1951

Unofficial answers to the Uniform certified public accountants examination, May 1948 to November 1950

Robert L. Kane

Spencer Gordon

Fontaine C. Bradley

UNOFFICIAL ANSWERS

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

May 1948—November 1950

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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 published periodically 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 seventh. 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 1948 to November 1950, 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, *Executive Director*
American Institute of Accountants

February 1951

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ACCOUNTING PRACTICE—PART I

May 19, 1948, 1:30 to 6 p.m.

No. 1 (25 points)

See also NOTE.

a. (1) Journal entries to open the books of the Watt Manufacturing Company:

(1) November 30, 1947

Cash	$160,000	
Preferred stock		$100,000
Common stock		60,000

To record issuance of capital stock for cash as follows:
1,000 shares of 4% cumulative preferred stock, par value $100, liquidating and call value $110 per share.
1,000 shares of no-par value common stock.

(2) November 30, 1947

Receivable from Hear Telephone Company	300,000	
Common stock		300,000

To record issuance of 5,000 shares of no-par value common stock to Hear Telephone Company for the net assets of Manufacturing Division (except cash) with book value of $500,000.

a. (2) Journal entries to record the transfer of assets acquired and liabilities assumed by Watt Manufacturing Company from Hear Telephone Company:

Entries on books of Watt Manufacturing Company:

(1) November 30, 1947

Accounts receivable	$ 50,000	
Inventories	100,000	
Plant and property	350,000	
Accounts payable		$ 40,000
Sundry accruals		10,000
Reserve for depreciation		150,000
Receivable from Hear Telephone Company		300,000

To record assets acquired and liabilities assumed from Hear Telephone Company at November 30, 1947.

(2) December 31, 1947

Receivable from Hear Telephone Company	$ 2,000	
Accounts payable	18,000	
Profit and loss	12,000	
Accounts receivable		$10,000
Inventories		20,000
Reserve for depreciation		2,000

To record December, 1947 transactions which were recorded on the books of Hear Telephone Company.

Entries on books of Hear Telephone Company—Communications Division: (continued on opposite page)

Note: Alternate Solution

The following entries may be substituted for entries a. (1), (1) and (2) and a. (2) (1):

(1) November 30, 1947

Subscribers to capital stock	$460,000	
Common stock subscribed		$360,000
Preferred stock subscribed		100,000

To record subscriptions to capital stock as follows:

Common stock, no-par value for:

Cash	1,000 shares	$ 60,000
Net assets	5,000 shares	300,000
	6,000 shares	$360,000

Preferred stock, $100 par, 4% cumulative, liquidating and call value $110, for:

Cash	1,000 shares	$100,000

(2) November 30, 1947

Cash	160,000	
Common stock subscribed	60,000	
Preferred stock subscribed	100,000	
Common stock		60,000
Preferred stock		100,000
Subscribers to capital stock		160,000

To record issuance of 1,000 shares of no-par value common stock and 1,000 shares of $100 par value preferred stock for $60,000 and $100,000, respectively.

(3) November 30, 1947

Accounts receivable	50,000	
Inventories	100,000	
Plant and property	350,000	
Common stock subscribed	300,000	
Accounts payable		40,000
Sundry accruals		10,000
Reserve for depreciation		150,000
Common stock		300,000
Subscribers to capital stock		300,000

To record issuance of 5,000 shares of no-par value common stock for net manufacturing assets acquired from Hear Telephone Company.

(*Continued on following page*)

(1) November 30, 1947

Investment in Watt Manufacturing Company	$300,000	
Cash	10,000	
Interdepartmental control		$300,000
Profit and loss		10,000

To record on communications books the transfer to Watt Manufacturing Company net manufacturing assets of $300,000, except cash, for 5,000 shares of no-par value common stock of that company and to record transfer from Manufacturing Division, profit of $10,000 for eleven months to November 30, 1947 and cash of $10,000.

(2) December 31, 1947

Cash	10,000	
Liability to Watt Manufacturing Company		2,000
Interdepartmental control		8,000

To set up liability for the difference between the $10,000 cash received in December, 1947 by Manufacturing Division (which should have been paid to Watt Manufacturing Company) and expenses of $8,000 incurred on behalf of Watt Manufacturing Company in December, 1947.

a. (3) Journal entries to effect the elimination of Manufacturing Division of Hear Telephone Company:

Entries on the books of the Hear Telephone Company—Manufacturing Division:

(1) December 31, 1947

Receivable from Watt Manufacturing Company	$ 10,000	
Cash		$ 10,000

To transfer cash due Watt Manufacturing Company to Communications Division, which has set up liability for same to Watt Manufacturing Company.

(2) December 31, 1947

Accounts receivable	10,000	
Inventories	20,000	
Reserve for depreciation	2,000	
Receivable from Watt Manufacturing Company		2,000
Accounts payable		18,000
Profit and loss		12,000

To reverse December, 1947 manufacturing operations which should be recorded on books of Watt Manufacturing Company.

(3) December 31, 1947

Accounts payable	40,000	
Sundry accruals	10,000	
Interdepartmental control	308,000	
Profit and loss	10,000	
Reserve for depreciation	150,000	
Cash		10,000
Accounts receivable		50,000
Inventories		100,000
Plant and property		350,000
Receivable from Watt Manufacturing Company		8,000

To close Manufacturing Division books.

a. (4) Journal entries to close books of both companies at December 31, 1947:

Entry on books of Hear Telephone Company:

(1) December 31, 1947

Profit and loss	78,000	
Surplus		78,000

To close communication profit and loss to surplus.

(*Continued on following page*)

Entry on books of Watt Manufacturing Company:

(1) December 31, 1947		
Surplus	$12,000	
Profit and loss		$12,000
To transfer to surplus account loss for month of December, 1947.		

HEAR TELEPHONE COMPANY

b. ***Balance-Sheet—December 31, 1947***

Assets

Current Assets:		
Cash	$ 80,000	
Accounts receivable	110,000	
Inventories	50,000	
Total Current Assets		$240,000
Investments in Subsidiary Companies:		
Watt Manufacturing Company, 5,000 shares no-par common, at cost, representing 83⅓% of the outstanding common stock (see note 1)	$300,000	
Other	20,000	
		320,000
Fixed Assets:		
Plant and property (at cost)	$500,000	
Less: Reserve for depreciation	252,000	248,000
		$808,000

Liabilities and Capital

Current Liabilities:			
Accounts payable		$ 78,000	
Payable to Watt Manufacturing Company		2,000	
Reserve for federal income taxes		40,000	
Accrued expenses		110,000	
Total Current Liabilities			$230,000
Capital:			
Capital stock		$300,000	
Earned surplus			
Balance, January 1, 1947	$200,000		
Profit for year ended December 31, 1947	78,000	278,000	
			578,000
			$808,000

NOTE 1: Since acquisition November 30, 1947, the Watt Manufacturing Company has incurred a net loss of $12,000. As of December 31, 1947 the accrued dividends on the 4% cumulative preferred stock of Watt Manufacturing Company amounted to $333.33. The preferred stock has a liquidating and call value of $110,000; 1,000 shares are outstanding, par value $100,000.

WATT MANUFACTURING COMPANY

Balance-Sheet—December 31, 1947

Assets

Current Assets:		
Cash	$160,000	
Accounts receivable	40,000	
Receivable from Hear Telephone Company	2,000	
Inventories	80,000	
Total Current Assets		$282,000
Fixed Assets:		
Plant and property	$350,000	
Less: Reserve for depreciation	152,000	
		198,000
		$480,000

Liabilities and Capital

Current Liabilities:		
Accounts payable	$ 22,000	
Accrued expenses	10,000	
Total Current Liabilities		$ 32,000
Capital:		
Cumulative 4% preferred stock, callable @ $110 per share, issued and outstanding 1,000 shares, dividend accumulation on outstanding preferred stock for month of December, 1947, $333.33	$100,000	
No-par common stock, issued and outstanding 6,000 shares	360,000	
	$460,000	
Deficit—loss from operations for the month of December, 1947	12,000	448,000
		$480,000

(Continued on following page)

No. 2 (2, points)

Solution

A.

JONES, INC.

Statement of Affairs

March 31, 1948

ASSETS

Book Value			Appraisal Value	Available for Unsecured Creditors	Estimated Shrinkage (Gain)
	FULLY PLEDGED ASSETS				
$ 10,000	U. S. Treasury bonds—deducted contra		$10,000	None	None
40,000	Real estate (Net book value)		$30,000		$10,000
	Less first mortgage		15,000		
	Available for second mortgage—deducted contra		$15,000	None	
	PARTLY PLEDGED ASSETS				
	Inventories				
15,000	Finished goods		$16,500		(1,500)
4,500	Goods in process				(710)
	Value when complete	$7,810			
	Less completion cost: Raw material, $1,200; labor and other costs, $1,400.	2,600	5,210		
6,000	Raw material				
	To be used in completion of goods in process	$1,200	1,200		
	To be sold	4,800	1,200		3,600
			$24,110		
9,000	Factory equipment (Net book value)		5,000		4,000
			$29,110		
	Less note payable to Alex Smith		25,000	$ 4,110	
	UNPLEDGED ASSETS				
2,000	Cash		$ 2,000	2,000	None
4,640	Notes receivable			None	4,640
4,000	Accounts receivable				
	$2,000 good		2,000	2,000	
	2,000 doubtful		1,000	1,000	1,000
	$4,000				
12,500	Subscriptions to capital stock		12,500	12,500	None
1,500	Investment in common stock of Bourbon Company		3,390	3,390	(1,890)
$109,140				$25,000	$19,140
	Deduct preferred claims—see contra			1,452	
	Balance available to general unsecured creditors—deducted contra			$23,548	

LIABILITIES

Book Value			Unsecured Claims
	PREFERRED CREDITORS		
$ 460	Accrued property taxes	$ 460	
992	Salaries and wages	992	
	Deducted contra	$ 1,452	
	FULLY SECURED CREDITORS		
10,000	Notes payable to Manufacturers' Trust Co.	$10,000	
	Less U. S. Treasury bonds—contra	10,000	
15,000	First mortgage on real estate	$15,000	
	Less portion of proceeds from sale of real estate—contra	15,000	
25,000	Note payable to Alex Smith—deducted contra	$25,000	
	PARTLY SECURED CREDITORS		
20,000	Second mortgage on real estate	$20,000	
	Less balance of expected proceeds of sale of real estate	15,000	$ 5,000
	UNSECURED CREDITORS		
4,640	Liability on notes receivable discounted		4,640
24,000	Accounts payable		24,000
	CAPITAL		
	Capital stock	$50,000	
	Less Treasury stock—20 shares at cost	800	
49,200		$49,200	
(40,152)	Deficit		
$109,140			$33,640
	Estimated amount available to unsecured creditors (70%)—contra		23,548
	Deficiency to unsecured creditors		$10,092

(Continued on following page)

B.

JONES, INC.

Estimated Deficiency to Unsecured Creditors

March 31, 1948

ESTIMATED SHRINKAGE IN THE VALUE OF ASSETS		
Real estate	$10,000	
Notes receivable	4,640	
Accounts receivable	1,000	
Raw materials	3,600	
Factory equipment	4,000	$23,240
ESTIMATED INCREASES IN THE VALUE OF ASSETS		
Bourbon Company common stock	$ 1,890	
Finished goods and goods in process	2,210	4,100
		$19,140
NET ESTIMATED SHRINKAGE IN THE VALUE OF ASSETS		
Capital		
Capital stock	$50,000	
Less Treasury stock—20 shares at cost	800	
	$49,200	
Deficit	40,152	9,048
Estimated deficiency to unsecured creditors		$10,092

C.

JONES, INC.

Estimate of Amounts Available for Each Class of Creditors

March 31, 1948

Class of Creditor	Amount of Claim	Ratio of Estimated Payment to Claim	Estimate of Amounts Available
Preferred Creditors	$ 1,452	100.0%	$ 1,452
Fully secured creditors	50,000	100.0%	50,000
*Partly secured creditors	20,000	92.5%	18,500
Unsecured creditors	28,640	70.0%	20,048
	$100,092		$90,000

*Estimate of amount available from pledged asset	$15,000
Estimate of amount available on unsecured balance	3,500
	$18,500

ACCOUNTING PRACTICE—PART II

May 20, 1948, 1:30 to 6 p.m.

No. 1 (20 points)

AB, ABC, AND ABCD PARTNERSHIPS

Work Sheet for the Two Years Ended December 31, 1947

	Balances January 1, 1946 Dr.	Balances January 1, 1946 Cr.	Transactions 1946 Dr.	Transactions 1946 Cr.	Balances December 31, 1946 Dr.	Balances December 31, 1946 Cr.	Transactions 1947 Dr.	Transactions 1947 Cr.	Balances December 31, 1947 Dr.	Balances December 31, 1947 Cr.
Cash	$ 70,000		(1) $ 19,000	(2) $ 17,000	$ 72,000		(7) $ 27,000	(8) $ 27,500	$151,500	
							(9) 80,000			
Accounts receivable	50,000				50,000		(9) 70,000		120,000	
Notes receivable	40,000				40,000				40,000	
Reserve for bad debts				(4) 10,000		$ 10,000				$ 10,000
Merchandise inventories	35,000				35,000				35,000	
Land	85,000				85,000				85,000	
Building and equipment—less reserve for depreciation	15,000			(5) 4,000	11,000				11,000	
Investments—at cost	35,000				35,000		(9) 10,000		45,000	
Valuation reserve for investments				(3) 5,000		5,000				5,000
Prepaid insurance	4,500				4,500				4,500	
Office supplies	3,000				3,000				3,000	
Goodwill							(9) 25,000		25,000	
Bank loans		$ 45,000				45,000		(9) 30,000		75,000
Accounts payable		60,000				60,000		(9) 20,000		80,000
Accrued taxes		2,500				2,500				2,500
First mortgage 2% long-term notes		55,000				55,000				55,000
Capital accounts:										
A		100,000	(2) 10,000	(1) 9,500		60,000	(8) 7,500	(7) 9,000		61,500
			(3) 2,500							
			(4) 5,000							
			(5) 2,000							
			(6) 30,000							
B		75,000	(2) 7,000	(1) 9,500		45,333	(8) 6,000	(7) 9,000		48,333
			(3) 2,500							
			(4) 5,000							
			(5) 2,000							
			(6) 22,667							
C				(6) 52,667		52,667	(8) 14,000	(7) 9,000		47,667
D								(9) 135,000		135,000
	$337,500	$337,500	$107,667	$107,667	$335,500	$335,500	$239,500	$239,500	$520,000	$520,000

Explanation of transactions:

(1) To record profit for 1946
(2) To record drawings for 1946
(3) To establish valuation reserve for investments
(4) To establish reserve for bad debts
(5) To write down buildings and equipment
(6) To record transfer of 1/3 of capital interests of A and B to C
(7) To record profit for 1947
(8) To record drawings for 1947
(9) To record D's investment in the partnership

(Continued on following page)

Examination Answers—May, 1948

AB, ABC AND ABCD PARTNERSHIPS

Balance-Sheets

January 1 and December 31, 1946 and December 31, 1947

	AB Jan. 1, 1946	ABC Dec. 31, 1946	ABCD Dec. 31, 1947
Assets			
Current Assets			
Cash	$ 70,000	$ 72,000	$ 151,500
Accounts receivable	50,000	50,000	120,000
Notes receivable	40,000	40,000	40,000
Reserve for bad debts		(10,000)	(10,000)
Merchandise inventories	35,000	35,000	35,000
Prepaid insurance	4,500	4,500	4,500
Office supplies	3,000	3,000	3,000
Total current assets	$202,500	$194,500	$344,000
Investments—at cost	$ 35,000	$ 35,000	$ 45,000
Less valuation reserve for investments		(5,000)	(5,000)
Investments—net	$ 35,000	$ 30,000	$ 40,000
Fixed assets			
Land	$ 85,000	$ 85,000	$ 85,000
Building and equipment—less reserve for depreciation	15,000	11,000	11,000
Total fixed assets	$100,000	$ 96,000	$ 96,000
Goodwill			$ 25,000
Total assets	$337,500	$320,500	$505,000
Liabilities and Capital			
Current liabilities			
Bank loans	$ 45,000	$ 45,000	$ 75,000
Accounts payable	60,000	60,000	80,000
Accrued taxes	2,500	2,500	2,500
Total current liabilities	$107,500	$107,500	$157,500
First mortgage 2% long-term notes	$ 55,000	$ 55,000	$ 55,000
Total liabilities	$162,500	$162,500	$212,500
Capital:			
A	$100,000	$ 60,000	$ 61,500
B	75,000	45,333	48,333
C		52,667	47,667
D			135,000
Total capital	$175,000	$158,000	$292,500
Total liabilities and capital	$337,500	$320,500	$505,000

No. 2 (10 points)

Solution A

HOOVER HANDKERCHIEF MANUFACTURING CO.

Balance-Sheet, April 30, 1948

Assets

Current Assets			
Cash		$ 310,000	
Accounts receivable		800,000	
Inventory of raw material		750,000	
Inventory of finished goods (including $100,000 out on consignment)		600,000	
Prepaid expenses		5,400	
Total current assets			$2,465,400
Plant and machinery (at appraised value $398,000 in excess of cost at a receiver's sale		xxx	
Less reserve for depreciation		xxx	1,460,000
Deferred charges			
Unamortized expenses of bond issue			16,333
Total assets			$3,941,733

Liabilities

Current Liabilities			
Notes payable		$ 100,000	
Accounts payable		175,000	
Accrued payroll		6,000	
Accrued interest payable on 6% bonds		10,000	
Total current liabilities			$ 291,000
Six per cent bonds, due June 30, 1956			500,000
Total liabilities			$ 791,000

Capital Stock and Surplus

Capital Stock			
Six per cent preferred			
Authorized, issued and outstanding 10,000 shares, par $100 per share		$1,000,000	
Common			
Authorized and issued, par $100 per share	15,000 shares		
Less, reacquired and cancelled	840 shares		
	14,160 shares	1,416,000	2,416,000
Surplus			
Paid-in surplus			
Premium on issuance of common stock 15,000 shares at $20 per share		$ 300,000	
Excess of par value over purchase price of 840 shares of common stock reacquired and cancelled		28,980	
		328,980	
Surplus arising from appraisal of fixed assets		398,000	
Earned surplus		7,753	734,733
Total liabilities, capital stock and surplus			$3,941,733

Analysis of Earned Surplus

			Solution A	Solution B
Earned surplus, 12/31/47 per trial balance			$ 520	$ 520
Net income for four months ended April 30, 1948				
Sales		$2,500,000		
Less returns		25,000		
		$2,475,000		
Cost of sales		2,350,000		
Gross profit		$ 125,000		
Expenses				
Administrative salaries	$65,000			
Travel expense	30,030			
Interest	10,570			
Amortization of expenses of bond issue (6% bonds, ⅓ year at $2,000 per year)	667	106,267		
Net income for solution A		$ 18,733	$18,733	
Amortization of expenses of bond issue (4½% bonds, ⅓ year at $1,000 per year)		333		
Net income for solution B		18,400		18,400
			19,253	18,920
Less transfers from paid-in surplus				
Unamortized discount of issue of 4½% bonds charged in error to paid-in surplus at 6/30/46			(8,500)	
Portion of unamortized discount and expense of bond issues, charged in error to paid-in surplus 6/30/46, but applicable to earnings of period from 7/1/46 to 12/31/47				
Discount on 4½% issue (1½ years at $1,000 per year)				(1,500)
Expenses of 6% issue (1½ years at $2,000 per year)			(3,000)	(3,000)
Earned surplus, 4/30/48			$ 7,753	$14,420

Solution B

In solution A the entire unamortized expense on the 4½% bond issue was written off at July 1, 1946, the date the issue was refunded. It is permissible to continue the amortization of this expense over the original period for which the 4½% bond issue was contracted. This would result in a $4,833 increase in "unamortized expenses of bond issue" and "earned surplus," with resulting balances of $23,000 and $14,420, respectively.

Comments

1. In Accounting Research Bulletin No. 2 both of the above solutions are approved. It is considered inappropriate to charge expense on bond issues to paid-in surplus.

2. Under the laws of some states the cancellation of issued stock results in a corresponding reduction of authorized stock. Solutions which reflect such a reduction should be acceptable.

(Continued on following page)

No. 3 (20 points) (Alternate to No. 4)

PETER PHILLIPS

Statement of Taxable Income for Calendar Year 1947

Income		
Director's fees	$ 400	
Less travel and accommodations	80	
		$ 320
Dividends from domestic corporations		2,600
Other income		
Income from annuities (Schedule A)	$ 3,000	
Loss from sales or exchanges of capital assets (Schedule B)	(850)	
Income from Phillips, Fast and Garda, a partnership (Schedule C)	13,725	15,875
Adjusted gross income		$18,795

Mr. Phillips' personal cash book and memoranda for 1947 disclosed the following:

Cash receipts,—1947:	
Compensation received from Phillips, Fast & Garda	$ 9,000
Directors' fees, less travel and accommodations, $80	320
Dividends from domestic corporations	2,600
Interest on capital invested in Phillips, Fast & Garda	2,250
Current cash withdrawals from Phillips, Fast & Garda against expected share of profits	1,500
Annuity under a life annuity contract acquired on January 1, 1942 for $100,000	5,000
Proceeds from sale of residence	28,000
Proceeds from sales of securities	28,000
Cash disbursements—	
Tax (1947 estimated U.S. income tax)	$ 5,000
Taxes—	
Real property	750
State income—1946	4,250
City sales	120
Contributions	300
Legal fee paid to protect partnership interest	1,500
Cost of securities acquired during 1947	33,700
Amounts paid to two sisters	7,200
Other disbursements	1,150

Securities Transactions:

		Acquisition	Disposition	Cost	Exchange or Proceeds
U.S. Industries, Inc.	1,000 shares	July 15, 1937	Jan. 1, 1947	$24,000	$30,000
Tire Supply Co.	100 shares	Jan. 6, 1947	—	10,450	—
Holyoke Tubing, Inc.	100 shares	May 2, 1947	Aug. 8, 1947	7,100	6,450
Temple Metals, Inc.	200 shares	May 2, 1947	Sept. 6, 1947	6,500	4,300
Tinplex, Ltd.	500 shares	Jan. 6, 1947	—	4,500	—
U.S. Tool Co.	100 shares	Jan. 6, 1947	—	5,150	—
Yoke Metals, Inc.	200 shares	Apr. 8, 1936	Feb. 16, 1947	18,300	17,250

On January 2, 1947, Phillips sold for $28,000 a residence acquired by him for $30,000 on July 1, 1938, rented until September 30, 1941 and subsequently used by him until date of sale. Depreciation of $3,250 has been allowed during the rental period on the basis of a useful life of 30 years.

