insurer to indicate the defects in the proofs of loss as given, so that the deficiencies may be supplied. His retention of the defective proofs constitutes a waiver of his objections.

No. 7

(a) Burt's action was maintainable. The thief acquired the property in the goods as against everyone but Burt. The thief's bailee could derive no greater right by reason of the bailment than the bailor had. Upon Burt's making a demand for the article, the bailee's innocent receipt thereof became wrongful.

(b) Burt was not justified. Burt lost his right to a lien when he agreed to extend credit for his services, and the credit term had not expired for it was to commence after delivery of the medallion.

(c) According to the weight of authority, the garage owner is liable for damages resulting from his failure to exercise due care by the employment of trustworthy servants and otherwise for the safekeeping of cars in his charge. Many jurisdictions hold that a *prima facie* case for a recovery is made out by showing the use of an automobile by an employee of the garage where it was stored, without the knowledge or consent of the automobile's owner and resulting damage. It has been held, although there is a conflict in the decisions, that a car owner may recover nominal damages for breach of the contract of bailment on a mere showing that the automobile was taken out of the garage without authority from the automobile owner.

(d) The levy was good. The bailee Williams, had a property right in the goods by reason of his lien for services rendered thereon. This right could be the subject of levy under an execution. Under older law, however, the view was that a bailee's lien for the improvement of property was personal and not subject to attachment.

No. 8

(a) An agency is generally terminated by operation of law in any of the following ways:
1. By the death of either the principal or agent.
2. By the insanity of either the principal or agent.
3. By the bankruptcy of the principal, and generally by that of the agent.
4. By war between the country of the principal and that of the agent.

(b) In the following cases an agent may become personally liable to third persons:
1. When he acts without authority or exceeds his authority, whether such acts are done intentionally or through ignorance as to the extent of his authority.

2. When an authorized agent, intending to bind his principal, executes an instrument in such a way as to bind himself instead of his principal.
3. When he expressly pledges his own liability.
4. When he conceals his character as agent, or conceals the name of his principal or renders his principal inaccessible.
5. Where there is no responsible principal, either from want of legal existence or from want of legal responsibility.
6. He is liable for his torts, whether done in obedience to or in disobedience of his instructions.

(c) An agent is not liable to a third person merely by reason of failure to perform a duty which he owes to his principal. However, if he enters upon the performance of any act, he is liable to a third person for any injury resulting from his failure to exercise such reasonable care in the manner of its performance as he owes to such person.

(d) The duties of an agent to account to his principal require him to keep accurate accounts of all his transactions in the course of the agency, and to render his accounts whenever required by the terms of his employment or upon demand; to keep money and property of the principal separate from his own and from those of third persons; to pay or deliver to the principal all money or property of the principal coming into his hands as agent whenever required by the terms of the employment or upon demand.

(e) The rule is that all profits made and advantages gained by the agent in the execution of the agency belong to the principal. It makes no difference whether the profit or advantage results from a strict performance or from a violation of the agent's duty.

(f) The merchant cannot recover the price of the goods if the principal's executor rejected them. The death of the principal terminated the agent's authority unless it was an agency coupled with an interest. When the offer was made, the agent still had authority to make it. The offer, however, even if made directly by the principal, lapses upon his death. Hence, if the acceptance took place after the principal's death, the offer having lapsed, there was no contract, and there could be no liability thereon.

(g) The principal is bound by the contract. Where an agent exceeds his authority, the principal on being informed must repudiate the act within a reasonable time thereafter or he will be bound thereby.

No. 9

(a) Every corporation should keep accurate records of matters pertaining to its corporate proceedings. Even if not expressly required by statute, practical necessity requires that minute books, stock certificate books, stock ledgers and general books of account and records be kept to evidence the various corporate proceedings and business transactions.

(b) 1. The books and records kept by a corporation in the regular course of business, when shown to be such, are admissible in evidence in judicial proceedings.