(*Continued on following page*)

Deductions		
Contributions		
By Peter Phillips	$ 300	
Share of contributions of partnership (50% of 750)	375	$ 675
Taxes		
Real property tax	$ 750	
State income tax—1946	4,250	
City sales taxes	120	5,120
Miscellaneous		
Legal fee to protect partnership interest		1,500
Total deductions		$ 7,295
Net income		$11,500

Schedule A

PETER PHILLIPS—1947

Income from Annuities

Cost of annuity	$100,000
Amount received in 1947	$ 5,000
3% of cost of annuity	$ 3,000

Schedule B

PETER PHILLIPS—1947

Gains and Losses from Sales or Exchanges of Capital Assets

Kind of Property	Date Acquired	Date Sold	Gross Sales Price	Cost or Other Basis	Gain or (Loss)	Gain or (Loss) to be Taken into Account
Short-term capital gains and losses:						
Holyoke Tubing, Inc.—100 shares	5/2/47	8/8/47	$6,450	$7,100	($ 650)	($ 650)
Temple Metals, Inc.—200 shares	5/2/47	9/6/47	4,300	6,500	(2,200)	(2,200)
						($2,850)
Share of total net short-term capital gain of Phillips, Fast and Garda (Schedule B-1)						2,650
Total net short-term capital loss						($ 200)
Long-term capital gains and losses:						
Yoke Metals, Inc.—200 shares	4/8/36	2/16/47	$17,250	$18,300	($1,050)	($ 525)
Residence	7/1/38	1/2/47	28,000	26,750	1,250	625
						$ 100
Share of total net long-term capital gain of Phillips, Fast and Garda (Schedule B-1)						(750)
Total net long-term capital loss						($ 650)
Total net capital loss						($ 850)

Schedule B-1

PETER PHILLIPS—1947

Gains and Losses from Sale of Capital Assets
Through Phillips, Fast & Garda

Kind of Property	Date Acquired	Date Sold	Gross Sales Price	Cost or Other Basis	Gain or (Loss)	Gain or (Loss) to be Taken into Account
Short-term capital gains and losses:						
Outlet, Inc.—100 shares....	1/5/47	6/20/47	$6,000	$4,500	$1,500	$1,500
Gypsum Metals—100 shares.	4/14/47	6/20/47	4,700	3,600	1,100	1,100
Distributors Co.—500 shares	6/22/47	9/29/47	10,700	8,000	2,700	2,700
						$5,300
Share of Peter Phillips—50%....						$2,650
Long-term capital gains and losses:						
Central Stores—200 shares..	1/5/47	10/10/47	$10,000	$13,000	($3,000)	($1,500)
Share of Peter Phillips—50%....						($ 750)
Net capital gain of partnership....						$3,800
Share of Peter Phillips—50%....						$1,900

Schedule C

PETER PHILLIPS — 1947

Computation of Ordinary Income from
Partnership of Phillips, Fast and Garda

Income of partnership per books....		$ 4,000
Add: Salary to Peter Phillips....		10,000
Interest on capital....		7,500
Net long-term loss—(Schedule B-1)....		1,500
Contributions....		750
		$23,750
Deduct: Net capital gain (Schedule B-1)....		3,800
Ordinary net income....		$19,950
Computation of Phillips' share of ordinary net income		
Ordinary income....		$19,950
Less: Salary to Peter Phillips....	$10,000	
Interest on capital....	7,500	17,500
Residual income....		$ 2,450
Peter Phillips' share of residual income—50%....		$ 1,225
Salary....		10,000
Interest on capital—6% of $50,000 for 10 months....		2,500
Phillips' share of ordinary net income....		$13,725

(*Continued on following page*)

No. 4 (20 points)

Solution A

CITY OF ———

Closing Entries

April 30, 1948

(a)

Appropriations	$178,600	
Appropriation expenditures		$174,721
Encumbrances		3,250
Unappropriated surplus		629
To close appropriations, appropriation expenditures and encumbrances		

(b)

Revenues	$186,635	
Estimated revenue		$185,000
Unappropriated surplus		1,635
To close revenues and estimated revenue		

Solution B

CITY OF ———

Balance-Sheet—Expendable Revenue Fund

April 30, 1948

Assets

Cash		$19,401
Taxes receivable	$3,614	
Less reserve for uncollectible accounts	3,614	
Total assets		$19,401

Liabilities and Surplus

Vouchers payable	$ 5,137
Reserve for encumbrances	3,250
Unappropriated surplus	11,014
Total liabilities and surplus	$19,401

(Continued on following page)

Solution C

CITY OF ————

Statement of Revenue, Expenditures and Surplus

Year Ended April 30, 1948

Revenue:		
Taxes	$112,006	
Tax penalties	310	
Miscellaneous revenue	74,319	
Total revenue		$186,635
Expenditures:		
Operating expenses	$146,421	
Capital expenditures	21,000	
Bond retirement	5,000	
Bond interest	2,000	
Loan interest	300	
Total expenditures		174,721
		$ 11,914
Encumbrances unliquidated		3,250
Excess of revenues over expenditures and encumbrances		$ 8,664
Unappropriated surplus, May 1, 1947		2,350
Unappropriated surplus, April 30, 1948		$ 11,014

Work Sheet on following page

Work Sheet for Problem 4—for information only; not required for solution

CITY OF ———

Work Sheet for Year Ended April 30, 1948

Accounts	Balances May 1, 1947 and Transactions		Balances before Closing April 30, 1948		Closing Entries		Balance-Sheet April 30, 1948	
Cash	(1)$ 2,350	(7)$ 20,300	$ 19,401				$19,401	
	(5) 112,556	(13) 240						
	(6) 20,000	(14) 169,400						
	(12) 74,319							
	(15) 116							
Taxes receivable	(4) 115,620	(5) 112,246	3,614				3,614	
	(13) 240							
Reserve for uncollectible taxes	(16) 386	(4) 4,000		$ 3,614				$ 3,614
Estimated revenues	(2) 185,000		185,000			(b)$185,000		
Vouchers payable	(14) 169,400	(9) 146,421		5,137				5,137
		(10) 21,000						
		(11) 7,000						
		(15) 116						
Loans payable	(7) 20,000	(6) 20,000						
Encumbrances	(8) 3,250		3,250					
Reserve for encumbrances		(8) 3,250		3,250		(a) 3,250		3,250
Appropriations		(3) 178,600		178,600	(a)$178,600			
Unappropriated surplus	(3) 178,600	(1) 2,350		8,750		(a) 629		11,014
		(2) 185,000				(b) 1,635		
Revenue				186,635	(b) 186,635			
Taxes		(4) 111,620						
		(16) 386						
Tax penalties		(5) 310						
Miscellaneous		(12) 74,319						
Appropriation expenditures			174,721			(a) 174,721		
Operating expenses	(9) 146,421							
Capital expenditures	(10) 21,000							
Bond retirements	(11) 5,000							
Bond interest	(11) 2,000							
Loan interest	(7) 300							
	$1,056,558	$1,056,558	$385,986	$385,986	$365,235	$365,235	$23,015	$23,015

THEORY OF ACCOUNTS

May 20, 1948, 9:00 a.m. to 12:30 p.m.

GROUP I

No. 1 (15 points)

EMPLOYEES' PURCHASES FUND
Trustee's General Ledger Accounts

Cash in bank

Debit with the original transfer from the general cash account of the SMT Corporation, with subsequent receipts from employees and with any other additions to the fund.

Credit with payments by check.

Balance represents the cash in bank.

Employees' contracts receivable

Debit with the face amount receivable under sales contracts entered into with employees.

Credit with collections applicable to the principal of such contracts, with amounts allowed on recoveries of merchandise and with amounts written off because uncollectible.

Balance represents the uncollected portions of sales contracts due from employees.

Inventory—new merchandise

Debit with the cost (including freight-in and all other pertinent charges) of all merchandise bought for sale, the offsetting credit being to accounts payable or cash in bank.

Credit with the cost of merchandise sold, the offset being to cost of sales, and with the cost of merchandise returned to vendors, the offsetting debit being to accounts payable or cash in bank.

Balance is the inventory of new merchandise at cost.

Inventory—repossessed merchandise

Debit with the values allowed on repossessed merchandise, the offsetting credit being to employees' contracts receivable.

Credit with the values allowed on recovery of merchandise when such merchandise is transferred to SMT Corporation, the offsetting debit being to SMT Corporation account current.

Balance is the inventory of repossessed merchandise held for transfer to SMT Corporation.

Accounts payable

Credit with obligations incurred as the result of purchases of merchandise and operating supplies.

Debit with the amounts of such obligations liquidated through cash payments or reduced through debit memos for returns and allowances.

Balance represents unpaid obligations to vendors of merchandise and supplies.

Other current liabilities

Credit with accruals of payroll and other liabilities.

Debit with amounts liquidated.

Balance represents a liability of the trustee.

SMT Corporation—account current

Credit with the amount of net income from fund operations (offset by debit to profit and loss) and with cash advances by SMT Corporation.

Debit with losses from fund operations (offset by credit to profit and loss), with transfers of cash to SMT Corporation and with allowances on repossessed merchandise which has been transferred to SMT Corporation.

Balance represents the net current advances and retained profit due the SMT Corporation.

SMT Corporation—fund capital

Credit with amounts of assets transferred by SMT Corporation to the employees' purchases fund and with amounts transferred from SMT Corporation account current as permanent increases in the fund capital.

Debit with amount of fund capital permanently transferred to SMT Corporation, and with losses from the operation of the fund, transferred from SMT Corporation—account current.

Balance represents the net fund capital.

Profit and loss

Debit at the end of the fiscal period with the balances in cost of sales and operating expenses, respectively.

Credit with the balances in sales, interest income, and discount on purchases, respectively.

Close into SMT Corporation—account current.

Sales

Credit with the face value of contracts with employees for the sale of merchandise and with cash received from cash sales.

Close into profit and loss at the end of the fiscal period.

Interest income

Credit with the portion of payments by employees on their contracts which represents interest on deferred payments, the offsetting debit being to cash.

Discount on purchases

Credit with cash discounts taken.

Close into profit and loss at the end of the fiscal period.

Cost of sales

Debit with the cost of merchandise sold, the offsetting credit being to inventory—new merchandise.

Close into profit and loss at the end of the fiscal period.

Operating expenses

Debit with the cost of supplies purchased, salaries, wages, insurance, taxes, and other expenses incurred in conducting the enterprise; offset by credits to cash in banks, accounts payable or other current liabilities.

Close into profit and loss at the end of the fiscal period.

Comments on Solution

1. The use of a system with accounts for a periodic inventory instead of a perpetual inventory would be equally acceptable.

2. Since the merchandise is purchased and sold by the trustee, the solution uses accounts for purchases and sales in preference to a commissions account.

3. Item (d) of the problem provides for the transfer of recovered merchandise to the SMT Corporation at values allowed by the trustee as a basis for recovery. Because of this provision the above solution does not set up an account on the trustee's ledger for gain or loss on repossessed merchandise. A provision for gain or loss on repossessions on the trustee's books with appropriate explanation of the procedure for taking up such gain or loss incurred by the SMT Corporation would be acceptable.

No. 2 (5 points)

a. The cost of operating the power shovel in clearing the old road should be charged to a current expense account. The charge to expense is correct because the expenditure only maintained the old road in operating condition.

b. The cost of operating the shovel for the remainder of August should be charged to an asset account and written off over the estimated useful life of the road. The improved new road is expected to benefit operations for a twenty-year period extending from the time it is placed in service until its use is discontinued. The cost of the road should be allocated to this period of expected use.

No. 3 (10 points)

a. The liability should be shown on the balance-sheet of the Barnes Company as of March 31, 1948, if title to the merchandise has passed under the express or implied terms of the sales agreement or under established rules of law governing the passing of title where there is no specific provision in the contract. Under these rules the liability should be shown:

(1) If the merchandise in a deliverable state has been set aside for the Barnes Company with its assent.

(2) If the merchandise has been delivered to a carrier for purpose of transmission to the Barnes Company under a sales agreement that requires the buyer to pay the delivery charges; for example a c.i.f. contract or one f.o.b. point of shipment.

b. The amount may be omitted as a liability if title has not passed on or before March 31, 1948. Assuming no agreement to the contrary title would not have passed and the liability need not be shown:

(1) If the merchandise has not been unconditionally appropriated to the contract by the seller with the consent of the Barnes Company.

(2) If delivery was made to the carrier in accordance with contract terms that require the seller to pay the freight; for example, f.o.b. purchaser's warehouse.

c. If at March 31, 1948, the Barnes Company did not have title to the merchandise so that it might properly omit the asset and the related liability from its balance-sheet as of that date, the following is accepted practice:

(1) Disclose the purchase commitment of $100,000 by footnote if it is unusually large in relation to total purchases. No disclosure is necessary for a commitment which is normal for the Barnes Company.

(2) Any net loss on the purchase commitment, measured in the same way as inventory losses, should be reflected by a liability account. If the Barnes Company had firm sales contracts or assured future sales orders at prices which will recover cost of the merchandise with an approximately normal profit on sale in the ordinary course of business, no loss need be recognized in the accounts.

Comment on Solution

It is the practice of some accountants to omit the liability for goods in transit whether or not the title has passed, provided: (1) the merchandise is not shown as an asset, (2) the volume is normal, and (3) market prices as of the balance-sheet date are not materially lower than cost to the purchaser.

No. 4 (10 points)

The factors to be considered include:

(a) Generally accepted principles of fixed asset accounting.

Accounting for fixed assets is primarily a procedure for the allocation of cost (less expected salvage) to expense over the period of expected use. It is not a procedure for reflecting current values at specific balance-sheet dates. For this reason the cost of the building should be separately shown as a fixed asset and the accumulated reserve deducted therefrom notwithstanding a fully depreciated condition as of March 31, 1948.

(b) Cost and accumulated reserve on the basis of a 2½% rate of depreciation.

The original cost of $100,000 may not be the correct cost for the balance-sheet as of March 31, 1948. Capital expenditures may have been improperly charged to expense during the years since 1907–8. If such were the case adjustments should be made to correct the book cost.

Replacements chargeable to the reserve for depreciation may have been incorrectly charged to expense in the years since 1907–8. If such were the case adjustments should be made reducing the reserve balance as of March 31, 1948.

No adjustment of the asset and reserve for depreciation is required because of the excess of sound value over net book value provided the 2½% rate is reasonable in the light of the depreciation factors known or estimated during the years since 1907–8. The $100,000 cost which has been absorbed through depreciation charges is not generally considered to be subject to further accounting.

(c) Salvage value.

If the building will have salvage value, adjustment may be made reducing the reserve by the amount of the expected salvage value.

(d) Appraisal value.

With appropriate action by the board of directors the book value of the building and the related reserve may be adjusted to reflect sound value as of March 31, 1948, as established by appraisal by a recognized appraisal company. Such adjustment should be made through appropriate entries with full disclosure in the balance-sheet.

No. 5 (10 points)

(a) (b) (c). The following presentation of the bank balances in the balance-sheet as of March 31, 1948, is acceptable for the company's management, for credit purposes, and for stockholders and the general public.

Current Assets

Cash in banks	
Unrestricted	
New York, N. Y.	$10,175.00
San Francisco, Calif.	9,898.78
	$20,073.78
Restricted	
Chicago, Ill.	14,625.52
	$34,699.30

Current Liabilities

Bank overdrafts	
Houston, Texas	$18,895.40
Atlanta, Ga.	4,983.00
	$23,878.40

Note: Under an agreement with the Chicago bank to which the A Company is indebted on its own note in the amount of $150,000 a deposit of $15,000 or more is required as of March 31, 1948. The actual balance in the bank is $18,318.36, which amount can be reconciled with the book balance of $14,625.52 by taking into account outstanding checks as of March 31, 1948.

Comment on Solution

A solution which omitted bank names and which combined the balances in New York City and San Francisco would be acceptable.

GROUP II

No. 6 (10 points)

(a) Merchandise turnover may be computed by dividing cost of sales by average inventory at cost or sales by average inventory at retail. Assuming the first method of computation the following example shows how a difference in average inventory might cause the difference in merchandise turnover.

	J Company	S Company
Sales	$750,000	$750,000
Cost of sales	450,000	450,000
Gross profit	$300,000	$300,000
Average inventory at cost	$100,000	$ 45,000
Merchandise turnover	4.5	10.0

(b) Merchandise turnover can be used as a gauge of efficiency in purchasing, stock management, and sales. A store or department with a high turnover in relation to previous turnover, or in relation to norms for similar operations of other units, frequently has relatively lower expenses for insurance, taxes, interest, and merchandise handling. A favorable turnover may be a factor in control of losses from obsolescence and damaged stock. Also it may have an important bearing on the amount of working capital and the ratio of current assets to current liabilities.

Turnover is not the sole test of efficiency. A turnover figure for a specific enterprise or unit must be judged in relation to type of merchandise, volume of business, gross profit ratio, location, and general business conditions. Although these limitations apply, a careful study of turnover variations is frequently helpful in establishing profitable merchandising operations.

No. 7 (10 points)

At April 30, 1948, the balance-sheet of M included among its current assets notes receivable on hand from O with a face value of $30,000, while O's balance-sheet as of the same date included $50,000 of notes payable to M. In the consolidation the $30,000 of notes receivable on M's balance-sheet should be eliminated against $30,000 of the $50,000 liability to M shown on O's balance-sheet. The other $20,000 of O's $50,000 liability, based on the notes due May 15, 1948, and June 15, 1948, respectively, involves an outside party, the bank which discounted these notes for M, and should therefore be shown as a liability on the consolidated balance-sheet.

The discount of $75 charged to M should be reflected on the consolidated statements, apportioned between prepaid expenses on the consolidated balance-sheet and absorbed expenses on the consolidated income statement.

No. 8 (10 points)

a. Basic standard cost is a predetermined cost intended to serve primarily as a yardstick or standard of measurement for a period of years. Actual costs of subsequent years are measured as a percentage of the basic standard. Normal standard cost is a predetermined cost based upon normal capacity and a normal diversity of products, computed at standard quantities and standard prices for material, labor, and burden.

b. Burden variance is the difference between the total actual manufacturing overhead for a period and a theoretical standard based upon production. The latter is computed by multiplying a predetermined amount per unit of production by the total number of units produced.

c. Job cost is the cost of producing goods computed in accordance with a method of accounting under which the respective costs of material, direct labor and factory burden are collected under work-order numbers and posted to separate job accounts.

d. Labor price variance is the difference between the total actual direct labor cost and a theoretical standard computed by multiplying the predetermined labor rate or rates by the number of direct labor hours worked.

e. Material efficiency variance is the difference between the total cost of material consumed and the predetermined cost of material which should have been consumed by the number of units produced, both computed at the standard material price.

No. 9 (10 points)

The A Company's procedure with respect to cash discounts on sales is based on the assumption that the net price—98% of the billed price—is the selling price and that customers are normally expected to pay their bills when they become due. The additional amount which they are required to pay as a result of their failure to meet the discount deadline is a sort of penalty which the recipient treats as an item of income not identified with sales. This procedure for handling cash discounts on sales makes possible a direct presentation of the income from discounts not taken by customers. Although acceptable in theory this procedure is not followed as commonly as the other two procedures.

The B Company's procedure in recording sales is based on the assumption that the gross amount billed is the amount of a sale. In the income statement the discounts actually taken are deducted from sales in arriving at net sales. The net sales indicate the amounts which the customers have paid for goods, original billing less discount on original billing, depending upon whether or not discount was allowed. Under this procedure sales made near the close of a fiscal period with respect to which discounts may be taken during the early days of the succeeding period, are reflected at the gross amount in the period of the sales and any discounts on these sales are shown as a deduction from the gross sales of the following period. This understates the net sales of a subsequent period unless a reserve for sales discount is set up at the close of each fiscal period. Since the amounts involved are generally small in relation to sales, this objection has little practical significance.

The C Company's procedure is based on the assumption that the gross sales are the true sales and the discounts allowed are properly treated as expenses since they have the effect of reducing costs of collection and save interest on amounts which would have to be borrowed for financing or costs of otherwise obtaining working capital which would be necessary if customers were dilatory about paying their bills. However, the expense charge for the discount is generally excessive in relation to the reduction of costs. The simplicity of this procedure accounts for its preference in common practice.

No. 10 (10 points)

The fairness of the method of pricing goodwill which is proposed in the problem can best be judged by comparing the asked price with the capitalized value of expected future earnings in excess of a normal return on capital, using a rate of capitalization reasonable for the industry and for the period of time involved. If the T Company, for example, can be expected to earn $150,000 a year, after all income taxes, on a net worth of $1,000,000 exclusive of goodwill, and if a 10% return is normal in the industry, the $50,000 earnings in excess of $100,000 might reasonably be attributed to the intangible asset, goodwill. Capitalization of this excess at a 10% rate would result in goodwill value of $500,000.