2. When proper steps are taken to render corporate books and records competent as evidence, they are *prima facie* evidence of the matters or entries they contain.

3. While statutory provisions vary, in general such books and records in order to be admitted in evidence must:

a. be identified by their official custodian;

b. the person who made the entries must testify that he made them in the regular course of business;

c. if such person is not available the official custodian must testify to the fact that the entries were made in the regular course of business by the person authorized to make them.

(c) Ordinarily, every holder of common or voting stock has a preemptive right to preserve the proportionate interest which he has in the corporation when the capital stock is increased or decreased. Accordingly, he has a prior right to subscribe for or to purchase such part of any original stock issue as represents his proportion of the then outstanding capital stock. When a corporation acquires stock in partial liquidation to effect a legal reduction of the capital stock, it must do so in a manner which will preserve to each stockholder his proportionate interest in the corporation.

(d) 1. The term "proxy" is generally used to designate an agent appointed by a stockholder to represent him and cast his vote at a stockholders meeting. The instrument by which such an agent is appointed is also termed a "proxy."

2. Unless the instrument so provides, a person who has been appointed a proxy may not, in the event he is unable to attend, appoint another to represent the stockholder and vote the stock at a meeting. Instruments of appointment, how-

ever, usually provide for such a substitution, and such provisions are effective.

3. A director may not appoint another to represent him and vote by proxy at a meeting of the board of directors. The stockholders place their trust and confidence in the individual directors elected by them and the directors cannot delegate their powers.

(e) The stockholder should succeed. Directors cannot fix their own compensation unless authorized by the charter or by-laws, because their fiduciary relation to the corporation prevents them from contracting with the corporation when the corporation's interests conflict with the private interests of the directors. However, the weight of authority is that directors may receive compensation for rendering unusual or extraordinary services, the quantity of their compensation to be measured by what the services are reasonably worth. In a case such as this, if the directors were required to use exceptional or extraordinary efforts in the sale of stock, they might be allowed compensation for the value of their services, although not the value fixed by themselves in the resolution.

No. 10

(a) In computing the amount of gain or loss proper adjustment must be made for an expenditure, receipt, loss or other item, properly chargeable to capital account, and the basis must be diminished by deductions for depreciation and depletion which have been allowed or allowable. While the adjustments are specified arbitrarily by the statute, the underlying principle is to debit the account with those amounts laid out and not deductible, and to credit the account with the amounts representing in some way a return of capital.

(b) Substituted basis means the basis as determined by reference to the basis in the hands of the transferor, donor or grantor, or by reference to other property held at any time by the person for whom the basis is to be determined.

(c) If X, on July 15, 1945, made a gift to Y of certain shares of stock, the basis of the stock to Y, for determining gain on a sale is the same as it was in the hands of X, that is $10,000. Y's gain was $10,000.

(d) The net capital loss of $4,000 in 1945 from the sale of capital assets is allowed as a deduction from other net income to the extent of $1,000. Hence, the taxpayer's net income in 1945 should be $9,000 ($10,000-$1,000). The balance of such loss ($3,000) may be carried forward as a short-term capital loss for a period of the five succeeding years.

(e) In 1946, the taxpayer would have a net income of $9,000 computed as follows:

Net income other than capital asset transactions..		$10,000
Net capital gain in 1946 on sale of capital assets	$1,500	
Application of 1945 carry-over to extent of such net gain....................	1,500	
Less: Capital loss carry-over from 1945 applied against other net income.............		1,000
		$ 9,000

The balance of the net capital loss from the sale of capital assets ($500) sustained in 1945 ($4,000) may be carried over to 1947.

No. 11

(a) A guaranty is a collateral and conditional promise designed to protect the promisee from loss in case another fails to perform his duty. It is conditioned on the other's failure to perform and is unenforceable unless in writing. A warranty is an independent promise designed to protect the promisee against loss in the event that the facts warranted are not as the promisor states them to be when the contract is made. A warranty is broken as soon as it is made if the facts are not as represented, and is enforceable though oral.