The estimate of future earnings is frequently based on the earnings of a previous period, generally five or more years. When using past earnings for this purpose these precautions should be taken:

(1) Exclude extraneous items of a non-recurring nature
(2) Consider the trend in net income by years
(3) Select a period of years that reflects a representative earning performance
(4) Be certain that it is reasonable to expect that the earnings will continue under the prospective future conditions.

The method of pricing goodwill stated in the problem capitalizes total earnings of four post-war years. The resulting goodwill could be too low or too high depending on the amount of earnings in this period in relation to expected earnings in the future.

No. 11 (10 points)

Since the company's arrangement for enabling employees to purchase a portion of its capital stock will not affect the total capitalization, except to the extent that the cost of acquiring shares may differ from the amount collected from employees in accordance with their subscription contracts, no adjustment of the capital stock and surplus accounts is necessary in setting up the original liability incident to the fulfillment of the company's obligation to provide shares of its stock to its employees.

With respect to the financial statement treatment of the shares acquired to meet the company's obligation to its employees, the following two methods are generally considered acceptable (unless a particular method is required to comply with the laws of the state of incorporation).

In both these cases the assets should include the unpaid balances of employees' subscriptions for capital stock, and the liabilities an item for the total subscription price of the subscribed shares.

1. In the capital stock and surplus section of the balance-sheet:

Capital stock:		
100,000 shares, stated value $5 per share.....	$500,000	
Less treasury stock, 8,000 shares, stated value $5.	40,000	$460,000
Paid-in surplus:		
Per books..............	$750,000	
Less portion applicable to 8,000 shares of treasury stock...............	60,000	690,000

Amount forward $1,150,000		
Earned Surplus:		
Per books	$180,000	
Less portion applicable to 8,000 shares of treasury stock purchased for $13.20 per share	5,600	174,400
Net capital		$1,324,400

This method treats the expenditure of the B Corporation for shares of its own stock as a reduction of paid-in capital to the extent of the pro-rata amount of paid-in capital represented by the reacquired shares, making the allocation to capital stock and paid-in surplus according to the original credits to these accounts when the stock was issued. The excess of the outlay for the reacquired shares over the paid-in capital represented by such shares is treated as a distribution of earned surplus and deducted from the earned surplus account.

2. In the capital stock and surplus section of the balance-sheet:

Capital stock:	
100,000 no-par value shares, at stated value of $5 per share	$ 500,000
Paid-in surplus	750,000
Earned surplus	180,000
	$1,430,000
Less treasury stock, 8,000 shares acquired at $13.20 per share	105,600
Net capital	$1,324,400

This method treats the outlay for reacquired shares as an unallocated reduction from the total of capital stock, paid-in surplus, and earned surplus. It is considered acceptable if, as in this case, the shares are reissuable and in the process of being sold. It should not be used when the reacquired shares are retired.

Comment on Solution

Only two methods are required. The following is offered as an acceptable alternative method:

a. In the liability section of the balance-sheet:		
Capital stock subscribed by employees:		
10,000 shares at $13.50 per share	$135,000	
Less 8,000 shares purchased in the open market to deliver to subscribers	108,000	$27,000
b. In the capital stock and surplus section of the balance-sheet:		
Paid-in surplus	$750,000	
Add excess of subscriptions for shares of capital stock held for sale to employees over the cost of the shares reacquired for such sales	2,400	$752,400

This method of presenting the treasury stock is based on the assumption that provision for the liquidation of the liability is made as treasury stock is purchased, and since the shares were purchased solely for the purpose of liquidating the company's obligation to provide shares at an agreed price to its employees who subscribed for them, any shares purchased for that purpose are applied as a reduction of such liability at the unit value at which the liability was established. The difference between the cost of the treasury shares and the price at which the employees subscribed for them is a capital transaction reflected in the paid-in surplus.

No. 12 (10 points)

The receipt of the 500 shares of dividend common stock by Adams requires only a memorandum entry to record the fact that his holdings of common stock of the Rhodes Company are increased by 500 shares with no change in investment on his part. The payment of a stock dividend does not affect the net worth of the paying corporation since it is merely the result of transferring an amount in one capital account to another capital account. There is no change in the equity of any stockholder in the net assets of the corporation—merely a change in the number of shares which represent that equity. In this case the book value of each share of the corporation's common stock has decreased to two-thirds its former book value.

The receipt by Adams of the 100 shares of the Rhodes Company preferred stock, should, according to a decision of the United States Supreme Court, be treated by him as additiona income, the amount of which is determined by the market value of the preferred stock at the time of the payment of the dividend. On that basis Adams should debit Investment in Preferred Stock of Rhodes Company and credit Income from Investments with the market value of the preferred stock at the date of payment.

The Supreme Court's decision is based on the idea that payment of a dividend in a different class of a corporation's securities, even though the net worth of the corporation is not changed thereby, constitutes income to the recipient of such securities for purposes of the federal income tax. Many accountants believe that this decision is contrary to the basis of the Court's decision relative to the payment of stock dividends in general. In the opinion of most accountants the receipt of preferred stock as a dividend on common should be accounted for by allocating the original cost of the common shares to the common and preferred shares on the basis of their relative market values on the ex-dividend date.

AUDITING

May 21, 1948, 1:30 to 5 p.m.

No. 1 (15 points)

a.

THE WYE COMPANY

Bank Reconciliation, December 31, 1947

Balance per bank statement, 12/31/47			$ 88,489.12
Add:			
Receipts of 12/31/47, deposited 1/2/48		$ 5,317.20	
Deposit of 12/23/47, omitted from bank statement		2,892.41	
Error on bank statement in entering deposit of 12/16/47:			
Correct amount	$3,182.40		
Entered as	3,181.40	1.00	
Check No. 3917 of Wyeth Mfg. Co. charged by bank in error to Wye Co. account		2,690.00	
Bank debit of 12/23/47, erroneously charging Wye Co. account with settlement of bank loan, which was paid by check No. 8714 on same date		5,000.00	15,900.61
			$104,389.73
Deduct:			
Outstanding checks		$32,108.42	
Error on bank statement in entering deposit of 12/4/47:			
Entered as	$4,817.10		
Correct amount	4,807.10	10.00	
Deposit of Wyeth Mfg. Co. of 12/6/47 credited in error to Wye Co.		1,819.20	33,937.62
Correct bank balance, 12/31/47			$ 70,452.11
Balance per books, 12/31/47			$ 58,983.46
Add:			
Proceeds of $10,000 bank loan, 12/15/47, discounted for 3 months @ 5% per annum, omitted from Wye Co. books		$ 9,875.00	
Proceeds of note of J. Somers & Co., collected by bank, 12/10/47, not entered by Wye Co.:			
Principal	$2,000		
Interest	20		
	$2,020		
Less collection charge	5	2,015.00	11,890.00
			$ 70,873.46
Deduct:			
Bank service charge for November, per bank memo of 12/15/47		$ 3.85	
Check of Rome Products Co. charged back on 12/22/47 for absence of countersignature and redeposited with complete signature on 1/5/48, no entry having been made on the Wye Co.'s books for the chargeback or the redeposit		417.50	421.35
Bank balance per books, 12/31/47, after adjustment			$ 70,452.11

No. 2 (10 points)

Items	*From Whom Confirmation Obtained*
1. Cash in bank	Depositories
2. Notes receivable	Makers of notes
3. Notes receivable discounted	Banks which discounted them
4. Accounts receivable	Individual debtors
5. Accounts receivable assigned	Finance companies
6. Securities held in safekeeping	Banks or brokers
7. Securities pledged as collateral	Bank or other lender to whom securities were pledged
8. Cash and securities held by trustees under sinking fund or other fund agreements	Trustee of fund
9. Advances to salesmen and other employees required to travel or incur expenses chargeable to the organization	Individuals to whom such advances were made
10. Advances to cashiers for change funds which are not readily subject to count by the auditors	Individual cashiers to whom such advances were made
11. Insurance policies in the possession of mortgage holders	Mortgage holder or insurance company
12. Cash surrender value of life insurance	Insurance company
13. Deposits with bids on contracts	Municipality, other government organization or corporation with which bid was filed
14. Deposits for utility services	Utility company
15. Inventories in public warehouses	Warehouses
16. Inventories on consignment	Consignees
17. Accounts payable	Individual creditors
18. Advance payments by customers	Individual customers
19. Notes payable	Banks or other holders
20. Mortgages payable	Banks or other lenders
21. Bonds payable	Trustee under bond indenture or deed of trust
22. Contingent liabilities	Attorneys and officers of the company
23. Capital stock	Registrar and transfer agent

Comment: Although only ten items are required, additional items have been included in the answer for the use of candidates in checking their answers.

No. 3 (10 points)

In a balance-sheet audit the audit procedure is undertaken to test the efficacy of the system of internal check applicable to cash and accounts receivable, rather than verify in detail the accuracy of the discounts allowed or the entries in the books.

The minimum of work to be included is as follows:

Review monthly amounts for unusual fluctuations in the ratio of discounts to credits to customers arising from cash receipts. Investigate large items in any month that appear to be out of line.

Compare with like ratios in the preceding year to determine reasonableness of the amounts. Determine reason for marked fluctuations in ratios.

Determine procedures and policies in allowing sales discounts.

Review internal check and control.

In a detailed audit, the program suggested above for a balance-sheet audit should be supplemented by the following procedures, the number and extent of tests to be made being dependent on the size of the company, the degree of internal control, and other surrounding circumstances:

Verify the footings and postings of the discount column for one or more months.

Compare individual discounts with the corresponding amounts credited to accounts receivable to see that the discount terms have been complied with both as to date and amount.

Ascertain whether or not discounts allowed substantially after the expiration of the discount period were properly authorized.

When discounts have not been allowed or were allowed after the expiration of the discount period, compare entries of cash receipts in the cash receipt register with duplicate deposit slips or with other obtainable evidence as to the actual date of receipt.

If any of the foregoing tests suggest the perpetration of fraud, correspond with customers whose accounts are affected.

No. 4 (15 points)

(a) If The Q Corporation has never been audited, analyses of the fixed asset and related reserve accounts must be prepared and checked from inception of the corporation. The audit procedure should establish the basis of the accounts, the accuracy of asset amounts, the adequacy of reserves, and the title and ownership of assets. If during the life of the corporation an appraisal by a reputable organization of valuation engineers has been made, and the results of such appraisal were placed on the books, pursuant to appropriate action by the management of the company, it may be satisfactory to examine entries and records prior to the date of the appraisal only to the extent necessary to satisfy the auditor that all adjustments incident to setting up the appraisal values have been properly made and that the book values thus established are complete. Subsequent entries must be thoroughly analyzed or tested to be sure that sound accounting principles relative to property and equipment and their related reserves have been consistently applied.

The examination of the fixed asset and related reserve accounts should include inspection of supporting documents and evidence such as:

1. Vouchers, invoices, contracts, bills of sale and correspondence relating to asset acquisitions.
2. Deeds, title policies and abstracts of title.
3. Public records of mortgages, liens, judgments and property taxes.
4. Tax bills and receipts.
5. Insurance policies.
6. Income-tax returns and related papers.
7. Plant ledgers.

The examination may require a more detailed inspection of plant and equipment than that required in (b) and (c) of this question

A more detailed audit procedure would be necessary when specified in the audit arrangements or in the event that the above examination disclosed that additional work was necessary to satisfactorily present the account balances.

(b) In this situation it is not necessary to make as exhaustive an examination of the fixed asset and reserve accounts during prior years. However, the reports rendered by the previous auditors should be examined to determine from the evidence therein how extensive an audit is needed of these accounts for prior years. In any event, entries in the accounts during the years both prior to and during the previous audit should be tested. The results of such tests would determine whether a more extensive examination were needed. The balances of the fixed asset and reserve accounts at December 31, 1947, as contained in the last audit report should be checked to the general ledger. A complete summarization of the various accounts should be set up in the working papers.

(c) In this situation the ledger balances of fixed asset and related reserve accounts at December 31, 1947, should be checked against the balances in the working papers and the examination limited to verification of the transactions for the year 1948.

Whether the conditions of (a) or (b) or only (c) exist, the audit program for the current year should provide for a verification and analysis of the major changes in the fixed asset and related reserve accounts during the year 1948.

No. 5 (10 points)

The following types of information relative to fire insurance policies should be recorded in the auditor's working papers:

- Policy number
- Record of examination
- Name of insurer
- Coverage
  - Items
  - Location
  - Book value
  - Replacement value
- Amount of policy
- Co-insurance requirements
- Term of policy
  - Beginning date
  - Expiration date

- Premium
  - Amount paid
  - Verification
  - Charge to expense
  - Unexpired portion
- Comments
  - Adequacy of coverage
  - Reconciliation with accounts in ledger
  - Liability under mutual policies
  - Beneficiary if other than insured
  - Location of policies

If a client has an insurance register in which the above information is recorded, it usually would be sufficient for an auditor to summarize the data on amounts of policies, types of coverage, amounts of unexpired insurance, etc., and make suitable notations of pertinent matters requiring comment. If all details are desired for the working papers, photostatic copies of the pages of the insurance register may be obtained in lieu of hand-prepared copies.

The reasons for an examination of fire insurance policies are:

1. To obtain the basis for determining the amount to be set up on the balance-sheet as prepared expense and in the income statement as insurance expense.

2. To determine the adequacy of the insurance carried in relation to the replacement value of the property covered and co-insurance clauses in policies.

3. Insurance policies may disclose existence of mortgages on property insured by reason of the fact that proceeds from loss are payable to a named mortgagee.

No. 6 (10 points)

Program of examination to ascertain the amount of royalty due or overpaid to Adams under his contract with the Hayworth Manufacturing Company:

1. Examine all production orders from February 1, 1945, to date of examination to ascertain the number of units ordered produced under the Adams patent and the number of machines in which the installation of the Adams unit was ordered.

2. Trace the production orders through the manufacturing records to ascertain the number of Adams units completed and the number of Adams units installed in Hayworth machines.

3. Examine the shipping records to ascertain the number of Hayworth machines containing Adams units delivered out of the plant.

4. Take an inventory, or verify the inventory records, to ascertain the number of Adams units on hand and the number of machines containing Adams units on hand.

5. Reconcile the inventories taken or verified with the production and delivery records to ascertain that all Adams units produced have been accounted for.

6. Prepare a statement listing the serial numbers of the Hayworth machines in which the Adams unit was installed, and showing the disposition of each machine, including the number of the shipping order relative to its delivery from the plant.

7. Prepare a statement to show the amount of royalty earned by Adams, the amount paid him and the amount due or overpaid.

No. 7 (10 points)

(a) To obtain the quantity of coal in a large outdoor pile it is necessary to compute the cubic content of the pile and convert it into tons. This is ordinarily done by the company engineer, or an independent engineer employed for the purpose, under the observation of the auditor.

To obtain essential dimensions, such as height, circumference, etc., the engineer would use measuring instruments and compute the solid content of the pile. When this quantity has been obtained in terms of cubic feet or cubic yards, it can be converted into tons by means of standard tables or by using the weight of a cubic yard of coal in the pile obtained by actual weighing. Ground level and uniformity of packing must be considered in computing volume.

(b) To obtain the quantity of grain in an elevator it is customary to let down a plumb line from the top of the elevator, thereby obtaining the proportion of the elevator which is unfilled. Since the dimensions of the elevator are a matter of record, the solid content of the portion of the elevator filled with grain in terms of cubic feet or yards can be obtained by appropriate computation ($3.1416 \times \text{radius}^2 \times \text{height}$). These amounts can then be converted to bushels. If the mill or elevator company has a conversion table for each elevator, by reference to the table the number of bushels of grain in the elevator can be obtained when the length of the plumb line is known.

(c) The width and length of the bin are known or measurable. By boarding up the front of the bin and leveling off the top of the pile, the height of a rectangular parallelepiped can be obtained. The solid content of this pile is then computed by multiplying the product of the width and length by the height. The weight of one cubic foot of nails, obtained by actual weighing, multiplied by the number of cubic feet in the pile, will give the weight of the pile.

No. 8 (10 points)

Program for verifying and establishing the adequacy of a reserve for bad debts in the accounts of a chocolate manufacturer whose sales are in large measure to small candy manufacturers throughout the country.

A. In a balance-sheet audit:

1. Review bad debt history for a period of years.

2. Analyze the changes in the reserve for the year under review.

3. Obtain a list of accounts receivable, properly aged, and check the aging to the accounts receivable ledger.

4. Discuss with the credit manager, treasurer, or other proper official, the status of delinquent accounts and the propriety of write-offs, and in

the light of such discussion plus consideration of the company's past experience, arrive at the percentage of reserve required for accounts in each age group.

5. Compare the ratios of the balance in the reserve to sales for the year and to the total of outstanding accounts receivable, respectively, with the corresponding ratios of the three preceding years.

6. Make such adjustments to the reserve as seem desirable as the result of the examination.

B. In a detailed audit:

1. Include all steps under A above.

2. Analyze the reserve account in detail and foot.

3. Compare the opening balance in the reserve with the related item on the balance-sheet at the close of the preceding year.

4. Check all credits to the reserve offset by charges to the provision for bad debts to see that they conform to the basis for its establishment.

5. Check all charges against the reserve to see that they represent properly authorized write-offs of customers' accounts, or are offsets to erroneous credits to the account.

6. Check all credits to the reserve not offset by charges to the provision for bad debts, to see that they represent recoveries of accounts previously charged against the reserve, or are offsets to erroneous charges to the account.

No. 9 (10 points)

A certified public accountant acts in a manner discreditable to the profession:

a. If he fails to disclose a material fact known to him, but not disclosed in the financial statements, when disclosure is necessary to avoid making the financial statements misleading;

b. If he fails to report any material misstatement in the financial statement when he knows of such misstatement;

c. If he fails to acquire sufficient information to warrant expression of an opinion, or his exceptions are sufficiently material to negative the expression of an opinion;

d. If he fails to direct attention to any material departure from generally accepted accounting principles or to disclose any material omission of generally accepted auditing procedure applicable in the circumstances;

e. If he is grossly negligent in the conduct of his examination or in making his report thereon.

COMMERCIAL LAW

May 21, 1948, 9 a.m. to 12:30 p.m.

GROUP I

No. 1 (10 points)

a. (1) C can recover only $50.

(2) Section 54 of the Uniform Negotiable Instruments Law provides that where the transferee receives notice of any infirmity in the instrument or defect in the title of the person negotiating the same before he has paid the full amount agreed to be paid for it, he will be deemed a holder in due course only to the extent of the amount theretofore paid by him.

b. (1) C cannot hold D liable.

(2) The Uniform Negotiable Instruments Law provides that indorsers are liable to each other prima facie in the order in which they indorse. Evidence is admissible, however, to show that as between or among themselves they have agreed otherwise.

c. Under the Uniform Negotiable Instruments Law, where a signature is so placed upon the instrument that it is not clear in what capacity the person making the same intended to sign, and the language of the instrument is ambiguous as to his status, he is to be deemed an indorser.

No. 2 (10 points)

a. (1) A is liable to C for the one bill discounted by B but A is not liable for payment of bills subsequently discounted.

(2) A can withdraw. A's guarantee was a revocable offer.

(3) A revocable offer involving a series of independent contracts by separate acceptances may be effectively revoked so as to terminate the authority to create future contracts, even though one or more of the proposed contracts have already been created by the offeree's acceptance.

b. (1) There is no contract until the acceptance is delivered by B's office boy to A or to some person authorized by A to receive it in his behalf.

(2) An acceptance may be transmitted by any means which the offeror has authorized the offeree to use. This may be indicated expressly or by the means used by the offeror. If the acceptance is so transmitted it is operative and completes the contract as soon as it is put out of the offeree's possession without regard to whether it ever reaches the offeror. In this problem had the offeree B used the mails, the acceptance would have been complete when it was properly placed in the mails, regardless whether or not it reached the offeror A.

c. (1) B can get judgment for restitution of the price paid by him if he promptly tenders the return of the broken truck.

(2) The remedy of restitution, which has as its purpose the restoration of the injured party to as good a position as that occupied by him before the contract was made, is available because B's breach of warranty was a material failure which A could treat as a total breach of the contract.

No. 3 (10 points)

a. (1) The $5,000 should be divided as follows: $2,000 to Brown in respect to the advance made to the partnership and $1,000 each to Jones, Brown, and Smith in respect to their capital contributions.

(2) Subject to any agreement to the contrary, partnership liabilities on dissolution are to be paid in the following order: first, those owing to creditors other than partners; second, those owing to partners other than for capital and profits; third, those owing to partners in respect of capital; and fourth, those owing to partners in respect of profits.

b. (1) Under the Uniform Partnership Act, C's conveyance of his interest in the partnership does not, of itself, dissolve the partnership.

(2) (a) X, the assignee, is entitled to receive from the partnership in accordance with his contract the profits to which the assigning partner C would otherwise be entitled.

(2) (b), (c), (d) The assignment of a partner's interest, does not, as to the other partners, in the absence of agreement, entitle the assignee, X in this instance, during the continuance of the partnership (b) to inspect the books; (c) to an accounting; or (d) to participate or interfere in the management of the partnership affairs.

(3) In case of a dissolution of the partnership, the assignee is entitled to his assignor's interest and may require an account from the date only of the last account agreed to by all partners.

No. 4 (10 points)

a. (1) B could not be compelled to take the goods. In a sale by sample and description there is an implied warranty that the goods shall correspond with the description as well as with the sample.

(2) Where, as in this case, there is a breach of warranty by the seller, the buyer may refuse to accept the goods and either treat the sale as rescinded or maintain an action against the seller for damages for the breach of warranty. Had the buyer elected to do so, he might have accepted the goods and maintained an action against the seller for damages for the breach of warranty or set up the breach of warranty by way of recoupment in diminution or extinction of the price.

b. (1) B cannot recover.