(b) If a creditor releases a surety, his co-sureties are discharged to the extent to which they, upon payment, might have obtained reimbursement from the surety released. However, if as a part of the release of one surety the creditor reserves his rights against the remaining sureties, it is generally held that the release as such does not have the effect of discharging or reducing the obligations of the remaining sureties. This is because the release applies solely between the creditor and the released surety. The creditor's reservation of his rights against other sureties by implication reserves the rights of the other sureties against the released surety. The other sureties, if they ultimately pay more than their proportionate share, are entitled to contribution from the released surety.

(c) The surety is discharged if the creditor materially alters the principal's contract so that the principal is discharged. If the principal and creditor modify their contract without the surety's consent, an uncompensated surety is discharged unless the modification is of a sort that can only be beneficial to the surety; a compensated surety is discharged only if the modification materially increases his risk or, in case the risk is not materially increased, to the extent of loss due to the modification.

(d) If the creditor enters into a binding agreement with the principal debtor to extend the time of payment, the surety is discharged. This consequence does not follow unless the creditor's promise is definite enough to be enforced, and is supported by a legal consideration. An agreement extending the time of payment that is obtained by the principal's fraud, or that is made with a third person, is generally held not to discharge the surety. Nor is the surety discharged when the creditor reserves his remedies against the surety, when the surety is indemnified, when the surety consents to the extension, or when the creditor was unaware of the existence of the suretyship relation when he extended the time of payment. There is a tendency to hold compensated sureties, notwithstanding extensions of time, unless they show that injury has been caused them by the extension agreement.

(e) When a surety pays his principal's debt he is entitled to have his co-sureties repay him their proportion of the indebtedness paid. At law, a surety's proportion of the indebtedness was determined by the number of sureties; in equity, by the number of solvent sureties. The equity rule is generally followed in those jurisdictions in which separate courts of law do not exist. Where sureties are obligated for varying amounts, the proportion of the debt that a particular surety must contribute is determined by reference to the amount for which he is obligated.

(f) The statute of limitations on the right of contributions begins to run from the time the surety paid more than his share. A surety is not entitled to contribution until he pays more than his proportionate share of the debt, and the statute of limitations does not begin to run against his claim to contribution until he has paid to this extent.

(g) A surety is entitled to contribution from a co-surety of whose existence he did not know, in the proportionate amount by which his payment relieved the co-surety from liability. If the unknown co-surety had a defense against the creditor, the surety making the payment is not entitled to contribution.

No. 12

(a) When the carrier, without necessity or reasonable excuse, deviates from the usual or agreed route, he becomes absolutely liable for the goods, unless it is shown that the loss would have occurred from the same cause if there had been no deviation. The carrier may also be liable for additional charges incurred by reason of a deviation or, in some cases, for damages to the shipper for his loss of opportunity to accomplish some special purpose at an intermediate point in the shipment. In the absence of special contract to transport and deliver within a prescribed time, the common carrier is bound to use only reasonable care or ordinary diligence in completing the transportation without delay. The carrier is therefore liable for delay only when it is due to his negligence.

(b) By contract, founded upon a consideration, the carrier's liability may be limited to a certain extent which the law can recognize as just and reasonable and not inconsistent with sound public policy. Statutes in some states and the Interstate Commerce Act restrict the right to contract for limitation of liability. Notices limiting liability are ineffectual unless assented to by the shipper, and such assent cannot be inferred merely because the shipper delivers the goods for shipment after he has knowledge of the notice, but regulations enacted for the proper conduct of the carrier's business are binding on the shipper, when they are reasonable and knowledge of them is brought home to the shipper, even without his assent.

(c) No special form is usually required. Acceptance by the shipper of a bill of lading, or similar instrument purporting generally to contain the contract between the carrier and shipper, creates a contract binding on both parties. Such contracts are construed strictly against the carrier. Some statutes require that the assent of the shipper be evidenced by an express contract or something more than the acquiescent receipt of a bill of lading containing stipulations limiting liability.

(d) In the case of carriers by water, after the arrival of the goods, the carrier must give notice of such arrival to the consignee, and also give him a reasonable time to remove the goods. As to railroads, the insuring liability ends

(a) by the Massachusetts rule, when the goods have arrived at their destination and have been stored by the carrier;

(b) by the New Hampshire rule, when, after the arrival and storage of the goods, a reasonable time has elapsed within which the consignee could have removed the goods;

(c) by the Michigan or New York rule, only when, after the arrival of the goods, notice has been given to the consignee, and a reasonable time for their removal has elapsed after such notice.

(e) A common carrier is excused for a failure to deliver goods to the consignee when the goods are demanded by one having paramount title to them; when the consignor, owing to the insolvency of the buyer, has exercised the right of stoppage in transitu; 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 by Act of God, the public enemy, public authority, etc.; or when due to the fault of the shipper or owner the carrier has delivered the goods to the wrong person.

(f) The livery-man is not liable as a common carrier. A livery-stable keeper is not a common carrier, because he does not carry the persons or goods of others indifferently. He may choose to deal with those whom he pleases. His carriage of goods is that of an ordinary bailee for hire, and he is under a duty to exercise reasonable care with respect to the goods he carries. He is only liable for a breach of the duty as to reasonable care and is not an insurer of the goods as is the common carrier.

Auditing

November 14, 1947, 1:30 to 5:00 p.m.

No. 1

The auditor should particularly look for the following in the examination of Articles of Incorporation:

(a) Correct name of company.
(b) Date of incorporation.
(c) Classes of capital stock authorized.
(d) Number of shares of each class authorized.
(e) Whether the shares for each class are to be issued at a par value (and if so, at what par) or without par value.
(f) State or other political jurisdiction in which incorporated.
(g) Provisions with respect to each class of capital stock—preferences, liquidating and retirement values, voting rights, dividend rates, etc.
(h) Time limitation, if any.
(i) Purpose or purposes for which the corporation is organized.
(j) Powers.
(k) Authorized number of directors.

No. 2

(a) By "window dressing" is meant the attempt or act to improve apparent financial position as shown by the balance-sheet, as of a given date, by improperly increasing the amount of assets or reducing the amount of liabilities or both.

(b) Some ways of effecting "window dressing" are:

1. Holding open the cash book at the end of the year so as to enter receipts which properly belong to the following month.
2. Holding open the cash book at the end of the year to enter disbursement items for which checks have not been actually released at the end of the accounting period.
3. Payment, shortly before the end of the accounting period, of loans to officers, following by reborrowing shortly after the end of the period.
4. Holding open the sales book at the end of the year to include sales of the following period.

No. 3

Methods to which dishonest employees may resort in manipulating payrolls include:

(a) Placing names of fictitious employees in the payroll.

(b) Increasing the total amount of the payroll by overfooting.

(c) Carrying the names of former employees on the payroll after their resignation or discharge.

(d) Appropriating unclaimed wages.

(e) Showing earnings of employees at amounts in excess of actual.

(f) Failure to record deductions from employees' wages.

No. 4

Items which should be considered by an auditor in the evaluation of the nature and extent of the internal check and control relating to accounts receivable include:

(1) Are the duties of the accounts receivable bookkeeper separate from any cash functions?

(2) Are write-offs of bad debts and adjustment credits approved by an officer?

(3) Are customer accounts regularly balanced with the control?

(4) Are delinquent accounts periodically reviewed by an officer?

(5) Are monthly statements sent to all customers?

Note: The foregoing items are taken from the example of questionnaire for evaluation of internal control in *Contemporary Accounting,* Chapter 13, page 13.

Other items in the example are:

(1) Are accounts independently confirmed by client's personnel with customers?

(2) Are the accounts aged periodically for review?

(3) Are disputed items handled by someone other than accounts receivable bookkeepers?