(2) Where goods of a perishable nature are sold and the seller has a right of lien on them, the unpaid seller may resell the goods and shall not thereafter be liable to the buyer for any profit made on such resale.

No. 5 (10 points)

a. (1) A's agency was not revoked.

(2) The notice of revocation was ineffective as it did not come to A's notice.

(3) Notice of revocation takes place when the letter is received and read by A.

(4) In the absence of agreement, the mailing of a letter by the principal to the agent does not of itself constitute notification of revocation. The communication is ineffective unless it actually comes to the attention of the agent, or unless it is delivered to the agent's place of business or other proper place in such form that the agent receiving it is likely to take notice of its contents. Letters sent by other than first-class mail and in the form of circulars, if not read by the agent, have no effect.

b. (1) The factor was authorized to reroute the shipment of oranges.

(2) The unexpected destruction of the oranges by flood in Philadelphia does not subject the factor to liability to the principal.

(3) In the absence of other agreements, when an agent has been given authority and an unforeseen situation arises for which the terms of the authorization make no provision and it is impracticable for the agent to communicate with the principal, he is authorized to do what he reasonably believes to be necessary in order to prevent substantial loss to the principal with regard to the interests committed to the agent's charge.

GROUP II

No. 6 (10 points)

a. The law and regulations often give taxpayers an option of doing a thing in one of two or more ways to compute taxable income.

(1) As to accounting methods the taxpayer may keep his accounts on a cash basis or an accrual basis.

(2) The tax accounting period may be on a calendar year or a fiscal year basis.

(3) Bad debt deductions may be for specific debts or by annual charges to reserve for bad debts.

(4) Income from long-term contracts may be computed on a percentage of completion or on the basis of completed contracts.

b. (1) The taxpayer had a long-term capital gain of $250 of which 50% or $125 is recognized for tax purposes.

(2) The lot purchased on July 1, 1939, was sold. This situation comes under the "first-in, first-out" rule. The general rule is that when shares of stock are sold from lots purchased at different dates or at different prices and the identity of the lots cannot be determined, the stock sold must be charged against the earliest purchase.

c. Fees paid to attorneys and accountants for tax advice and preparation of tax returns in connection with income-producing property are deductible from the taxpayer's gross income. The general rule is that legal and accounting fees are deductible if incurred (1) in a transaction directly connected with or resulting from the taxpayer's trade, business, or profession; or (2) in the production or collection of income, or management or maintenance of property held for the production of income.

d. (1) The "Partnership Return" was not correct. The partnership return should show a net income of $21,000 allocated as follows:

To A—Salary	$5,000	
⅔ profit	8,000	
Total to A		$13,000
To B—Salary	$4,000	
⅓ profit	4,000	
Total to B		8,000
Total Partnership net income		$21,000

(2) To A—$13,000
To B— 8,000
(Detail in (1))

(3) Book profits should be distinguished from ordinary net income under tax laws. Payments made to a partner for services rendered are not deductible in computing the net income of the partnership for tax purposes. Such payments represent a division of partnership profits. Each partner must include in his individual tax return his distributive share of partnership net income, whether distributed to him or not.

No. 7 (10 points)

a. (1) (a) The payment of salaries to the directors was not proper unless, before the services were rendered, such compensation was expressly provided for by a statute, or by the corporate charter, or by a by-law or a resolution of the board of directors approved by resolution at a stockholders' meeting. The principle underlying the rule forbidding compensation, unless expressly provided for, is that directors are trustees for the stockholders and the corporation, and the law does not imply any promise to pay trustees for performing their duties as such or allow them to compensate themselves out of corporate funds under their control.

(b) The payment of a salary to the treasurer was proper if it was provided for before the services were rendered, or, even though there was no express contract, if it represented reasonable compensation for his services and was authorized by the board of directors. A treasurer who is not a director is a ministerial officer having no power of management and control of the property and affairs of the company, and hence does not occupy such a fiduciary relationship to the company as would forbid the recovery of reasonable compensation for services performed under circumstances indicating an intention and expectation of payment.

(2) In order to ascertain the authority for these payments the accountant should look at:

First: The minutes of the board of directors to see if payments were authorized.

Second: The by-laws to see if the directors had such power.

Third: The minutes of the stockholders to see if the actions of the board of directors were approved.

Fourth: The corporate charter and its amendments to see if there are any restrictions. (Generally there are none.)

Fifth: The statutes under which the corporation is organized. In general verification under the first three items mentioned above is considered sufficient.

b. (1) A was not entitled to dividends for 1941 and 1942 as no dividends were declared.

(2) As to 1941, there were no earnings or surplus from which rights to dividends could arise. As to 1942, it has been generally held that even if there are earnings or surplus available in any year, dividends once "passed" or omitted on non-cumulative shares are lost forever.

(3) A could not have compelled the directors to pay dividends.

(4) In 1941 there were no earnings or surplus. In 1942 the directors justifiably withheld distribution of earnings or surplus as dividends because they were necessary for the expanding business. The board of directors have full discretionary power to determine when the business is in position to declare dividends. It requires a strong showing of abuse of discretion by directors to compel a declaration of dividends where they employ surplus in the business.

No. 8 (10 points)

a. (1) The client should have carried fire insurance for $16,000 if he accepted a policy with an 80% co-insurance clause. That required him to carry insurance to the extent of 80% of $20,000, the fair, sound value of the building at the time of the fire, which amounts to $16,000 regardless of what it cost him or what his book value may be.

(2) Since his insurance policy was for only $8,000, which was one-half of what he should have carried under an 80% co-insurance clause, he failed to comply with this clause and became a co-insurer to the extent of one-half of the risk. Therefore, the insurance company will pay one-half of the loss, or $4,000.

(3) The insured's loss is $4,000, which can be used for income-tax purposes.

(4) The recoverable loss can be worked out by a formula applied as follows:

Let A represent the value of the property	\$20,000
Let I represent the amount of insurance	8,000
Let L represent loss	8,000
Let R represent the insurance recoverable	?

$$\text{Formula is: } R = \frac{I}{.80 \times A} \times L$$

Applying figures of the problem:

$$R = \frac{8{,}000}{.80 \times 20{,}000} \times 8{,}000 = \tfrac{1}{2} \times 8{,}000 = 4{,}000$$

$R = \$4{,}000$

b. (1) Fire insurance contracts cannot be assigned before loss without the consent of the insurer.

(2) Marine insurance contracts are assignable at any time without the consent of the insurer, in the absence of contrary stipulations in the contract.

(3) Life insurance contracts payable to the estate of the insured or which reserve the right to change the beneficiary or to assign the policy without the consent of the beneficiary may generally be assigned at any time. Where a third party is designated as a beneficiary in a policy which does not authorize a change of beneficiary he has a vested right in the policy and such policies cannot be assigned without his consent.

No. 9 (10 points)

a. (1) As a general rule interest is not allowed on running accounts so long as they remain open and unliquidated, unless it is permitted by a statutory provision, a contract between the parties or a trade custom or usage.

(2) After an account has been liquidated and settled and a balance due has been adjusted and agreed upon between the parties, interest on the balance will be allowed and chargeable as upon other matured debts of specific amounts, in the absence of an agreement to the contrary.

b. Where a contract provides for the payment of interest but specifies no particular rate, the legal rate at the date of the contract will attach thereto.

c. The general rule is that interest on a debt payable on demand accrues and starts only from the time when a demand is made for payment or in case no specific demand is made from the time of the commencement of suit.

d. Where an instrument provides for the payment of interest without specifying the date from which interest is to run and the instrument is undated the interest runs from the date of issue thereof.

No. 10 (10 points)

a. (1) An account may be defined as a detailed statement of items of debit and credit arising out of contract or some fiduciary relation which will furnish to a person having a right thereto information which will enable him to make some reasonable test of its accuracy. It is insufficient to merely state a balance.

(2) A current running account is an open account, that is, one that is not closed. It must consist of different items of different dates and there must be items on both sides. A balance of a stated account may become an item of a succeeding current account.

(3) A mutual account is one based on a course of dealing, wherein each party has given credit to the other in reliance on the understanding that upon settlement each side of the account will be allowed, so that one will reduce the other. Mutual accounts are made up of matters of set-off and only the balance is recoverable.

(4) An account stated is an agreement between parties who have had previous transactions of a monetary character that all the items of the account representing such transactions and the balance shown are correct, together with the promise for the payment of such balance.

(5) An account rendered is one which is drawn up and delivered by the creditor to the debtor as showing the items of the creditor's demand.

b. The accountant's report does not constitute an account stated. Where, for the purpose of ascertaining the correct balance of accounts between parties, they refer their accounts to an accountant to ascertain the correct balance and the balance he finds is acquiesced in by them, this will constitute a stated account, but there must be an agreement that the accountant's findings are agreed to by the parties and are to be used in final settlement.

c. An account stated operates as a confession that there is a fixed and definite sum due from one person to another at the date of the accounting. All the details of the account, the charges and credits or doubts as to on which side the balance may fall are thereby disposed of. When an account is stated involving mutual or cross demands, and the demands of one side are set off against the demands of the other, this is considered as an actual part payment. An account stated, whether expressly or by implication, is prima facie evidence of the accuracy and correctness of the items therein and of the liability of the party against whom the balance is found.

No. 11 (10 points)

a. Every public warehouse receipt must embody within its written or printed terms:

(1) the location of the warehouse where the goods are stored;

(2) the date of issue of the receipt;

(3) the consecutive number of the receipt;

(4) a statement whether the goods will be delivered to the bearer, to a specified person, or to a specified person or his order;

(5) the rate of storage charges;

(6) a description of the goods or of the packages containing them;

(7) the signature of the warehouseman, which may be made by his authorized agent;

(8) if the receipt is for goods of which the warehouseman is owner, either solely or jointly or in common with others, the fact of such ownership; and

(9) a statement of the amount of advances made and liabilities incurred for which the warehouseman claims a lien. If the precise amount is unknown to the warehouseman when the receipt is issued, a statement that advances have been made or liabilities incurred and the purpose thereof is sufficient.

b. (1) A non-negotiable warehouse receipt is a receipt in which it is stated that the goods received will be delivered to the depositor or to any other designated person.

(2) A non-negotiable receipt shall have plainly placed on its face by the warehouseman issuing it the words "non-negotiable" or "not negotiable."

(3) In case of the warehouseman's failure to so mark a non-negotiable receipt, a holder of the receipt who purchased it for value supposing it to be negotiable, may, at his option, treat such receipt as imposing upon the warehouseman the same liabilities he would have incurred had the receipt been negotiable.

c. (1) Warehousemen must exercise ordinary care for the protection of stored goods. The standard of care for warehousemen is such as an ordinarily prudent person would take of his own property under the same or similar circumstances.

(2) A warehouseman is not an insurer of goods in storage, but he is charged with ordinary care for the protection of the same.

(3) A warehouse company is not an insurer of cotton stored in its warehouse and is liable for loss of cotton by fire only in the event its negligence was the proximate cause thereof.

No. 12 (10 points)

a. The statute of limitations begins to run from the date that a cause of action accrues.

(1) On open book accounts the time is computed from the entry of the last item in the account.

(2) In a contract of sale an action for the purchase price accrues at the time of delivery unless the parties have agreed upon a different date for payment. The statute of limitations begins from that time.

(3) In the case of a bill or note payable on a day certain, the statute of limitations runs from the date of maturity. In the case of a demand note, the statute runs from the date of execution unless there are circumstances showing that the intention of the parties is that the statute of limitations shall not begin to run until the making of demand. Such a case would be where a note is payable three days after demand.

b. A is bound by his new promise to pay only $250. A promise to pay all or part of the money due from the promisor is binding if the antecedent debt was once enforceable and still would be except for the effect of the statute of limitations.

c. The promise is binding on A, but B's only right is to the payment of $50 at the end of each month. While a promise to pay money due from a promisor is binding if the antecedent debt was once enforceable and still would be except for the effect of the statute of limitations, if the terms of the promise are conditional or performable at a future time performance becomes due only upon the happening of the condition or upon the arrival of the specified time.

Examination Answers, November, 1948

ACCOUNTING PRACTICE—PART I

November 17, 1948, 1:30 to 6 p.m.

No. 1 (25 points)

A. *Waverly Manufacturing Company*

Departmental Distribution of Manufacturing Expenses

Basis of Distribution	Reference	Total	A	B	C	1	2
			Departments				
Floor space	(A-1)	$ 6,117	$ 2,039	$ 1,020	$ 408	$ 1,529	$ 1,121
Salaries and wages	(A-2)	23,404	11,047	4,119	1,451	5,406	1,381
Investment in machinery and equipment	(A-3)	36,859	22,558	9,067	737	4,091	406
Depreciation rates	(A-4)	42,800	24,929	10,038	1,011	5,643	1,179
Direct distribution							
Indirect labor		41,740				37,240	4,500
Factory clerical salaries		4,950					4,950
						$53,909	
Redistribution of Service Department Expense							
No. 1			36,777	11,111	630		5,391
							$18,928
No. 2			12,795	5,111	1,022		
		$155,870	$110,145	$40,466	$5,259		
Burden Rates							
Machine hours			31,912	9,640			
Rate per machine hour			$3.45	$4.20			
Labor hours					4,160		
Rate per labor hour					$1.26		

(*Continued on following page*)

B. COST OF JOB ORDER NO. 987

Material		$ 487.92
Direct labor		465.00
Burden:		
Department A—50 machine hours, @ $3.45	$172.50	
Department B—12 machine hours, @ $4.20	50.40	
Department C—20 labor hours, @ $1.26	25.20	248.10
Total		$1,201.02

Schedule A

		Distribution of Factory Expense				
ITEMS AND BASIS OF DISTRIBUTION	TOTAL	A	B	C	1	2
1. *Floor space*—square feet:						
Amount	30,000	10,000	5,000	2,000	7,500	5,500
Per cent of total	100.0%	33⅓%	16⅔%	6⅔%	25%	18⅓%
Factory rent	$ 2,400					
Fuel	3,172					
Electricity (¼ x $2,178)	545					
	$ 6,117	$ 2,039	$ 1,020	$ 408	$ 1,529	$ 1,121
2. *Salaries and wages:*						
Amount	$ 161,317	$ 76,180	$ 28,472	$ 9,975	$ 37,230	$ 9,460
Per cent of total	100.0%	47.2%	17.6%	6.2%	23.1%	5.9%
Compensation insurance	$ 2,486					
Superintendence	6,000					
Manufacturing supplies used	3,617					
Social security taxes	9,210					
Factory office supplies	879					
Miscellaneous factory expense	1,212					
	$ 23,404	$ 11,047	$ 4,119	$ 1,451	$ 5,406	$ 1,381
3. *Investment in machinery and equipment:*						
Amount	$1,019,047	$623,225	$250,960	$20,210	$112,862	$11,790
Per cent of total	100.0%	61.2%	24.6%	2.0%	11.1%	1.1%
Insurance—machinery and equipment	$ 4,216					
Machinery maintenance and repairs	31,010					
Electricity (¾ x $2,178)	1,633					
	$ 36,859	$ 22,558	$ 9,067	$ 737	$ 4,091	$ 406
4. *Depreciation rates*	(6 mo.)	4%	4%	5%	5%	10%
Depreciation	$ 42,800	$ 24,929	$ 10,038	$ 1,011	$ 5,643	$ 1,179

(*Continued on following page*)

5. *Machine hours*	42,112	31,912	9,640	560
Per cent of total	100%	75.8%	22.9%	1.3%
Distribution of 90% of expenses of Department 1	$ 48,518	$ 36,777	$ 11,111	$ 630
6. *Labor hours*	76,960	52,000	20,800	4,160
Per cent of total	100%	67.6%	27.0%	5.4%
Distribution of expenses of Department 2	$ 18,928	$ 12,795	$ 5,111	$ 1,022

No. 2 (20 points)

AB Trading Company

Cash Budget

For the Three Months ending March 31, 1949

	January	February	March
Cash balance at beginning of month	$112,000	$259,760	$226,272
Receipts (Schedule 1)	228,160	66,432	75,520
Cash available	$340,160	$326,192	$301,792
Disbursements (Schedule 2)	80,400	99,920	101,840
Balance at end of month	$259,760	$226,272	$199,952

Schedule 1

AB Trading Company

Receipts from Sales

January, February and March 1949

Month of Collection	Applicable to Sales of 2nd Prior Month	Applicable to Sales of Prior Month — Discounted — Gross	Discount	Net	Not Discounted	Total Receipts
January, 1949	$16,000(1)	$192,000(2)	$3,840	$188,160	$24,000(2)	$228,160
February, 1949	24,000(2)	38,400(3)	768	37,632	4,800(3)	66,432
March, 1949	4,800(3)	64,000(4)	1,280	62,720	8,000(4)	75,520
Totals	$44,800	$294,400	$5,888	$288,512	$36,800	$370,112

(1) November, 1948 sales,— 8,000 units* @$20 = $160,000; 10% = $16,000
(2) December, 1948 sales,— 12,000 units* @$20 = $240,000 of which 80% = $192,000; 10% = $24,000.
(3) January, 1949 sales,— 2,400 units* @$20 = $ 48,000 of which 80% = $38,400; 10% = $4,800.
(4) February, 1949 sales,— 4,000 units* @$20 = $ 80,000 of which 80% = $64,000; 10% = $8,000.

(a) Gross cost per unit: $72,000 ÷ 4800 = $15.
(b) Selling price per unit: $\frac{4}{3} \times \$15 = \$20$.

*See Schedule 3 for determination of the number of units.

(*Continued on following page*)

Schedule 2

AB Trading Company

Disbursements

January, February and March, 1949

	Payments for ⅓ of Prior Month's Purchases			Payments for ⅔ of Current Month's Purchases			Fixed Expenses	Variable Expenses	Total
	Gross	Discount	Net	Gross	Discount	Net			
January, 1949	$44,000	$ 880	$43,120	$224,000	$ 480	$ 23,520	$ 8,000	$ 5,760	$ 80,400
February, 1949	12,000	240	11,760	72,000	1,440	70,560	8,000	9,600	99,920
March, 1949	36,000	720	35,280	48,000	960	47,040	8,000	11,520	101,840
Totals....	$92,000	$1,840	$90,160	$144,000	$2,880	$141,120	$24,000	$26,880	$282,160

Schedule 3

AB Trading Company

Number of Units of Product to be Handled

January 1, 1949–March 31, 1949

	Beginning Inventory	Purchases(a)	Sales(b)	Closing Inventory
November, 1948.......................	8,000*	8,000	8,000(1)	8,000
December, 1948.......................	8,000	8,800	12,000(2)	4,800**
January, 1949.......................	4,800	2,400	2,400(3)	4,800
February, 1949.......................	4,800	7,200	4,000(4)	8,000
March, 1949.......................	8,000	4,800	4,800(5)	8,000*
		31,200	31,200	

* 10% of estimated annual sales of 80,000 units.
** 6% " " " " " " "
(1) 10% " " " " " " "
(2) 15% " " " " " " "
(3) 3% " " " " " " "
(4) 5% " " " " " " "
(5) 6% " " " " " " "

No. 3 (5 points)

Required Answer	Comments (not required by question)		
a. (4) $0			
b. (5) $0	A partnership is not a taxable entity.		
c. (1) $10,280	Salaries November 1, 1946, to June 30, 1947		$ 5,280
	Profit after salaries	$6,000	
	Less capital gain	1,000	5,000
			$10,280
d. (1) $ 5,380	Salary		$ 2,880
	Share of profit less capital gain		2,500
			$ 5,380

ACCOUNTING PRACTICE—PART II

November 18, 1948, 1:30 to 6 p.m.