(4) Are credit memoranda approved by proper authority and are they under numerical control?

(5) Is approval of credit department a prerequisite to payment of customers' credit balances?

(6) Are statements independently checked to accounts and kept under control to insure their being mailed by someone other than the accounts receivable bookkeeper?

(7) If there is more than one accounts receivable bookkeeper, are the account sections for which they are responsible changed from time to time?

(8) Are cash postings made simultaneously with the posting of the cash receipts records by means of a machine bookkeeping device?

(9) Are allowances for discounts in violation of regular terms of sale specifically authorized by a responsible official?

(10) Is the collection department independent of and does it constitute a check on accounts receivable bookkeepers?

(11) Is the management of the credit department completely divorced from the sales department?

(12) Is proper control exercised over bad debts after they have been written off?

No. 5

(a) Balance of branch account on HO books—Dr.....		$131,690.00
Add back credits:		
No. 2	$300.00	
No. 7	475.00	775.00
		$132,465.00
Deduct debits:		
No. 1	$870.00	
No. 3	325.00	
No. 4	433.00	
No. 5	785.00	2,413.00
Balance on branch books, before 1 to 8—Cr........		$130,052.00
Add credits:		
No. 1	$780.00	
No. 3	250.00	
No. 4	433.00	
No. 4	433.00	
No. 5	78.50	
No. 8	475.00	2,449.50
		$132,501.50
Deduct debits:		
No. 2	$350.00	
No. 6	293.00	643.00
Balance on branch books before adjustment—Cr...		$131,858.50

(b) $132,165.00.

HOME OFFICE ACCOUNT ON BRANCH BOOKS

	Adjusting Entries Dr.	Adjusting Entries Cr.	Balance Cr.
Balance before adjustments			$131,858.50
No. 1	$	$ 90.00	
No. 2		50.00	
No. 3		75.00	
No. 4	433.00		
No. 5		706.50	
No. 6		293.00	
No. 8	475.00		
	$ 908.00	$1,214.50	
Net adjustment			306.50
Corrected balance			$132,165.00

(c) Reconciliation of balance of $131,690 on HO books, with adjusted balance:

	Correcting Entries Dr.	Correcting Entries Cr.	Balance Dr.
Balance before correction			$131,690.00
No. 7	$ 475.00		475.00
			$132,165.00

(d) Journal entries and postings to adjust branch books:

Office furniture		$ 90.00	
Purchase allowances		50.00	
Interest expense		75.00	
Freight in		706.50	
Truck repairs		293.00	
Truck			$475.00
Labor			433.00
Home office current			306.50
To correct accounts.			
Home Office Current:			
Balance	$131,858.50		
Net adjustment	306.50		
Balance	$132,165.00		

No. 6

1. Examine completely or test entries in the control account.

2. Compare opening balance in the account with the balance at the end of the previous fiscal period as shown on work papers or balance-sheet.

3. Check postings to the control account from books of original entry, especially noting any entries other than from purchase journals and from the cash disbursement book. (When a single cash book for both receipts and disbursements is used, investigate particularly credits in the ledger which have been posted from the cash book.)

4. Prove footings of the general ledger control account and the resultant balance.

5. Obtain client's trial balance of the accounts payable ledger; compare individual balances in the ledger with listings on the trial balance; prove footing of the trial balance and compare with the balance in the control account. When client's trial balance is not available make the listing of balances.

6. Examine individual accounts for open items making up the balance; inquire as to the reason for old items being unpaid.

7. Debit balances not offset by credit balances in other accounts with the same vendors, if material, should be treated as miscellaneous receivables in the balance-sheet.

8. Test-check larger invoices entered toward the end of the period with the receiving department and with inventory records to see that purchases were included in inventory or otherwise accounted for in the same period.

9. Examine unentered invoices and test-check large invoices entered in the subsequent period to determine whether they apply to the period under review.

10. Large balances and balances in active accounts, where transactions are substantial, should be compared with creditors' statements received directly by the auditor from suppliers or directly confirmed.

11. Test-check for unrecorded liabilities by examining payments subsequent to the balance-sheet date, unpaid invoices as of that date or later, and receiving records for a few days preceding the close of the accounting period.

12. Obtain a written statement from the client that all known liabilities have been properly recorded.

13. Separate trade accounts payable from other types of open liability accounts.

No. 7

The following records of cash and sales should be kept:

(a) A cash book in which both receipts and disbursements are recorded or a cash receipts book and cash disbursement book.

(b) Entries of cash receipts should be supported by cash register tapes or by a certified record or readings of daily totals of the cash register dial made and recorded by a person other than a sales clerk.

(c) Entries in the disbursement book or in the disbursement side of the cash book should be supported by vouchers or paid invoices.

(d) The cash record should include a column for the entry of bank deposits. These entries should be supported by duplicate deposit slips, stamped by the bank, or by entries in the bank pass book.

(e) The cash receipts record should contain one or more columns for sales, the entries in which should be supported by duplicate sales tickets or a cash register tape.

(f) Preferably all cash disbursements not made by check should be made from a petty cash fund kept on the imprest basis and independently of the cash register. The cash register should then record only receipts.

(g) The disbursement record should also provide a column for checks drawn on the bank and for bank charges not paid by check. The difference between the deposit column and the bank withdrawals column should then be the basis for bank reconciliation.

(h) The difference between the receipts column and the disbursement column should be the balance of cash on hand, other than that in imprest funds.

No. 8

Criticisms of the form and terminology of the balance-sheet of the ABC Company include:

(a) The heading of the balance-sheet is incorrect; a balance-sheet is not for a period, but reflects a condition as of a specific date.

(b) Sub-totals of the classifications are not indicated.

(c) "Related items" if not the cash in bank and on hand should be separately set forth with appropriate descriptive titles.

(d) Accounts and notes receivable should be shown separately.

(e) A reserve for uncollectible accounts is not indicated.

(f) Under the commonly applied rule of the lower of cost or market, raw material should be valued at $100,000, that amount being lower than cost.

(g) Finished goods at sales price anticipates a profit unless sales price is not more than cost. Finished goods are generally stated at the lower of cost or market.

(h) The "Investments" in the current assets section should indicate their nature, i.e., whether notes, stocks or bonds. If they are current assets, the fact that they are marketable should be indicated. No basis of valuation is stated; temporary investments in marketable securities should be valued at the lower of cost or market.

(i) "Land, buildings, machinery, and patents" should not be combined in one title. The reserve for depreciation for each depreciable asset should be deducted from the related asset account.

(j) "Investments among the fixed assets" should be described to indicate their nature and valuation basis.

(k) Treasury stock is not an asset; it should be presented in the net worth section of the balance-sheet. The class of stock, number of shares, and the basis of valuation should be stated.

(1) The deficit should be shown as a deduction from the common stock equity in the net worth section of the balance-sheet.

(m) The term "miscellaneous current liabilities" is not acceptable in view of the large amount involved, $54,000.

(n) Accounts and notes payable should be segregated. Notes payable should be subdivided into trade and bank notes.

(o) Mortgages and bonds should be separated. Maturity dates, interest rates, and a description of the type of each long-term liability should be presented. The assets mortgaged should be indicated.

(p) Preferred and common stocks should be segregated; a brief description of each class of capital stock should be presented with information as to shares authorized, shares issued, the par or stated value (if any), dividend rates, and retirement provisions.

(q) Capital stock is not a fixed liability. It should be listed under a distinguishing caption, such as Capital, Net Worth or the like.

(r) Depreciation reserves are not liabilities.

(s) The depreciation reserves should be segregated in accordance with the asset to which they apply.

(t) Each reserve in "miscellaneous reserves" appearing among the liabilities should have a mutually exclusive title and should be placed in the proper location on the balance-sheet.