No. 1 (30 points)

ACE MART CO.—PHOENIX BRANCH

Work Sheet

Year Ended September 30, 1948

	Trial Balance Phoenix Branch August 31, 1948		Transactions September, 1948		Adjustments September 30, 1948		Phoenix Branch Income Statement Year Ended 9/30/48		Balance-Sheet Phoenix Branch Sept. 30, 1948	
	Dr.	Cr	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Cash	$ 13,930		(5) $ 6,570	(3) $ 195					$16,665	
				(4) 1,140						
				(6) 2,500						
Cash in transit			(6) 2,500						2,500	
Imprest cash fund	200					(9) $114			86	
Notes receivable	8,000		(5) 2,100						10,100	
Accrued interest income	190				(7) $ 14				204	
Accounts receivable	18,000		(1) 12,000	(2) 1,485		(8) 595			19,250	
				(5) 8,670						
Inventory, at interoffice billing price	12,000				(10) 4,000				16,000	
Sales		$ 56,200		(1) 12,000				$68,200		
Sales returns	2,500		(2) 600				$ 3,100			
Sales allowances	3,815		(2) 885				4,700			
Shipments from H. O.	61,840		(3) 2960			(c) 64,800				
Freight in	3,064		(3) 195			(12) 300	2,959			
H. O. merchandise account		61,840		(3) 2,960	(c) 64,800					
H. O. current account		11,309			(8) 595					$64,805 (g)
					(12) 300					
Selling expenses	2,910		(4) 390				3,300			
Administrative and general expenses	4,150		(4) 750		(9) 114		5,014			
Interest income		1,250				(7) 14		1,264		
Cost of sales—credit for inventories					(10) 12,000	(10) 16,000		4,000		
	$130,599	$130,599	$28,950	$28,950	$81,823	$81,823	$19,073	$73,464	$64,805	$64,805

	Ace Mart Co. Accounts Related to Phoenix Branch Sept. 30, 1948				Adjustments		Income Statement		Ace Mart Co. Accounts Related to Phoenix Branch Sept. 30, 1948	
	Dr.	Cr.			Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Imprest cash in transit					(9) $ 114				$ 114	
Reserve for bad debts—Phoenix branch		$ 850			(8) 595	(a) 130				$ 385
Reserve for interoffice profit on inventories—Phoenix branch		3,000			(d) 3,000	(e) 4,000				4,000
Furniture and fixtures—Phoenix branch	$ 4,500								4,500	
Depreciation reserve—Phoenix branch, furniture and fixtures		1,800				(b) 450				2,250
Phoenix branch accounts:										
Current account	11,423					(8) 595			64,805	
						(9) 114				
						(12) 300				
Merchandise account	64,800					(c) 64,800				
Shipments (at billing price)		64,800			(c) 64,800					
Administrative and general expense control:										
Clerical and other expenses					(11) 1,270		1,270			
Insurance on direct shipments					(11) 185		185			
Bad debts					(a) 130		130			
Depreciation					(b) 450		450			
Cost of sales					(e) 4,000	3,000	49,600			
					(f) 48,600					
Undesignated home office accounts		10,273				(11) 1,455				60,328
						(f) 48,600				
Bartonville branch—current					(12) 300				300	
Branch profit							2,756			2,756
	$ 80,723	$ 80,723			$123,444	$123,444	$73,464	$73,464	$69,719	$69,719

Comments

Numbered adjustments are keyed to the examination problem. Lettered adjustments are explained below:

(a)	Required reserve (2% of $19,250)		$385
	Balance before adjustment ($850–$595)		255
	Additional reserve required		$130
(b)	Depreciation for year (10% of $4,500)		$450

(c) To close these accounts.
(d) To close out the reserve relating to beginning inventory.
(e) To set up reserve for closing inventory.
(f) To set up cost of shipments:

Shipments at billed price	$64,800	
Less profit (one-fourth)	16,200	$48,600

(g) Detail of current accounts as of September 30, 1948:

Balances as adjusted		$10,414
Balance of income accounts on branch books		
Revenue	$73,464	
Expense	19,073	54,391
Balance-sheet amount		$64,805

No. 2 (20 points)
(Alternate to No. 3)

Alexander Company

Work Sheet

September 30, 1948

	Trial Balance September 30, 1948		Adjustments		Adjusted Trial Balance September 30, 1948	
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Accounts payable		$ 1,830,000		(5) $ 60,000		$ 1,890,000
Accounts receivable	$ 3,800,000				$ 3,800,000	
Bonds payable—4%—1952		2,000,000				2,000,000
Capital stock		4,000,000				4,000,000
Cash	1,983,333				1,983,333	
Deferred income (discounts receivable)		375,000	(1) $ 94,167			280,833
Discounts receivable	3,216,667				3,216,667	
Fixed assets	4,000,000				4,000,000	
Goodwill	80,000				80,000	
Notes payable		1,000,000				1,000,000
Reserve for depreciation		1,000,000				1,000,000
Reserve for losses (receivables)		625,000				625,000
Surplus:						
Balance—October 1, 1947		1,915,000	(4) 78,000			1,837,000
Income for the year ended September 31, 1948		435,000	(2) 833 (5) 35,000	(1) 94,167 (3) 20,000 (6) 3,333		516,667
Treasury stock	100,000				100,000	
	$13,180,000	$13,180,000				
Accrued rent				(2) 10,000		10,000
Deferred rent expense			(2) 9,167		9,167	
Prepaid taxes			(3) 20,000		20,000	
Dividends payable				(4) 78,000		78,000
Prepaid advertising			(5) 25,000		25,000	
Accrued interest				(6) 36,667		36,667
Cash deposited with trustee for bond interest			(6) 40,000		40,000	
			$302,167	$302,167	$13,274,167	$13,274,167

Working Papers

September 30, 1948

(1) To adjust deferred income. Computation of the income from discounts is indicated below:

Acquisition Date	Face Amount of Notes	Discount Thereon	Income Realized			
			July	August	September	Total
6/15/48	$2,000,000	$200,000	(15/120) $25,000	(14/120) $23,333	(13/120) $21,667	$70,000
7/21/48	1,000,000	100,000		(15/120) $12,500	(14/120) $11,667	$24,167
9/10/48	750,000	75,000				
Total	$3,750,000	$375,000	$25,000	$35,833	$33,334	$94,167

(2) To accrue one year's rental and to charge 1/12 thereof to expense.

(3) To set up prepayment of real estate taxes as follows:

1948—1/3 of $60,000 .... $20,000

(4) To record dividend payable November 1, 1948.

(5) To set out the advance payment made to an advertising agency and to accrue the agency's billing for the month of September.

(6) To set up cash transferred to a fiscal agent and to set out accrued interest on bonds:

Cash deposited (1/2 of 4% of $2,000,000) $40,000
Accrued interest on September 30, 1948 (11/12 of $40,000) 36,667

Income credit assuming $3,333 (from prior year) and $40,000 (in the current year) have been charged to income .... $ 3,333

(*Continued on following page*)

Alexander Company

Balance-Sheet, September 30, 1948

Assets

Current:			
Cash		$1,983,333	
Notes receivable (collectible in installments, of which $216,667 is due after September 30, 1949 but prior to December 31, 1949)		3,216,667	
Accounts receivable	$3,800,000		
Less reserve for bad debts	625,000	3,175,000	
Cash deposited with trustee for payment of bond interest		40,000	
Prepaid expenses		54,167	
Total current assets			$ 8,469,167
Property and equipment		$4,000,000	
Less reserve for depreciation		1,000,000	3,000,000
Goodwill			80,000
			$11,549,167

Liabilities

Current:			
Notes payable		$1,000,000	
Accounts payable		1,890,000	
Accrued expenses		46,667	
Dividends payable		78,000	
Unamortized discount on notes receivable		280,833	
Total current liabilities			$ 3,295,500
Bonds payable—4% bonds due in 1952			2,000,000
Total liabilities			$ 5,295,500

Capital Stock and Surplus

Capital stock		$4,000,000	
Earned surplus:			
Balance, October 1, 1947	$1,915,000		
Net income for year ended September 30, 1948	516,667		
	$2,431,667		
Less 2% dividend declared on outstanding capital stock	78,000	2,353,667	
		$6,353,667	
Less treasury stock		100,000	6,253,667
			$11,549,167

Comments

1. Prepaid taxes may be computed on the basis of the fiscal year of the taxing authority rather than on the basis of the lien date as used above. If this is done, prepaid taxes would be $15,000 and the income for the year $511,667. Consistency must be observed in the method followed by the corporation.

2. Unamortized discount on notes receivable is frequently classified separately immediately follow-

ing current liabilities and is captioned as "Unearned discount on notes receivable" or "Deferred income."

3. If it is assumed that the deposit of $40,000 and the accrued interest of $3,333 had not been set up in the accounts as of September 30, 1947, and only $40,000 was charged against income in 1948, the $3,333 applicable to one-half of October, 1948, should be credited to surplus as of December 31, 1947, instead of 1948 income.

No. 3 (20 points) (Alternate to No. 2)

Z County Hospital

Work Sheet

Year Ended August 31, 1948

	Transactions 9/1/47–8/31/48				Operations		Balance Sheet August 31, 1948	
		Dr.		Cr.	Dr.	Cr.	Dr.	Cr.
General Fund								
Accrued interest on U. S. Treasury bonds	(4)	$ 1,250	(11)	$ 1,250				
Cash	(8)	10,000	(15)	20,000				
	(9)	20,000	(16)	15,000				
	(10)	500	(17)	15,000				
	(11)	2,500	(18)	10,000				
	(12)	44,000	(19)	20,000				
	(13)	12,000	(20)	2,000				
	(14)	52,000	(21)	5,000				
			(22)	1,000				
			(23)	15				
			(24)	4,000				
			(A)	48,985				
Due endowment fund	(A)	48,985	(14)	52,000				$ 3,015
Advances to plant fund	(15)	20,000						
	(16)	15,000					$ 35,000	
Contributions			(8)	10,000		$30,000		
			(9)	20,000				
Proceeds from charity bazaar	(23)	15	(10)	500		485		
Interest income			(11)	1,250		1,250		
			(13)	12,000		12,000		
Dividends received			(12)	44,000		44,000		
Contributions receivable	(26)	5,000					5,000	
Reserve for uncollectible contributions			(26)	5,000				5,000
Prepaid insurance	(27)	500					500	
Operating expenses:								
Salaries	(17)	15,000			$15,000			
Food and dietary supplies	(18)	10,000			10,000			
Medicinal supplies	(19)	20,000			20,000			
Life insurance premiums	(20)	2,000			2,000			
Property insurance	(21)	5,000	(27)	500	4,500			
Light, heat and power	(22)	1,000			1,000			
Miscellaneous	(24)	4,000			4,000			
Fund surplus, Sept. 1, 1947			(4)	1,250				1,250
Excess of revenue over expenses					31,235			31,235
		$ 288,750		$ 288,750	$87,735	$87,735	$ 40,500	$ 40,500
Endowment Fund								
U. S. Treasury bonds—principal	(3)	$ 100,000					$ 100,000	
Stocks and bonds	(5)	1,300,000	(14)	27,000			1,273,000	
Cash surrender value of life insurance	(7)	5,000					5,000	
Due from general fund	(14)	52,000	(A)	48,985			3,015	
Cash	(A)	48,985					48,985	
Endowment Fund principal:								
Principal—Sept. 1, 1947			(3)	100,000				1,405,000
			(5)	1,300,000				
			(7)	5,000				
Gain on sale of securities			(14)	25,000				25,000
		$1,505,985		$1,505,985			$1,430,000	$1,430,000

(Continued on following page)

Plant Fund						
Hospital site	(1)	$ 25,000			$ 25,000	
Hospital buildings	(2)	200,000			220,000	
	(15)	20,000				
Equipment	(6)	60,000			75,000	
	(16)	15,000				
Due general fund			(15)	$ 20,000		$ 35,000
			(16)	15,000		
Net investment in plant			(1)	25,000		285,000
			(2)	200,000		
			(6)	60,000		
		$ 320,000		$ 320,000	$ 320,000	$ 320,000

Z County Hospital

Balance-Sheet, August 31, 1948

General Fund

Assets			Liabilities		
Contributions receivable	$5,000		Due endowment fund		$ 3,015
Less reserve for uncollectible contributions	5,000	$ —	**Surplus**		
			Surplus—Sept. 1, 1947	$1,250	
Advances to plant fund		35,000	Excess of revenue over expenses	31,235	32,485
Prepaid insurance		500			
		$35,500			$35,500

Endowment Fund

Assets		Liabilities		
Cash	$ 48,985	none		
U. S. Treasury bonds	100,000	**Principal**		
Other bonds and stocks	1,273,000	Principal—Sept. 1, 1947	$1,405,000	
Cash surrender value of life insurance policies at date of receipt (present cash surrender value $6,500)	5,000	Gain on the sale of securities	25,000	$1,430,000
Advance to General Fund	3,015			
	$1,430,000			$1,430,000

Plant Fund

Assets		Liabilities	
Hospital site	$ 25,000	Due General Fund	$ 35,000
Hospital buildings (appraised at $250,000)	220,000	**Capital**	
Equipment	75,000	Net investment in plant	285,000
	$320,000		$320,000

Comments

1. While generally accruals need not be made for interest on investments, the $1,250 accrued at the date of the contribution should be set up as a part of the principal of the Endowment Fund if this is the intent of the donor.

2. If it is construed that the entire proceeds of the policy become part of the Endowment Fund capital the increase in cash surrender value could be brought on the books and credited to principal of the Endowment Fund.

3. The entire cash balance of the General Fund has been transferred to the Endowment Fund as payment on the Due to Endowment Fund Account. Such transfer would be discretionary with the trustees.

THEORY OF ACCOUNTS

November 18, 1948, 9:00 a.m to 12:30 p.m.

No. 1 (12½ points)

(a) Under usual accounting theory the old machine cost would be eliminated from the asset account and the accumulated depreciation would be eliminated from the depreciation reserve. Consequently it is only necessary to take into consideration the new asset cost (including installation charges) and the estimated scrap value of the new machines. The loss on the trade-in is not a factor in the determination of depreciation under this method.

(b) Under income-tax regulations the loss on the trade-in is not deductible. It is to be added to the cost of the new asset in establishing the basis for depreciation to be taken in subsequent periods.

The annual depreciation for the year beginning June 1, 1948, is computed under each of these methods in the following schedule.

	(a) Under Usual Accounting Theory	(b) Under Federal Income-Tax Regulations
Determination of annual depreciation beginning June 1, 1948		
New machine cost	$9,000.00	$ 9,000.00
Installation cost	225.00	225.00
Loss on trade-in of old machine (1)		1,137.50
Total	$9,225.00	$10,362.50
Less estimated scrap value	100.00	100.00
Amount to be depreciated	$9,125.00	$10,262.50
Depreciation for year beginning June 1, 1948	$ 912.50	$ 1,026.25

(1) The loss on the trade-in of the old machine is determined as follows:

Date	Items	Net book amount
June 1, 1943	Machine cost	$5,000.00
	Freight cost	200.00
	Installation cost	125.00
		$5,325.00
June 1, 1945	Depreciation June 1, 1943–May 31, 1945 (2)	1,055.00
		$4,270.00
	Replacement of essential part	600.00
		$4,870.00
May 31, 1948	Depreciation June 1, 1945–May 31, 1948 (3)	1,807.50
		$3,062.50
	Less trade-in allowance	2,000.00
		$1,062.50
	Cost of removing old machine	75.00
	Loss on trade-in	$1,137.50

(Continued on following page)

Determination of Depreciation in (1)

Item	(2) 6/1/43 to 5/31/45	(3) 6/1/45 to 5/31/48
Net book amount	$5,325.00	$4,870.00
Estimated scrap value	50.00	50.00
	$5,275.00	$4,820.00
Years of remaining life	10	8
Annual depreciation	$ 527.50	$ 602.50
Years taken	2	3
Total depreciation	$1,055.00	$1,807.50

Comment

Comment on the treatment of the replacement of the essential part may be helpful. The amount of the charge in relation to the asset cost (12% of invoice cost) and the fact that such replacement occurred only once in a five-year period are indications that the replacement should not be treated as ordinary repairs chargeable to expense. If the original cost of the replaced part is known the asset account should be relieved of the accumulated depreciation relating to the replaced part. If the exact original cost is not known it would be desirable to use an engineer's estimate of original cost. The original cost of the replaced part is not stated in the problem. Consequently, a candidate who sets up asset and reserve accounts in his solution should preferably assume such a cost. If he does not use an assumed cost he might charge the replacement cost to the reserve and include a statement explaining the departure from the accepted procedure in the treatment of replacement costs. The use of net book cost in the solution of the Students Department avoided this problem.

In the department's solution the removal cost of the replaced asset has been treated as an increase in the loss on the trade-in. This procedure is generally followed when the depreciation charge is based on cost without recognition of salvage value or when it is based on cost less expected net salvage (salvage less removal cost). If the depreciation charge were based on cost less gross salvage the removal cost should preferably be charged to expense.

No. 2 (12½ points)

The investment in the S Company's common stock is preferably shown at cost with a parenthetical or footnote disclosure of the higher market value.

If the increase of the asset value of the S Company's common stock to $150 per share is entered in the investment account the credit should be made to a revaluation surplus account. There is no realization of profit and it is not acceptable to credit the increase to revenue or to earned surplus. It would not be acceptable to adjust the investment account to a value in excess of cost for the S Company's stock unless other holdings in the account were adjusted to reflect higher or lower market values. The adjustment in the book value of the S Company's stock should be reversed when the stock is sold so that the investment account will reflect the true basis for gain or loss in the sale.

Reasons for adjustment to the higher value:

1. The increase in value has been steady and has extended over a period of 23 years.

2. The reflection in the accounts has been made without anticipation of the profit.

3. Reflection in the accounts may insure appropriate recognition in the analysis of working capital, the current ratio, book value of stock and return on current market value.

Reasons for the retention of the cost basis:

1. The generally accepted basis of valuation is cost with a writedown to a lower market in case of temporary investments or in case of significant decline in permanent investments.

2. The reflection of the higher market value by footnote or parenthetical disclosure provides information as to such value and at the same time retains in the accounts the true basis for gain or loss on sale of the stock.

No. 3 (12½ points)

(a) Fund accounts should be established for each project. Each fund account will provide the accounts of assets, liabilities, income, expenditures and balances necessary to reflect the operation and condition of the project for which it was established. The fund accounts should be classified and accounted for according to the conditions of the gift or gifts for the separate projects. Earnings of each fund should also be entered in fund accounts according to the specifications of the gift.

The fund accounts appropriate for gifts and income from gifts are classified as follows:

Current funds

General funds—funds unrestricted as to use. Although the principal of a gift may be for a specific project and consequently not to be classified as general funds, the income from the gift might be unrestricted and available for current purposes.

Restricted funds—funds currently expendable for designated purposes such as scholarships or library maintenance. Earnings from endowment gifts should be entered here if expendable for designated current purposes.

Loan funds—gifts the principal of which may be loaned and earnings on funds classified elsewhere which are designated for use as loans.

Endowment funds—gifts which provide that the principal shall be maintained for limited or unlimited future periods. Income on these funds should be placed in the fund group appropriate for the conditions relating to their expenditure.

Annuity funds—gifts subject to the payment of an annuity by the institution. Annuity funds are frequently shown as a subgroup under endowment funds.

Plant funds—gifts expendable for land, buildings, or equipment.

(b) The general fund receiving the loan would be debited with the cash or other asset received and credited with a liability such as "Due other funds" or "Due ____________ fund."

The fund from which the loan was made would be debited with a receivable such as "Due from other funds" or "Due from ____________ fund" and credited with the cash or other asset loaned. The inter-fund asset and liability would be reflected in the fund balance-sheets until repayment or authorized and proper cancellation. If the loan was not permitted under the by-laws of the institution the violation of the by-laws should be clearly and fully stated in the annual report.

No. 4 (12½ points)

(a) *Accounts receivable—trade debtors:* current rate of exchange at date of statement. The assumption is that the dollar amount resulting from use of this rate will be that which will be made available to the home office through remittances of collections.

Sales: average rate of exchange throughout the period. If sales are seasonal an appropriate system of weighting may be used.

Factory building: rate of exchange in effect when building was constructed or purchased. The dollar equivalent of the cost in foreign currency may be entered in memorandum form. This procedure eliminates changes in dollar values because of fluctuation in exchange rates.

Accrued payroll: current rate of exchange at date of statement. This basis is generally justified because of the relative insignificance of the accrual. It fails to consider the expense aspect of the accrual.

Depreciation of building: appropriate depreciation rate applied to the value of the building as converted to home office currency. This method of conversion maintains the same relation of reserve for depreciation to asset amounts on the home and branch books.

Home office account: the dollar amount of the branch office account on the books of the home office. This account is the reciprocal of the branch office account on the books of the home office. (Generally the accounts are described as current accounts, for example "home office account current.")

(b) Any difference between the two sides of a foreign branch trial balance after it has been converted to the currency of the home office is the result of the various exchange rates applied to the items on the trial balance. If the sum of the debits in the converted trial balance exceeds the sum of the credits, the difference may be treated as a profit on exchange and credited to branch profit and loss. If the sum of the credits exceeds the sum of the debits, the difference may be treated as a loss and charged to branch profit and loss. The offsetting debit or credit in these entries is to the branch office account.

As an alternative to the above procedure the adjustment for the difference may be made by credit or debit to a "reserve for fluctuations in exchange" in place of "branch profit and loss." However, a loss in excess of the credit balance of the reserve account should be charged to branch profit and loss.

No. 5 (12½ points)

Assuming that when Graves purchased 100 shares of the capital stock of Monaco Mining Company, he charged the investment account with the cost of the shares, the investment account would have been charged with $500.

The following table indicates how Graves should have recorded the dividends received from 1941 through 1948:

	Amount Received	Credit to Dividend Income	Credit to Investment	Long-term Gain on Sale of Capital Asset
1941	$ 250	$ 75	$175	$ —
1942	250	150	100	—
1943	250	250	—	—
1944	250	200	50	—
1945	250	150	100	—
1946	250	225	25	—
1947	250	150	50	50
1948	250	100	—	150
	$2,000	$1,300	$500	$200

In the above schedule amounts representing earnings are credited to dividend income. The first $500 of liquidating dividends represents a return of capital and should be credited to the investment account. The liquidating dividends in excess of the cost of the investment must be treated as long-term capital gains.

The investment account may be shown at no value in the balance-sheet or at a nominal value of $1 since its cost has been fully recovered. The showing at a nominal amount would show the fact of investment and indicate a real but possibly indeterminate value not reflected in the statement. Market value, if determinable, may be shown parenthetically or in a footnote.

No. 6 (12½ points)

a. (1) As defined in Accounting Research Bulletin No. 29 "market" as used in the phrase "lower of cost or market" means current replacement cost (by purchase or reproduction, as the case may be).

(2) (a) Market *should not exceed* the net realizable value (i.e., estimated selling price in the ordinary course of business less reasonably predictable costs of completion and disposal) and

(b) Market *should not be less than* net realizable value, as defined above, reduced by an allowance for an approximately normal profit margin.

b. Accounting Research Bulletin No. 29 specifies the following conditions as requisites for stating inventories above cost:

(1) Inability to determine appropriate approximate costs,

(2) Immediate marketability at quoted market price, and

(3) The characteristic of unit interchangeability.

Where goods are stated above cost the fact should be fully disclosed. Under no conditions should inventories be stated above selling price less expected cost of disposal.

The following are illustrations of inventories meeting the above conditions:

(1) Inventories of gold and silver. They have a fixed monetary value and virtually no cost of marketing.

(2) Inventories of grain, cotton, coffee and other products regularly traded in on commodity exchanges.

No. 7 (12½ points)

5% convertible general mortgage bonds.......	$100,000	
Capital stock........		$100,000

To convert 100 bonds of Green, serial numbers x to y inclusive, to capital stock at par in accordance with the terms of the indenture.

The above entry is made on the assumption that there is an exchange of bonds for stock. Capital stock is credited for the amount paid in by the bondholder. This amount represents the contribution of equity capital. Although the cash or other assets received by the corporation came from bondholders, there was a contractual agreement with the bondholder which permitted him to change to a stockholder. The conversion does not alter the amount of contributed capital offsetting the credit to capital stock.

Comment

A different answer is outlined by W. A. Paton in *Advanced Accounting* (New York: MacMillan Co., 1941) page 630. He views the conversion as a telescoping of two transactions: (1) the issuance of stock which should be credited at cash market value if determinable and (2) the use of the funds received to retire bonds. Assuming cash market value of the issued shares to be $110,000, the entry according to this theory is:

5% convertible general mortgage bonds.......	$100,000	
Loss on bond conversion..	10,000	
Capital stock........		$100,000
Paid-in surplus......		10,000

The cash market value of the capital shares is not stated in the problem. In the absence of this information, proponents of the procedure outlined in these comments would necessarily assume a cash value or use the book value of $120,000 in lieu thereof. The Students Department does not consider these alternative solutions as acceptable.

No. 8 (12½ points)

Suggestion (e) is approved for adoption:

(e) While the laws of the state under which the corporation is organized, or the regulations of a commission to which it must report, may govern or affect the manner in which discount on capital stock is stated on its balance-sheet, the method suggested in (e) is generally to be preferred. No one can be misled by showing the discount as a deduction from the par value of the related issued stock in the capital section of the balance-sheet, since both the amount and the manner of acquisition of the capital acquired through the issue of stock is thereby clearly shown.

The other suggestions are objectionable for the reasons stated:

(a) The conditions of the subscription show no intention to collect this amount from stockholders and the weight of authority does not support the treatment of discount on capital stock as an asset. If for any reason it is so treated, it should be designated on the balance-sheet as "Discount on capital stock." Comment from Robert H. Montgomery, *Auditing Theory and Practice*, New York, Ronald Press, 6th Ed., page 263. "Nevertheless the Uniform System of Accounts for Public Utility Holding Companies, prescribed by the Securities and Exchange Commission, and that for Public Utilities and Licensees prescribed by the Federal Power Commission, both provide for accounts on the asset side of the balance-sheet which are to include discounts on capital stock. The Securities and Exchange Commission classification provides that a debit balance in this account . . . may be written off to earned surplus or amortized by charges to income. The Federal Power Commission classification states, 'The utility may amortize the balance carried in this account by charges to . . . surplus.' *Regulation S-X—Uniform Accounting Requirements for Financial Statements under the Securities Act of 1933 and the Securities Exchange Act of 1934*—provides in Rule 3.17: 'Discount on capital shares, if significant in amount, shall be shown separately as a deduction from capital shares or from surplus, as circumstances require, with an indication of what provisions have been made for writing off this item.' "

(b) Discount on capital stock bears no relation to the cost of the plant, and should not be identified with the asset account. To close discount on capital stock into plant account or treat it as an element of plant in the balance-sheet would be misleading. If the plant was acquired at a bargain, and consequently understated on the balance-sheet, any adjustment to bring it to its proper value should be made directly to revaluation surplus.

(c) Discount on capital stock is a contingent claim against stockholders; organization expense represents capital expenditures relating to formation and incorporation.

(d) The asset goodwill reflects a purchase of value attached to the business that is in excess of the value of its other assets. Discount on capital stock should not be shown as goodwill.

(f) While it may be acceptable practice to offset discount and premium in situations where a portion of one class of stock has been issued at a discount and another portion of the same class has been issued at a premium, the offsetting of discount on one class of stock against premium on another class is not generally considered acceptable. In instances where the offset is made, it must be recognized that the right of call with respect to the amount of discount is not thereby abrogated. A fully informative balance-sheet should therefore show one as a deduction from the other when that procedure is followed.

No. 9 (12½ points)

In the balance-sheet of a going concern it is not customary to apply pledged assets directly against the liabilities, payment of which is secured thereby. Thus, items in the question listed as assets should appear on the Soya Company's balance-sheet as assets in the amounts stated, and the liabilities be shown as such in the amounts reported.

An exception to this general rule may be recognized in the case of the U. S. Treasury Tax Notes, which are sometimes stated on the liability side of the balance-sheet as a deduction from the federal tax liability for the payment of which they were purchased. Even in this case, however, it would not be appropriate to show the amount of accrued federal taxes as $10,000, except by extending it as the difference between $35,000 (the liability) and $25,000 (the related asset).

In the interest of accurate and complete reporting, however, it is essential that the facts relative to the assets pledged be so indicated that the reader of the statement cannot misunderstand the company's financial position. Thus, in parentheses, after "trade debtors," it might be stated that collections from trade customers were pledged to apply against the loan of Bank A, or a parenthetic explanation of "notes payable to Bank A" might make it clear that these notes were secured by amounts due from trade debtors in the amount of $48,250. Similar notations could be made with respect to the marketable securities and the loan by the president and the nature of protection offered to Bank B in connection with its loan.

If such explanations are not made in the body of the balance-sheet, they should be made as notes to the statement.

No. 10 (12½ points)

In a consolidated balance-sheet negative goodwill is the excess of the book value of the subsidiary stock, on its own books, over the purchase price paid by the holding company.

To illustrate, assume the capital stock and surplus of S Company to be as follows:

Capital stock	$125,000
Earned surplus	50,000
Total	$175,000

H Company acquires the entire issue of S Company's capital stock for $150,000.

In consolidating the balance-sheets of H Company and S Company the investment in S Company ($150,000) would be eliminated against the H Company's capital stock ($125,-000) and surplus ($50,000), leaving a credit balance of $25,000 for the consolidated balance-sheet. If the conditions had been reversed, and the H Company had paid $175,000 for the capital stock of the S Company, the book value of which was $150,000, in consolidating the statements the balance remaining after eliminating the capital stock and surplus accounts of the S Company against the H Company's investment in S Company stock would be shown as an asset and be labeled "goodwill." Hence the term "negative goodwill" when the uneliminated amount appears as a credit balance.

When there is also positive goodwill, either on the balance-sheet of the holding company or subsidiaries before consolidation or as the result of purchases of the capital stock of other subsidiaries at prices in excess of their book values, or both, items of negative goodwill are sometimes deducted from amounts of positive goodwill to obtain a single amount of goodwill for the consolidated balance-sheet. A deduction of negative goodwill from positive goodwill can be justified when the positive goodwill appears on the books of the subsidiary whose consolidation with the parent company gives rise to the negative goodwill. When one or more of assets other than goodwill are overstated on the subsidiary's books, negative goodwill is preferably deducted from the amounts of such assets thus eliminating the excessive valuation. Negative goodwill which is not properly used to offset positive goodwill or to eliminate excessive asset values, is generally shown on consolidated balance-sheet as surplus arising from consolidation.

AUDITING

November 19, 1948, 1:30 to 5 p.m.

No. 1 (15 points)

Suggested Procedure for Verifying Cash on Hand

Before the Count

a. Arrange for the control of cash, securities, notes and other liquid assets and their count during the period of control.

b. List the amount of all change funds by bag number and custodian and tie the total into the general ledger control account.

c. Arrange to have a representative present when the cash register tapes are pulled by the store's auditor and instruct the representative personally to take and record the readings.

Count of the Change Bag Funds

a. Arrange to be present at the general cashier's office at the close of business so that all bags can be checked to the list referred to in b above.

b. Count the cash in the change bags and list the amount counted for each fund.

c. As each cash fund is counted, the amount of the change fund should be returned to the bag and the balance representing the day's receipts should be set aside. When all bags have been counted, the funds which have been set aside should be turned over to the general cashier for preparation of the deposit. In order to avoid any substitution, the auditor should not turn over these funds to the general cashier until all other funds have been counted.

d. Subtract the amount of the change funds from the total cash in the change bags to obtain the day's receipts turned in by the sales clerks.

e. On the following day the store auditor's report to the accounting clerk should be checked to see that it is in agreement with the cash register tapes. The sum of the cash register tapes as shown by the auditor's report should equal the amounts turned in by the sales clerks. Any difference is an overage or shortage.

General Cashier Funds

a. Count the petty cash fund listing all vouchers and checks.

b. Reconcile the count with the general ledger control account.

c. Count the collections of accounts receivable and tie them into the cash register tape total as reported by the store's auditor to the accounting department.

Control of the Deposit

a. After all funds have been counted the amounts to be deposited should be turned over to the cashier and a receipt obtained from him.

b. Supervise the preparation of the deposit by the general cashier and observe that no substitution of funds is attempted.

c. Have the cashier place the deposit funds in the company's safe and place the auditor's seal on the safe.

d. The next morning the auditor should break the seal and accompany the cashier to the bank and obtain an authenticated duplicate deposit slip for the working papers.

No. 2 (10 points)

Since the auditor was in attendance during the course of counting the inventory, the remainder of the audit procedure would be concerned with the following:

a. The inventory tags should be tested against the classified inventory sheets and the final summary should be proven against the totals of the classified sheets.

b. All the prenumbered inventory tags should be accounted for in the classified inventory sheets.

c. If consigned merchandise was on hand, it must be excluded from the inventory.

d. If there were undelivered sales billed to customers, that inventory must be excluded.

e. Prices used in pricing the inventories should be compared with current quotations or current invoices in order to verify the accuracy of the lower of cost or market.

f. The auditor must determine that obsolete and damaged goods were priced at not in excess of their realizable resale value when that figure was below cost or market.

g. Extensions on the inventory sheets should be tested thoroughly.

h. Footings of the inventory sheets should be proven.

i. The auditor must ascertain that the perpetual inventory records have been adjusted to audit accuracy, both at the lower of cost or market and at retail, and for quantities.

j. Invoices and receiving reports for the last few days of the fiscal period must be examined to determine proper inclusion in the inventory.

k. Inventory charges and payable (or cash) credits must exist for all goods included in the inventory.

l. Investigate to ascertain if the inventory, or any portion of it, has been pledged as loan security or is otherwise encumbered.

m. To test the general accuracy of the inventory, the gross profits test may be applied.

n. Ascertainment must be made that the inventories were valued on the same basis (lower of cost or market) at the close of the preceding fiscal period. If a change in the method of valuation has taken place, the effect on profits should be determined and explained in the audit report.

o. An inventory certification should be obtained from the client.

p. Ascertainment should be made that purchase commitments are not in excess of reasonable future requirements and that there is no probable substantial loss on existing purchase commitments.

No. 3 (15 points)

a. 1) Review the company's income account to see whether the business has a gross profit percentage which corresponds to the mark-up. If there are major fluctuations, or if the average varies from what it should be, obtain explanations from responsible officers and make such tests as are necessary to satisfy yourself concerning the variations.

2) During audit work, observe the handling of mail receipts, cash sales, and collections, as well as the cashier's handling of invoices, his working after regular hours, or other matters which may be a clue to the possibility of irregularities.

3) Take a trial balance of the customers' ledger, classify by age, foot, and compare with the accounts receivable account. If the aged trial balance is prepared by the client's employees, check the individual balances, the age distribution, and the total.

4) Check postings of sales to control accounts, and test postings of charge sales to individual customers' accounts.

5) Check postings from cash receipts record to control accounts, and test postings to individual customers' accounts, especially for last two months.

6) Test charges to customers in the sales or other journals examining order, shipping records, and other supporting evidence.

7) Compare total deposits with cash receipts for the period and test entries in cash receipts record by comparison with duplicate deposit tickets, covering the last month completely if practicable.

8) Trace postings from journal to controls for accounts receivable and sales and to individual accounts receivable.

9) Ascertain by tests that discounts have been allowed when earned and have not been allowed, unless by appropriate authorization, when not earned under stated company policy.

10) If customers' accounts are paid in cash to any extent, check date of receipt with date of entry in cash receipts record or summary, giving particular attention to discounts allowed.

11) Scrutinize entries for returned sales, adjustments and amounts written off to see that the write-offs have been properly authorized. If write-offs are material in amount, further investigation should be made as to authenticity.

12) Examine customers' statements prepared for mailing and check to trial balance of accounts receivable ledger.

13) Control the mailing of customers' statements which you have examined.

14) Compare cash receipts during month following date of accounts receivable verification with customers' balances then outstanding, keeping control over the incoming mail so as actually to examine the cash receipts for a test period.

15) Discuss with the proper officer or official all balances not paid within 30 days after the date as of which verification was made.

b. Generally under the conditions stated, an unqualified certificate could not be given. Confirmation of receivables is one of the procedures set forth in the Statements on Auditing Procedure No. 12, entitled "Extensions of Auditing Procedure," issued by the committee on auditing procedure of the American Institute of Accountants. The committee recommended that disclosure be required in all cases in which the procedure as to confirmation of receivables was not carried out even though the accountant may have satisfied himself by other methods. Such disclosure is mandatory as to all reports filed with the Securities and Exchange Commission. In an audit where the receivables are insignificant in amount, confirmation might not be considered essential under the principles of materiality. However, in the case herein considered there is no clear indication of immateriality.

No. 4 (15 points)

a. Test the details underlying gross credit to income (or deferred subscription income) to properly executed subscription applications or renewals.

b. List (or obtain a listing) and check the amortization of subscription income, giving details of the test in terms of the basic records.

c. Review the renewal policies to ascertain the effect on income of possible practice of continuing subscriptions beyond expiration before a renewal subscription is received.

d. Test postings to ledger accounts for a selected period or periods.

e. The workpapers should include some permanent file summaries of number of subscriptions on hand at year ends, by one-year, two-year, three-year, and five-year types, with related deferred income. As succeeding years' statistics become available, assuming constant subscription prices, and modified by trends for increase or decrease in total subscriptions, there would become available an over-all measure of reasonableness of amounts of increased subscription income when related to number of outstanding subscriptions of each type at each year end.

Comment [*not required by question*]

In a manual system certain fundamental records must be provided. The subscriptions must be closely controlled, and there should be a register of income apportionment in some form. The forms can be expected to be varied because of opportunities to incorporate single-purpose features or multiple-purpose features in their organization.

Various types of records suggest themselves:

a. A subscription register providing for four columns (one year, two year, three year, five year) with only the amount of a monthly allocated subscription income indicated. Expirations or cancellations would be registered in red in same columns. The column totals would be the amounts to be credited to income and charged to deferred subscription income in each succeeding month.

b. A subscription register (separate one for each type of subscription) with columns for months across the top. The amount of deferred subscription income allocable to succeeding years would be set out in the last column to be carried forward to the first column of the similar register in the succeeding year. In such case, the total of each month's columns would be the amount credited to earned income each month and the final column of allocation to the succeeding year would be the control on total unearned subscription income at the end of each fiscal period.

c. There might be devised some type of sorter device along the lines of the McBee system, with provision for setting forth the number of months unexpired at the end of each successive period; a comptometer operator would tabulate by type of subscription the number of unexpired months, multiplying the total by the monthly allocable part of each type of subscription.

d. Addressograph plates commonly used provide information as to the length of the cash subscriptions and the expiration date.

No. 5 (15 points)

F COMPANY
Analysis of Investments Account
January 1, 1948 to September 30, 1948

Date 1948	Particulars	Account per Books Dr.	Account per Books Cr.	Adjustments Dr.	Adjustments Cr.	Account as Revised Dr.	Account as Revised Cr.	Other Accounts Affected by Adjustments Dr.	Other Accounts Affected by Adjustments Cr.	
1 1	Balance:									
	A Co. common— 1M shares @ $10.00 (bt. 6–1940)	$ 10,000(a)	—	—	—	$ 10,000(a)	—	—	—	
	2M shares @ $8.00 (bt. 8–1942)	16,000(a)	—	—	—	16,000(a)	—	—	—	
	1.5M shares @ $11.00 (bt. 5–1945)	16,500(a)	—	—	—	16,500(a)	—	—	—	
	B Co. common— 2M shares @ $16.50 (bt. 1–1946)	33,000(b)	—	—	—	33,000(b)	—	—	—	
	C Co. common— 100 shares @ $73.00 (bt. 8–1941)	7,300(c) (d)	—	—	—	7,300(c) (d)	—	—	—	
	D Co. 5% gen'l mtg. bonds: 20 $1,000 bonds @ $98.4 (bt. 7–1944)	19,680(e)	—	—	—	19,680(e)	—	—	—	
	E Co. chattel mortgage on machinery 5% $7,000 mortgage (9–1947)	6,456(f)	—	—	—	6,456(f)	—	—	—	
1 31	Sold A Co. common (bt. 5–1945)	(a)	$ 10,682	—	(1)$ 318	— (a)	$ 11,000	(1)$ 318	—	Profit & loss
3 31	Bt. B Co. common 500 shares @ $24.00+	12,125(b)	—	—	—	12,125(b)	—	—	—	
6 30	C Co. 100% stock dividend—100 shares	10,000(c)	—	—	(2) 10,000	— (c)	—	(2) 10,000	—	Dividends received
7 31	Sold C common	— (d)	8,750	(3)$ 5,100	—	— (d)	3,650	(3) 3,750	—	Accounts receivable—special
									(3) 8,850	Profit & loss
8 31	Sold D bonds	— (e)	22,500	(4) 2,820	—	— (e)	19,680	—	(4) 500	Interest income
									(4) 2,320	Profit & loss
9 30	Interest in E mortgage	—	350	(5) 350	—	—	—	—	(5) 350	Interest income
		$131,061	$42,282	$8,270	$10,318	$121,061	$34,330			
			88,779	2,048			86,731			
		$131,061	$131,061	$10,318	$10,318	$121,061	$121,061			
10 1	Balance:									
	A Co. common— 1M shares @ $10.00					(a) $10,000				
	2M shares @ $ 8.00					(a) 16,000				
	500 shares @ $11.00					(a) 5,500				
	B Co. common— 2M shares @ $16.50					(b) 33,000				
	500 shares @ $24.00+					(b) 12,125				
	C Co. common—					(c) 3,650				
	E Co. chattel mortgage					(f) 6,456				
						$86,731				

b. Entries to Correct Investments Account at September 30, 1948

(1) Profit and loss		$ 318	
Investments			$ 318
To correct credit to Investment account on January 31, 1948:			
Sold 1,000 shares A stock for	$10,682		
which were bought in May, 1945 for $11 per share	11,000		
Loss on sale	$ 318		

(2) Dividends received	$10,000	
Investments		$10,000
To eliminate entry of 6/30/48, which recorded the receipt of a stock dividend of C stock—common on common—as an increase in investments		
(3) Accounts receivable—special	$ 3,750	
Investments	5,100	
Profit and loss		$ 8,850
To set up unpaid balance due from F company president in connection with sale to him of 100 shares of C Company common stock, and to correct investment account to eliminate only cost of such shares sold		
(4) Investments	$ 2,820	
Interest income		$ 500
Profit and loss		2,320
To correct investment account to eliminate only cost of D Company 5% general mortgage bonds redeemed on August 1, 1948, at 110 and accrued interest		
(5) Investments	$ 350	
Interest income		$ 350
To eliminate interest income item from investments account		

No. 6 (10 points)

a. Scrutinize the voucher register or purchase register and the vouchers to ascertain whether charges pertinent to the period under review had been entered after the date of the balance-sheet.

b. Make a search for all unrecorded vouchers, held by department heads and others, and scrutinize as in a.

c. Scrutinize the cash disbursement or check register to ascertain whether cash disbursements had been made subsequent to the date of the balance-sheet in payment of obligations incurred before such date and not vouchered.

d. Have the client write the legal firms and other professional consultants who may have served the client during the period under review to learn whether all services rendered during such period have been billed and whether they are pending suits or claims.

e. Check to see that all accruals with respect to payrolls, salesmen's commissions, taxes, compensation insurance, interest on bonds, notes and contracts have been correctly and completely computed and entered on the books or otherwise made available for inclusion in the balance-sheet.

f. Ascertain that liabilities with respect to installment contracts have been recorded in full. (Check to see that it has not been the practice to debit the asset account as payments on the contract are made without setting up any liability for the unpaid balance.)

g. Request the banks (either as part of the confirmation of bank balances or by letter) to state whether there are direct or indirect obligations to the banks.

h. Have all known obligations of substantial size confirmed in writing. Ascertain that the amounts which the creditors claim agree with those shown on the books.

i. Examine creditors' statements of account which have been received and reconcile the balances with those shown on the books, or, if there are few creditors, obtain confirmations of large balances and circularize the principal vendors, including those which according to the books had small or no balances due them. Reconcile balances as shown by replies received with balances shown on the books.

j. Examine all contracts relative to employee pension funds, employee and management bonus agreements, and ascertain whether obligations incurred thereunder have been fully included in the accounts.

k. Examine any royalty and commission contracts, and ascertain that adequate provision for royalties and commissions accrued thereunder have been recognized in the accounts.

l. Obtain from the appropriate responsible official or officials of the client a certificate stating that to the best of his or their knowledge and belief all liabilities of the client have been fully disclosed to the auditor.

m. Examine minutes for indication of liabilities such as dividends payable, purchase commitments, contracts payable, and notes payable.

(Continued on following page)

n. Examination of tax returns, correspondence with Treasury Department, and tax expense accounts should be made for disclosure of unrecorded tax liabilities.

No. 7 (10 points)

1. Obtain a list of the departments and the operations performed in each. Take a trip through the plant in order to visualize better the operations of each. Consider the number and character of the departments in the light of operations performed.

2. Review the costs charged to each department for a reasonable period. This will include a determination that only expenses properly classified as manufacturing expenses are included. For example, it would not be acceptable in most instances to include any selling, administrative or financial expenses in this category.