No. 9

The vouchers commonly accepted in support of entries in each of the following are:

(a) Sales Register:

Copies of sales invoices and sales tickets, preferably consecutively numbered; cash register tapes; signed contracts; shipping records; customers' orders.

(b) Sales Returns Register:

Copies of consecutively numbered credit memoranda, properly approved; correspondence; receiving records.

(c) Creditors' Voucher or Invoice Register:

Vendors invoices (originals) or signed contracts, properly approved by the purchasing department, with attached receiving reports; consecutively numbered copies of purchase orders; freight bills.

(d) Payroll:

Approved periodic payroll statements; approved time cards or piece work tickets; approved wage and salary increase or decrease notices; personnel department records; union contracts; contracts with individual employees (including officers); cancelled checks; payroll receipts, if any; social security and tax withholding records.

(e) Check Register:

Approved vendors' invoices; cancelled checks; signed vouchers; bank statements; payrolls.

No. 10

Under no circumstances should the public accountant express his opinion on the 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. He should 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 his report discloses such interest.

If the financial interest is not substantial in relation to the capital of the enterprise or to the personal fortune of the public accountant the restrictions stated in the above paragraph do not apply.

The above statement is based on Rule No. 13 of the rules of professional conduct of the American Institute of Accountants. While the rule does not prohibit an audit of a closely held corporation where the report discloses the financial interest of the public accountant, such audits might be refused on the grounds that his independence may be impaired.

No. 11

Estimated Revenue: In support of debits to this account an official copy of the budget approved by the city council or other body authorized to approve the budget and any subsequent officially approved amendments to the budget would be satisfactory evidence. If actual revenue is credited to this account such credits would ordinarily be offset by debits to cash or charges to accounts receivable for taxes and other income items. The documentary evidence of such receipts or charges would be satisfactory evidence in support of these credits to this account.

Appropriations: Official copies of the budget and of amendments to the budget provide satisfactory evidence in support of credits to this account. If expenditures are debited directly to the account, the usual vouchers in support of authorized expenditures provide adequate evidence of the propriety of debits thereto. If expenditures are charged to a separate expenditures account, authorized journal entries closing expenditures to Appropriations are acceptable evidence of such debits.

Encumbrances: Debits to this account are based on purchase orders and contracts, which the auditor should examine, to satisfy himself of the propriety of the amounts charged against the account. The actual postings will be made from an encumbrance register or journal, which should be examined in connection with the examination of the purchase orders and contracts. The offsetting credits to debits to Encumbrances are usually to Reserve for Encumbrances. When expenditures are made the corresponding encumbrances are debited to the reserve and credited to Encumbrances. The auditor should compare the vouchers charged to expenditures (or appropriations) to see that the corresponding purchase orders and contracts have been closed out of Encumbrances and Reserve for Encumbrances.

A balance in this account at the beginning or end of the period should be compared with the corresponding balance in "Reserve for Encumbrances" to see that the two are in agreement. A beginning balance should also be compared with purchase orders and contracts unvouchered at the close of the preceding period, while a balance at the end of the period should be supported by purchase orders and contracts unvouchered as of that date.

Unappropriated Surplus: The original credit to this account is the offset to the debit to estimated revenue. The official copies of the budget and amendments to it deemed satisfactory as evidence of the propriety of debits to estimated revenue are satisfactory evidence of the propriety of credits to Unappropriated Surplus. Other transactions, not budgeted, which may result in credits to the account, may be recorded in the general journal or in other books of original entry. Supporting documents for such entries should be examined by the auditor.

The budget and its amendments also provide the basis for the major debit to the account, which is offset by the corresponding credits to appropriations. Journal entries may provide the basis of other charges to the account. The data underlying such journal entries should be examined by the auditor. At the end of the year the balance of the appropriations account, representing unexpended appropriations, is closed into Unappropriated Surplus by means of a journal entry.

An opening balance should be scrutinized to see that it has been properly carried forward and that it agrees with or can be reconciled with the related amount on the official financial statements as of the end of the preceding period.

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