Direct costs should be test-checked to original sources such as payroll time tickets and material requisitions. The distribution of general plant costs and service-center costs to the departments should be reviewed as follows:

a. Test-check the general plant and service-center costs to payroll time tickets, vendors' invoices, etc., in the same manner as direct costs.
b. Determine the reasonableness of the basis of distribution which is used. For example, it would be reasonable for power costs to be determined on the basis of metered usage, but it would not be reasonable to use square feet of occupancy in most instances.
c. Test-check the basis of distribution to original sources, such as floor plans (for square feet of occupancy by each department), reports of meter readings, etc.
d. Test-check the mathematical accuracy of the computations of the amounts applicable to each department.

3. Review the bases used for distributing costs to products. In those departments where direct labor is the most important factor and machines are relatively unimportant, direct labor hours or direct labor dollars may be the most desirable basis to use. In other cost centers, machine hours may be the logical basis due to the prominence of machine operations.

4. Determine the direct labor hours, direct labor dollars, machine and hours for the applicable departments for the test period selected by reference to time ticket summaries, payroll records and reports of machine hours operated.

5. Check the mathematical computations of the rates.

6. Test-check the application of the manufacturing expense rates to products by reference to job orders or other data.

7. Test a reasonable number of computations on such job orders or other records to determine the accuracy of ultimate costs based on the use of the established overhead rates.

8. Trace, by tests, individual job orders or other records to summaries, thence to product cost summaries and to the cost of goods manufactured and sold.

9. Make certain that the treatment of over and under absorbed factory overhead accords with generally accepted cost practice.

No. 8 (10 points)

[*Only five items are required*]

a. *Interest*

An examination of the interest expense account may disclose the existence of obligations which have not been entered on the books, or which have been incorrectly reflected in the accounts; the payment of interest on the personal obligations of an officer or partner, which should be shown as a receivable due from such officer or a charge against his drawing account; the payment of interest, part of which is applicable to a future period and should therefore be shown as an asset—prepaid expense, the failure to enter as an expense interest which has accrued.

b. *Taxes—real estate*

An examination of the account for taxes on real estate may disclose the payment of taxes paid in advance, which should be shown as a prepaid expense; the failure to enter as an expense taxes which have been assessed, though not due, or which may be past due, and which, in any event should appear as an accrued liability; taxes paid for an officer or partner which should appear as a receivable or a charge against his drawing account; taxes on property no longer owned by the client but, due to carelessness in the office of the taxing authority, have been billed to the client as the former owner; special assessments on property which should be charged to the property account, rather than to the expense account.

c. *Bad debts*

An examination of the bad debts account, when accounts written off are charged directly to it, may disclose fraud arising from the improper writing off of accounts which have been collected. In such an event the determination of the amount may result in its being set up as a receivable from the perpetrator of the fraud, if it can be collected from him. If the account is a provision for bad debts, debits to which are offset by credits to an allowance for bad debts, an examination may disclose either inadequate or excessive charges, in either of which cases an adjustment of the allowance for bad debts is in order.

d. *Advertising*

An examination of advertising expense may disclose payments made to agencies which are in the nature of deposits against future expenditures or for printed matter which is to be distributed during the ensuing fiscal year, in either case properly included among prepaid expenses. A dearth of charges to advertising expense, when it is known that expensive advertising campaigns have been conducted, may lead to the disclosure that agencies have not billed the client for all services and advertising costs applicable to the period under review, and that both expenses and liabilities should be correspondingly increased.

e. *Insurance*

An examination of the insurance account will ordinarily disclose the amount which should be charged as an expense and the amount which represents the cost of unexpired insurance—an asset. If the account includes compensation insurance, the amount charged therefor may be merely a deposit, based on estimated payroll costs, with the result that at the end of the year a portion of the deposit may be an asset, or an additional liability for compensation insurance may have accrued, which should be entered as both an expense and a liability.

f. *Royalties*

An examination of the royalties expense account may disclose the inclusion of royalties paid in advance, and properly treated as a prepaid expense, or the failure to include the expense incident to unpaid royalties earned by the patentee or assignee, and therefore subject to inclusion both as an expense and a liability.

g. *Maintenance and repairs*

An examination of expense accounts for maintenance and repairs of buildings, machinery, and equipment may disclose expenditures which should have been capitalized, not expensed.

h. *Miscellaneous Expense*

An examination of a miscellaneous or general expense account may disclose expenditures which should have been capitalized rather than expensed.

i. *Depreciation*

Inadequate or excessive charges to depreciation affect the earned surplus and the allowances for depreciation, and consequently the amount of the related assets. To the extent that improper charges for depreciation enter into the cost of goods manufactured, the inventories of finished goods and work-in-process will be erroneously stated.

COMMERCIAL LAW

November 19, 1948, 9:00 a.m. to 12:30 p.m.

GROUP I

No. 1 (10 points)

a. There is no contract. The rejection of the offer by B terminated the offer and a contract could not be created by his subsequent acceptance.

b. (1) Yes, this is a contract.

(2) B's acceptance of A's offer resulted in a contract.

(3) An acceptance which requests a change or addition to the terms of the offer is not invalidated unless the acceptance depends on the consent or approval by the offeror, A in this case, of the change or additional terms. This situation should be distinguished from a reply to an offer which adds a qualification or requires performance of conditions. Such a reply is not an acceptance but a counter offer.

(4) A is not bound to deliver in installments as this was not part of his offer.

No. 2 (10 points)

a. A may apply to a court of equity for a decree of judicial dissolution upon the ground that the partner has been guilty of such conduct in matters relating to partnership affairs that it is not reasonably practical to carry on the business in partnership with him.

b. (1) C cannot recover from A and B as partners.

(2) Although sharing of profits may be prima facie evidence of the existence of a partnership, it is not such evidence when the profit is received as payment of wages of an employee. A and B are not carrying on the business as co-owners and no partnership exists.

c. Partnership assets should be allocated to partnership creditors and the individual partner's assets to the individual partner's creditors. On marshalling the assets of the partnership and of both individual partners for the benefit of the respective creditors, the partnership creditors are not entitled, after exhausting the partnership assets, to resort to the individual assets until after the individual creditors have been satisfied.

d. (1) The partnership books should be kept, subject to any agreement between the partners, at the principal place of business of the partnership.

(2) Every partner has, at all times, a right of access to partnership books and may inspect and copy any of them.

No. 3 (10 points)

a. (1) Crosby, the seller, was entitled to the flour.

(2) Crosby, as an unpaid seller, may enforce his lien by stoppage in transitu. The flour was still in transit when the goods were rejected by the buyer, Smith, since the carrier still continues in possession of it even if the seller refused to take it back.

b. (1) X can maintain a suit for damages for breach of warranty.

(2) A buyer may refuse to accept the goods if the property therein has not passed to him, and he may maintain an action against the seller for damages for breach of warranty.

c. (1) The statute of frauds is not a good defense in this instance.

(2) Section 4 of the Uniform Sales Act provides that 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 provisions of that section requiring a writing shall not apply.

No. 4 (10 points)

a. The company is liable for the public accountant's services. The president of a corporation who is permitted to manage its affairs in the usual course of business has authority and power to employ a public accountant to go over the company's books. When he does so, the corporation is liable for the services.

b. The status of the public accountant is that of an independent contractor. He is not an employee of the company and the relation does not constitute the legal relation of master and servant and is not governed by the rules of law applicable to such relation.

c. Public accountants who are employed as independent contractors to make audits, prepare tax returns and perform other accounting services, have the right to make and retain office copies of tax returns prepared by them, the originals of letters addressed to them, copies of letters written by them, work sheets on which original computations and analyses are made, tax schedules and other data gathered by the accountants in the course of their employment.

No. 5 (10 points)

a. As a result of the sale X corporation had a deductible ordinary loss of $70,000 and an ordinary gain of $2,000 on the inventory. The loss on the land, building, and machinery and equipment were losses sustained during the taxable year and not compensated for by insurance or otherwise. Inasmuch as the losses exceeded the gains the net loss is to be treated as an ordinary loss. The net loss of X corporation as a result of the sale was $68,000, which may be set off against the ordinary income from operation resulting in a net loss of $8,000.

b. Under Section 122 of the Internal Revenue Code the net loss of $8,000 may be carried back first to 1945 and the excess of the loss over the net income for 1945, if any, may be carried to 1946. It has never been held that the fact that the net loss in 1947 resulted from the cessation of operation would prevent the application of the carry-back provision of the Code.

GROUP II

No. 6 (10 points)

a. (1) Jones cannot levy on Smith's goods in the possession of the warehouseman.

(2) If goods are delivered to a warehouseman by the owner and a negotiable receipt is issued for them, they cannot be levied upon under an execution unless the receipt be first surrendered to the warehouseman, or its negotiation enjoined. The warehouseman shall in no case be compelled to deliver up the actual possession of the goods until the receipt is surrendered to him or impounded by the court.

b. (1) In the absence of agreement, the law imposes no duty on a warehouseman to insure the property of his customers.

(2) The warehouseman is not entitled to recover the amount of premiums for insurance taken out for his customers without express or implied authority.

c. (1) This was not a sale but was a bailment of the drums.

(2) The stipulation as to the payment of $5 for each drum not returned was not the price to be paid at the option of Allen but the stipulated damages to be paid in the event of the loss of each drum.

No. 7 (10 points)

a. Adrian can recover only the amount he paid, that is $8,000, in addition to any expenses in connection with the settlement which are properly chargeable to Burt. The contract between a principal and surety is for indemnity only.

b. The principal debtor's discharge in bankruptcy does not release the surety but is a personal defense of the debtor. The surety's inability to obtain reimbursement from his principal after he pays the creditor is said to result from the operation of law rather than from the voluntary act of the creditor, and, for this reason, the creditor's right against the surety is unimpaired.

c. The general rule is that the creditor must resort first to the debtor's collateral to apply on the defaulted debt. If that is not sufficient, then he may resort to the surety's collateral.

No. 8 (10 points)

a. (1) The test of insurable interest is said to be whether an injury to the property or its destruction by the peril insured against would involve the insured in pecuniary loss. Or, as it is sometimes expressed, anyone has an insurable interest in property who derives a benefit from its existence or would suffer loss from its destruction.

(2) (a) and (b) In fire and marine insurance the general rule is that the insurable interest must exist in the insured at the time the risk is placed as well as at the time of loss. There is authority, however, that insurance issued at a time when the insured has no interest will attach when the interest is acquired.

b. (1) The corporation is entitled to the $50,000 insurance.

(2) The corporation had an insurable interest in the life of the president when the insurance was procured in that it was in a position to benefit by the continued existence of the insured. It is a general rule in life insurance that such insurable interest need only exist at the time the insurance is procured and that subsequent termination is immaterial.

c. (1) A can recover on his fire insurance policy from the insurance company.

(2) A had an insurable interest in the real estate of B as that was the only asset held by the estate of B. In order to satisfy A's judgment

it would have been necessary to sell B's real estate. When insurance is on property, it is a contract of indemnity. The insured, therefore, must have an insurable interest in that property when the insurance is placed and also at the time of loss. The insurance recovery by the insured is limited to the loss actually sustained.

No. 9 (10 points)

a. (1) An accrual basis taxpayer reports all income to which it has become entitled as a result of operations without respect to whether the entire amount has been received.

b. (3) Tympany should take no account of the amount claimed by Jones. There is no unconditional liability until the suit is concluded, and the damages, if paid, will affect the income in the year when liability does become unconditional and not in the year in which the questioned transaction took place.

c. (3) The liability became unconditional and fixed in amount at the time of the agreement in 1948.

No. 10 (10 points)

a. (2) Numbers may elect to spread his income in accordance with Section 107 (a) of the Internal Revenue Code.

b. (1) Numbers must file a separate return unless with the permission of the Commissioner either he or Mrs. Numbers changes taxable years. A joint return cannot be made so long as their fiscal years are different.

No. 11 (10 points)

(1) False. It will necessarily be performed within a year from June 1, and is not within any other clause of the statute of frauds.

(2) True. The doctrine of anticipatory breach is applicable.

(3) True. He has treated A as having broken his contract, and therefore excusing B from further readiness to perform.

(4) False. In the United States the majority view is that after A's notification to B, B cannot add to the prospective damages which A must pay by continuing preparations.

(5) False.

(6) True. A having only stated an intention to commit a breach, he can change his mind and perform when the time comes unless his statement has caused the other party to take some action which makes it unfair to let A decide to abide by contract.

(7) True. It was a contract for personal services. B's death made performance impossible. We now know that A could never have been in actual default on August 1, B having died.

(8) True. There was an actual breach for a month, for which A is liable.

(9) False. A minor may make a contract, though his promise is voidable.

(10) False. In a contract for personal services, neither side will be ordered to perform specifically.

(11) True. One may assign a right to a payment in the future, even though one has not yet earned it.

(12) False. Though by what is possibly the majority rule, an assignment of the benefit of a contract impliedly delegates the duty, or the assignee prima facie impliedly undertakes to perform it, yet where the duty is personal such an implication cannot arise.

No. 12 (10 points)

(1) P Company is not liable to X on the note. P was not a party to it, and only parties appearing on it may be sued on a negotiable instrument.

(2) P is liable on the contract of purchase of X's lot, as an undisclosed principal. Though X did not rely on the P Company's credit, nor expect to obtain a right against it, the actual authority P gave A supplies the connection that enables X to sue P when he learns that A was in fact acting for P.

(3) P Company is not liable to Y. Though A might possibly properly delegate his authority to a subagent to get a particular piece of property (in general it cannot be delegated), yet since the lot was not within actual authority, and there was no apparent authority, P is not bound. There was no ratification, because SA had not purported to act as agent and also P was not aware of all of the facts, which would prevent effectual ratification.

(4) SA would have to take the Y lot himself.

(5) P would not be prevented from enforcing either contract since there was no duty to disclose.

Examination Answers, May, 1949

ACCOUNTING PRACTICE—PART I

May 18, 1949; 1:30 to 6 p.m.

No. 1 (10 points)

Entries

(1)

Common stock—Company C	$450,000	
Capital surplus—Company C	34,200	
Earned surplus—Company C	87,300	
Earned surplus—Company B	8,700	
Investment in Company C stock		$ 540,200
Surplus arising from consolidation (excess of book value over cost of investment)		40,000

To make the eliminations necessary to consolidate Company B and Company C.

(2)

Common stock—Company B	$800,000	
Earned surplus—Company B	248,000	
Surplus reserve for redemption of bonds	200,000	
Surplus arising from consolidation of Company B and Company C	32,000	
Excess of cost of investment over net assets acquired (goodwill)	120,000	
Investment in Company B		$1,400,000

To make the eliminations necessary to consolidate Company A with Company B and its subsidiary.

Computations

SURPLUS FROM CONSOLIDATION OF B AND C

Earned surplus of C, 12/31/48	$ 116,400
Add—dividends paid since acquisition	40,000
	$ 156,400
Deduct—earnings since acquisition	28,400
Earned surplus at date of acquisition of stock by B	$ 128,000
Capital surplus	45,600
Common stock	600,000
Capital and surplus of C at date of acquisition	$ 773,600
75 per cent of $773,600	$ 580,200
Cost of investment	540,200
Surplus arising from consolidation	$ 40,000

ADJUSTMENT OF EARNED SURPLUS OF COMPANY B

Dividends from C which were credited to income (75 per cent of $40,000) ..	$ 30,000
Earnings of C applicable to B's interest in Company C (75 per cent of $28,400)	21,300
Amount of credit to surplus not represented by earnings since acquisition	$ 8,700

Notes:

(1) The $8,700 could properly be debited to earned surplus of B and credited to investment in C prior to making the eliminating entry given above. If that entry were made, it would not be necessary to compute the $40,000 since it would be determinable by balancing the eliminating entry.

(2) The remaining items in the first entry represent 75 per cent of the equity accounts of Company C.

EXCESS OF COST OF INVESTMENT OVER NET ASSETS ACQUIRED

Equity of Company B after consolidation of C:	
Common stock	$1,000,000
Earned surplus	310,000
Surplus reserve for redemption of bonds	250,000
Surplus arising from consolidation	40,000
Total	$1,600,000
Interest acquired by A (80 per cent of $1,600,000)	$1,280,000
Cost of stock acquired	1,400,000
Excess of cost over net assets acquired (goodwill)	$ 120,000

Note: Since there is no statement regarding overvaluation of the assets of Company C the above solution is based on the assumption that the excess of the book value of the net assets of Company C over the cost of the investment in Company C is the result of a fortunate purchase.

If the problem stated that specific assets of Company C were overvalued, consolidation adjustments would be made to reduce the book value of the overvalued assets to their present value with a

(*Continued on following page*)

Worksheet for Consolidated Balance-Sheet of Company A

[*Not Required*]

	Company B	Company C	Eliminations Debit	Eliminations Credit
Current assets	$ 731,282	$340,274	—	—
Fixed assets	1,322,607	514,987	—	—
Investment in C (cost)	540,200	—	—	$540, 200
Investment in B (cost)	—	—	—	—
Total	$2,594,089	$855,261		
Current liabilities	$ 275,389	$ 93,261	—	—
Bonds	750,000	—	—	—
Reserve for redemption of bonds	250,000	—	—	—
Common stock—B	1,000,000	—	—	—
Common stock—C	—	600,000	$450,000	—
Capital surplus—C	—	45,600	34,200	—
Earned surplus—C	—	116,400	87,300	—
Earned surplus—B	318,700	—	8,700	—
Excess of book value over cost of investment (surplus arising from consolidation)	—	—	—	40,000
Common stock—A	—	—	—	—
Capital surplus—A	—	—	—	—
Earned Surplus—A	—	—	—	—
Excess of cost of investment over net assets acquired (goodwill from consolidation)	—	—	—	—
Total	$2,594,089	$855,261	$580,200	$580,200

contra-debit to earned surplus of Company C. If the assets of Company C were overvalued but there was no information as to the specific assets involved, the credit would be made to a general valuation reserve. This reserve would be shown as a deduction from the total assets in the consolidated balance-sheet. In either type of overvaluation the excess of cost of investment in Company B over its net assets (goodwill) would be $152,000 rather than the $120,000 shown in the computation.

No. 2 (15 points)

(1) September 30, 1940

Cash	$2,910,000	
Bond discount and expense unamortized	120,000	
4% first mortgage bonds		$3,000,000
Bond interest accrued		30,000
To record the sale of bonds at 96 and interest. ($^1/_4$ of 4% of $3,000,000)		
Bond discount and expense	6,360	
Cash		6,360
To record the expense of the bond issue.		

(2) December 31, 1940

Bond interest expense	$ 11,080	
Bond interest accrued		$ 10,000
Bond discount and expense unamortized		1,080
To accrue one month's interest ($^1/_{12}$ of 4% of $3,000,000) and write off discount for one month. ($^1/_{117}$ of $126,360)		
Bond interest accrued	60,000	
Cash		60,000
To record the payment of 6 months' interest. ($^1/_2$ of 4% of $300,000)		

Company B & Subsidiary	Company A	Eliminations Debit	Eliminations Credit	Company A & Subsidiaries
$1,071,556	$1,234,567	—	—	$2,306,123
1,837,594	3,030,933	—	—	4,868,527
—	—	—	—	—
—	1,400,000	—	$1,400,000	—
$2,909,150	$5,665,500			$7,174,650
$ 368,650	$ 400,500	—	—	$ 769,150
750,000	—	—	—	750,000
250,000	—	$200,000	—	50,000 M
1,000,000	—	800,000	—	200,000 M
150,000 M	—	—	—	150,000 M
11,400 M	—	—	—	11,400 M
29,100 M	—	—	—	29,100 M
310,000	—	248,000	—	62,000 M
40,000	—	32,000	—	8,000 M
—	3,000,000	—	—	3,000,000
—	710,300	—	—	710,300
—	1,554,700	—	—	1,554,700
—	—	120,000	—	(120,000) Debit
$2,909,150	$5,665,500	$1,400,000	$1,400,000	$7,174,650

(3) July 1, 1946

4% first mortgage bonds	$ 500,000	
Common stock		$ 250,000
Paid-in surplus		241,360
Bond discount and expense unamortized		8,640

To record the conversion of $500,000 bonds into 2500 shares of common stock, par value $100, and the write-off of all unamortized discount applicable to the bonds retired. ($^{48}/_{117}$ of $^{1}/_{6}$ of $126,630)

(4) December 30, 1947

4% first mortgage bonds	$ 500,000	
Bond interest accrued	10,000	
Cash		$ 506,250
Loss on bond redemption		3,750

To record the purchase and retirement of $500,000 of bonds at 99$^{1}/_{4}$ and accrued interest ($^{1}/_{2}$ of 4% of $500,000)

Loss on bond redemption	5,400	
Bond discount and expense unamortized		5,400

To write off the balance of discount and expense applicable to the $500,000 of bonds retired. ($^{1}/_{6}$ of $^{30}/_{117}$ of $126,630)

(5) June 30, 1948

Bond interest expense	$ 7,386.67	
Bond interest accrued		$ 6,666.67
Bond discount and expense unamortized		720

To record the interest accrued and amortization of discount for the month of June. (Bond interest—$^{1}/_{12}$ of 4% of $2,000,000) (Amortization of discount—$^{1}/_{117}$ of $^{2}/_{3}$ of $126,360)

Bond interest accrued	40,000	
Cash		40,000

Payment of six months' interest on bonds outstanding. ($^{1}/_{2}$ of 4% of $2,000,000)

Cash	3,950,000	
Bond discount and expense	50,000	
2$^{3}/_{4}$% bonds		4,000,000

To record the sale of the $4,000,000 twenty-year bonds at 98$^{3}/_{4}$.

4% first mortgage bonds	2,000,000	
Loss on bond redemption	57,280	
Bond discount and expense unamortized		17,280
Cash		2,040,000

To record the redemption of $2,000,000 of bonds at 102, charging the premium and the unamortized discount to the current year's expense.

Notations

(1) The accrual on December 30, 1947, is computed for a full six months' period. If computed for one day less than six months the accrual would be $9,444.45 and the cash $506,194.45 in this entry.

(2) For a full discussion of the treatment of unamortized discount and redemption premium on bonds refunded, see Accounting Research Bulletins 2 and 18 issued by the Committee on Accounting Procedure of the American Institute of Accountants.

The Students department prefers a charge to paid-in surplus for the $8,640 unamortized discount on July 1, 1946, offsetting the $250,000 credit arising in the conversion into stock. There is some basis for a charge to earned surplus or profit and loss of $8,640.

On the redemptions on December 30, 1947, and June 30, 1948, loss on bond redemption has been charged. Support for this procedure is found in Research Bulletin No. 18.

No. 3 (15 points)

THE MODERN RESTAURANT

Balance-Sheet January 31, 1949

ASSETS

Cash		$ 354.77
Accounts receivable		75.00
Inventory of merchandise		130.00
Furniture and fixtures	$2,375.00	
Less—Reserve for depreciation	222.29	2,152.71
		$2,712.48

LIABILITIES AND CAPITAL

Accounts payable—trade	$ 703.50
Accrued property taxes	26.00
Accrued social security taxes	40.00
Income tax withheld	81.00
Old age tax withheld	10.00
Accrued annual license	8.33
Proprietor's capital	1,843.65
	$2,712.48

Statement of Capital Account for the Month of January 1949

Balance per December 31, 1948, balance-sheet		$1,855.27
Adjustments applicable to December balance		
Add:		
Inventory of candy and tobacco (estimated)	$ 75.00	
Error in cash balance	18.00	
Total additions	$ 93.00	
Deduct:		
Account payable not recorded	$ 81.50	
Bank service charge for December	4.08	
Total deductions	$ 85.58	
Net increase		7.42
Adjusted balance December 31, 1948		$1,862.69
Net income for January	$ 230.96	
Withdrawals for January by proprietor	250.00	
Net decrease for January		19.04
Balance January 31, 1949		$1,843.65

(Continued on following page)

THE MODERN RESTAURANT

Worksheet for January, 1949

	Balance January 1, 1949		January Cash Transactions		Adjustments January 31, 1949		Income and Expense		Capital Account		Balance-Sheet January 31, 1949	
	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit
Cash	$1,016.52	—	$4,434.00	$5,105.75	$ 18.00 (6)	$ 8.00 (5)	—	—	—	—	$ 354.77	—
Accts. rec.	—	—	—	—	75.00 (3)	—	—	—	—	—	75.00	—
Inv. mds.	—	—	—	—	130.00 (4)	—	—	—	—	—	130.00	—
Furn. & fix.	2,025.00	—	350.00	—	—	—	—	—	—	—	2,375.00	—
Res. for depr.	—	$ 202.50	—	—	—	19.79 (7)	—	—	—	—	—	$ 222.29
Accounts payable	—	510.25	—	—	—	111.75 (2) 81.50 (1)	—	—	—	—	—	703.50
Accrued taxes:												
Property	—	24.00	—	—	—	2.00 (9)	—	—	—	—	—	26.00
S.S.	—	117.00	117.00	10.00	—	40.00 (8)	—	—	—	—	—	50.00
Income tax withheld	—	232.50	232.50	81.00	—	—	—	—	—	—	—	81.00
Accrued license	—	100.00	100.00	—	—	8.33 (10)	—	—	—	—	—	8.33
Proprietor's: Capital	—	1,855.27	—	—	4.08 (5) 81.50 (1)	75.00 (4) 18.00 (6)	—	—	—	$1,862.69	—	—
Drawings	—	—	250.00	—	—	—	—	—	$ 250.00	—	—	—
Income:												
Meals	—	—	—	4,112.30	—	—	—	$4,112.30	—	—	—	—
Catering	—	—	—	—	190.00	75.00 (3)	—	265.00	—	—	—	—
Candy, etc.	—	—	—	123.45	—	—	—	123.45	—	—	—	—
Miscellaneous	—	—	—	8.25	—	—	—	8.25	—	—	—	—
Expenses:												
Salaries	—	—	1,000.00	—	—	—	$1,000.00	—	—	—	—	—
Food, etc.	—	—	2,847.50	—	111.75 (2)	55.00 (4)	2,904.25	—	—	—	—	—
Rent	—	—	125.00	—	—	—	125.00	—	—	—	—	—
Utilities	—	—	106.00	—	—	—	106.00	—	—	—	—	—
Laundry	—	—	45.50	—	—	—	45.50	—	—	—	—	—
Printing	—	—	23.25	—	—	—	23.25	—	—	—	—	—
License	—	—	—	—	8.33 (10)	—	8.33	—	—	—	—	—
S.S. taxes	—	—	—	—	40.00 (8)	—	40.00	—	—	—	—	—
Bank charge	—	—	—	—	3.92 (5)	—	3.92	—	—	—	—	—
Depreciation	—	—	—	—	19.79 (7)	—	19.79	—	—	—	—	—
Property tax	—	—	—	—	2.00 (9)	—	2.00	—	—	—	—	—
Total	$3,041.52	$3,041.52	$9,630.75	$9,630.75	$494.37	$494.37	$4,278.04	$4,509.00	$ 250.00	$1,862.69	$2,934.77	$1,091.12
Net income							230.96	—	—	230.96	—	—
Total	—	—	—	—	—	—	$4,509.00	$4,509.00	$ 250.00	$2,093.65	—	—
Capital 1/31/49	—	—	—	—	—	—	—	—	1,843.65	—	—	$1,843.65
Total									$2,093.65	$2,093.65	$2,934.77	$2,934.77

(*Continued on following page*)

THE MODERN RESTAURANT

Income Statement of the Month of January 1949

Income:		
Meals		$4,112.30
Catering services		265.00
Candy, tobacco, and other sales		123.45
Miscellaneous income		8.25
Total income		$4,509.00
Expenses:		
Food and other purchases	$2,904.25	
Salaries	1,000.00	
Rent	125.00	
Utilities	106.00	
Laundry	45.50	
Printing	23.25	
Social security taxes	40.00	
Annual license	8.33	
Property tax	2.00	
Depreciation	19.79	
Bank service charges	3.92	
Total expenses		$4,278.04
Net income for January 1949		$ 230.96

Explanation of Transactions and Adjustments

Cash Transactions

Salary payment of $909 is "less $81 income tax and less O.A.B. tax withheld." The O.A.B. tax is 1%. Therefore, the gross salary is $1,000 computed as follows: $909 plus $81 equals $990 which is 99% of the gross.

Adjustments

(1) Proprietor's capital	$ 81.50	
Accounts payable		$ 81.50
To record the account payable omitted as of 12/31/48 and charge it to opening capital balance.		
(2) Food, tobacco, candy, etc.	$111.75	
Accounts payable		$111.75
To adjust the payables to the stated balance of $703.50.		
(3) Accounts receivable	$ 75.00	
Catering income		$ 75.00
To bring on the books the stated receivable and credit income therefor.		
(4) Inventory of merchandise	$130.00	
Proprietor's capital 12/31/48		$ 75.00
Food, tobacco, candy, etc.		55.00
To set up the inventory of merchandise as of 1/31/49. The estimated amount of $75.00 should have been recorded as of 12/31/48 and, therefore, it is adjusted to the capital account.		
(5) Proprietor's capital 12/31/48	$ 4.08	
Bank service charge	3.92	
Cash		$ 8.00
To record December charges as an adjustment of capital and January charges as expense.		
(6) Cash	$ 18.00	
Proprietor's capital 12/31/48		$ 18.00
To record the cash overage that occurred prior to January as a capital adjustment.		
(7) Depreciation	$ 19.79	
Reserve for depreciation		$ 19.79
To record the depreciation for one month at a rate of 10% as used heretofore, basing the charge on the asset balance at the end of the month.		

(*Continued on following page*)

(8) S.S. taxes—expense	\$ 40.00	
Accrued S.S. taxes		\$ 40.00
To record the expense and accrual of liability at the rate of 4% on salaries of \$1,000.		
(9) Property tax expense	\$ 2.00	
Accrued property tax		\$ 2.00
To record the estimated accrual of personal property taxes.		
(10) Annual license expense	\$ 8.33	
Annual license accrued		\$ 8.33
To record the estimated accrual of annual license on the basis of \$100 per annum.		

Comments

1. The capital adjustments in the Statement of Capital Account might be appropriately included in the non-operating section of the Income Statement rather than as capital adjustments as shown above.

2. Depreciation expense might properly be accrued at only one-half the usual rate on the January 1949 additions to the fixed assets. The rate for the full month has been used in this solution.

No. 4 (10 points)

a. (1) (a) 0 Sec. 112(c) (1)
(b)\$1,700 Sec. 113(a) (6)

(2) (a) 0 Sec. 112(b) (1)
(b)\$2,100 Sec. 113(a)

(3) (a) 0 Sec. 112(b) (1)
(b)\$2,500 Sec. 113(a) (6)

(4) (a) 0 Sec. 112(f)
(b)\$7,500 Sec. 113(a) (9)

(5) (a)\$2,000 loss
(b)\$8,000

b. (1) Yes. (2) No. (3) Yes. (4) Yes. (5) Yes. (6) No. (7) No. (8) No. (9) Yes. (10) No.

ACCOUNTING PRACTICE—PART II

May 19, 1949; 1:30 to 6 p.m.

No. 1 (18 points)

RHETA ROSE MANUFACTURING COMPANY

Statement of Prospective Operating Results—One Month
Showing the Effect of Sale to Chain Store

	Present Operations	Proposed Sale to Chain	Combined
Sales	$62,500.00	$35,000.00	$97,500.00
Cost of goods sold (Schedule 1)	35,489.00	27,445.00	62,934.00
Gross profit	$27,011.00	$ 7,555.00	$34,566.00
Selling expense (Schedule 2)	$23,942.60	—	$23,942.60
General and administrative expense (Schedule 2)	4,222.30	2,072.30	6,294.60
Total selling and general	$28,164.90	$ 2,072.30	$30,237.20
Net profit or (loss)	$(1,153.90)	$ 5,482.70	$ 4,328.80

Statement of Prospective Cost of Goods Sold **Schedule 1**
(Based on Past Costs)

	Past Operations 4,000 Units	Cost for 5,000	Added Cost for 5,000
Materials and purchased parts	$ 6,400	$ 8,000	$ 8,000
Direct labor	9,900	12,375	12,375
Variable overhead:			
Power	560	700	700
Indirect labor	2,240	2,800	2,800
Miscellaneous supplies	800	1,000	1,000
Repairs to machinery	480	600	600
S.S. taxes	456	570	570
Miscellaneous	1,120	1,400	1,400
Total variable cost	$21,956	$27,445	$27,445
Fixed overhead:			
Superintendent's salary	$ 1,000	$ 1,000	$ —
Assistant superintendent's salary	750	750	—
Depreciation—buildings	1,420	1,420	—
Maintenance—buildings	206	206	—
Heat and light	348	348	—
Depreciation—machinery	3,640	3,640	—
Property taxes	600	600	—
Fire insurance	80	80	—
Total fixed cost	$ 8,044	$ 8,044	$ —
Total cost	$30,000	$35,489	$27,445

(Continued on following page)

Schedule 2

Statement of Prospective Selling and Administrative Expenses (Based on Past Costs)

	Cost of Present Production	Added cost for 5,000 Units
Selling Expenses—Total (No selling expense would be incurred by the proposed sale to the chain store and for this comparison all such expenses are considered as fixed).....	$23,942.60	$ —
Administrative Expenses:		
Variable:		
Office salaries....................................	$ 975.50	$ 975.50
Telephone and telegraph..........................	217.73	217.73
Supplies...	486.21	486.21
Miscellaneous......................................	392.86	392.86
Total variable cost...............................	$ 2,072.30	$2,072.30
Fixed:		
Officer's salaries................................	$ 1,525.00	$ —
Bad debts..	625.00	—
Total fixed cost.................................	$ 2,150.00	$ —
Total administrative expenses..................	$ 4,222.30	$2,072.30

No. 2 (7 points)

Computation of Inventory at Cost and at Sales Price by the Retail Method

	Cost	Retail	Mark-on	Per cent of Mark-on to Retail
Open inventory..........................	$14,250.00	$19,105	$ 4,855.00	
Purchases—net of allowances...............	32,678.00	46,312	13,634.00	
Freight-in..................................	845.00	—	(845.00)	
Markups less cancellations..................	—	933	933.00	
Transfers in................................	100.00	140	40.00	
Total................................	$47,873.00	$66,490	$18,617.00	28
Sales.......................................		$37,246		
Markdowns...................................		1,460		
Shortage....................................		704		
Reduction of inventory.................		$39,410		
Closing inventory......................	$19,497.60	$27,080	$ 7,582.40	28

No. 3 (25 points) (Alternate to No. 4)

FAYETTEVILLE COMPANY

Capital and Surplus as of January 1, 1947

$3 Cumulative preferred stock—par value $40 (entitled to $50 per share in liquidation, redeemable at $55 per share)—outstanding 96,200 shares	$3,848,000
Class "B" stock—par value $10—outstanding 216,450 shares (Note 1)	2,164,500
Common stock—no par value—outstanding 120,000 shares at assigned amount of...	600,000
Capital surplus arising from reduction of the par value of preferred stock and assigned value of common stock (Note 2)	970,043
	$7,582,543

Notes: (1) Not entitled to dividends—redeemable at $20 per share and preferred over common as to assets in liquidation at $20 per share.

(2) The liquidating preference of the preferred stock together with the liquidating value of the class "B" stock creates a deficiency as to common stock amounting to $1,556,457.

FAYETTEVILLE COMPANY

Capital and Surplus as of December 31, 1947

$3 Cumulative preferred stock—par value $40 (entitled to $50 per share in liquidation, redeemable at $55 per share)—outstanding 96,200 shares	$3,848,000
Class "B" stock—par value $10—outstanding 216,450 shares (Note 1)	2,164,500
Common stock—no par value—outstanding 120,000 shares at assigned amount of (Note 2)	600,000
Earned surplus since January 1, 1947 (Notes 2, 3, and 4)	1,342,716
Paid-in surplus arising from reduction of the par value of preferred stock and assigned value of common stock	970,043
	$8,925,259

Notes: (1) Not entitled to dividends, redeemable at $20 per share and preferred over common as to assets in liquidation at $20 per share.

(2) The liquidating preference of the preferred stock amounting to $4,810,000 and of the class "B" stock amounting to $4,329,000 exceeds the entire capital and surplus of the company and creates a deficiency as to common stock amounting to $213,741 as of December 31, 1947.

(3) Under terms of the agreement governing the class "B" stock, no dividends may be paid on common stock as long as any class "B" stock remains outstanding.

(4) The agreement under which class "B" stock was issued provides that as long as any class "B" stock is outstanding a cash fund is to be provided each year equal to 50 % of the net profits in excess of dividend requirements on preferred stock. This fund is to be used to purchase or call class "B" stock and cancel it. The amount of the fund required to be set up as of December 31, 1947, is $671,358. The use of this fund to redeem class "B" stock will result in a reduction of surplus to the extent of the excess of the cost of the stock redeemed over the par value of $10 per share.

FAYETTEVILLE COMPANY

Statement of Bonded Indebtedness, Capital, and Surplus If a Proposed Plan of Capital Reorganization Were To Be Made Effective as of January 1, 1948

Long-term liabilities:	
5% Debentures	$4,810,000
Capital stock and surplus:	
6% Preferred stock—$100 par value—outstanding 21,645 shares	2,164,500
Common stock—no par value—outstanding 324,425 shares at assigned value	1,622,125
Total stock	$3,786,625
Paid-in surplus	328,634
Total stock and surplus	$4,115,259

Comments

1. The value assigned to each share of common stock prior to the proposed reorganization plan amounted to $5 per share. It has been assumed that an equal amount per share would be assigned to each share to be issued under this plan of capital reorganization.

2. In this solution it has been assumed that the existing earned surplus would be exhausted in the reorganization and that future earned surplus would be dated from January 1, 1948. However, a good argument can be presented for exhausting paid-in surplus, and dating earned surplus from January 1, 1947.

FAYETTEVILLE COMPANY

Earnings Available to Common Stock in 1947
Assuming the Reorganization Plan in Effect During the Year

Net income as reported for 1947	$1,631,316
Add—Tax saving resulting from deductibility of interest on debentures (38% of $240,500)	91,390
Total before debenture interest expense	$1,722,706
Deduct—Interest on debentures	240,500
Earnings available for dividends	$1,482,206
Dividends on preferred stock	129,870
Earnings available for 324,425 shares of common	$1,352,336
Amount per share of common	$4.17

No. 4 (25 points) (Alternate to No. 3)

CITY OF PATWRAY

Special Assessment Fund—Sewer District Balance-Sheet—December 31, 1948

Assets

Cash:		
Cash for construction	$128,390	
Cash for bond payment	2,300	
	$130,690	
Less—deficiency of cash for interest	4,867	$125,823
Assessments receivable:		
Current	$ 41,500	
Deferred	373,500	415,000
City's share of cost		43,811
Interest receivable		12,296
		$596,930

Liabilities, Reserves, and Surplus

Liabilities:		
Contracts payable—retained percentage	$ 34,500	
Bonds payable	460,000	
Interest payable	1,533	$496,033
Reserves:		
Reserve for authorized expenditures	$ 95,001	
Less—encumbrances	75,000	
	$ 20,001	
Reserve for encumbrances	75,000	95,001
Unappropriated surplus—interest		5,896
		$596,930

[*Not required*]

Working Accounts

Cash for construction

7	25,000	13,700	6
9	200,000	26,100	10
13	254,800	25,000	12
14	2,000	284,000	16
		4,210	17

Assessments receivable—current

3	41,500		

Assessments receivable—deferred

3	373,500		

Improvements authorized

1	455,000	461,111	3
4	6,111		

Encumbrances

2	15,000	15,000	5
8	420,000	29,000	11
		316,000	15

Loan from general fund

12	25,000	25,000	7

Contracts payable—retained percentage

		2,900	10
		31,600	16

Interest expense

18	10,733	4,333	13
		6,400	24

Interest receivable

21	12,296		

Interest revenues

24	12,296	12,296	21

Bonds payable

		200,000	9
		260,000	13

Cash for bond payment

20	2,300		

Cash for interest

13	4,333	2,000	14
9	2,000	9,200	19

City's share of cost

3	46,111	2,300	20

Reserve for authorized expenditures

22	3,200	455,000	1
23	362,910		

Reserve for encumbrances

5	15,000	15,000	2
11	29,000	420,000	8
15	316,000		

Construction expenditures

6	13,700	362,910	23
10	29,000		
16	316,000		
17	4,210		

Premium on bonds payable

22	2,000	2,000	9

Discount on bonds payable

13	5,200	5,200	22

Interest payable

19	9,200	10,733	18

Unappropriated surplus—interest

		5,896	24

[*Not required*]

Journal Entries

2/1/48

1.	Improvements authorized	$455,000	
	Reserve for authorized expenditures		$455,000

4/10/48

2.	Encumbrances	15,000	
	Reserve for encumbrances		15,000

(*Continued on following page*)

	4/15/48		
3.	Assessments receivable—current	41,500	
	Assessments receivable—deferred	373,500	
	City's share of cost	46,111	
	Improvements authorized ($415,000 ÷ 90 = $46,111)		461,111
4.	Improvements authorized	6,111	
	Reserve for authorized expenditures		6,111
	4/30/48 (5/5/48)		
5.	Reserve for encumbrances	15,000	
	Encumbrances		15,000
6.	Construction expenditures	13,700	
	Cash for construction		13,700
7.	Cash for construction	25,000	
	Loan from general fund		25,000
	5/20/48		
8.	Encumbrances	420,000	
	Reserve for encumbrances		420,000
	6/1/48		
9.	Cash for interest payments	2,000	
	Cash for construction	200,000	
	Bonds payable		200,000
	Premium on bonds payable		2,000
	7/31/48		
10.	Construction expenditures	29,000	
	Cash for construction		26,100
	Contracts payable—retained percentage		2,900
11.	Reserve for encumbrances	29,000	
	Encumbrances		29,000
12.	Loan from general fund	25,000	
	Cash for construction		25,000
	11/1/48		
13.	Cash for construction	254,800	
	Cash for interest	4,333	
	Discount on bonds	5,200	
	Bonds payable		260,000
	Interest expense ($260,000 @ 4% for 5 months)		4,333
14.	Cash for construction	2,000	
	Cash for interest		2,000
	12/31/48		
15.	Reserve for encumbrance	316,000	
	Encumbrances		316,000
16.	Construction expenditures	316,000	
	Cash for construction		284,400
	Contracts payable—retained percentage		31,600
17.	Construction expenditures	4,210	
	Cash for construction		4,210
18.	Interest expense	10,733	
	Interest payable ($460,000 @ 4% for 7 months)		10,733
19.	Interest payable	9,200	
	Cash for interest payments ($460,000 @ 4% for 6 months)		9,200
20.	Cash for bond payment	2,300	
	City's share of cost		2,300
21.	Interest receivable	12,296	
	Interest revenues ($461,111 @ 4% for 8 months)		12,296
22.	Reserve for authorized expenditures	3,200	
	Premium on bonds	2,000	
	Discount on bonds		5,200

(*Continued on following page*)

12/31/48 (closing)

23.	Reserve for authorized expenditures	362,910	
	Construction expenditures		362,910
24.	Interest revenues	12,296	
	Unappropriated surplus—interest		5,896
	Interest expense		6,400

Comment on Entries

1. No entry is necessary for the approval of the bond issue.
2. The improvements authorized amount to $461,111. Entry No. 4 is based on an assumption that a supplementary authorization was voted by the city council.
3. In entry No. 14 the transfer of cash for interest to cash for construction is made to offset the reduction in cash for construction for the $5,200 discount on bonds sold November 1.
4. Since there is a deficiency in cash for interest payments, an entry crediting cash for construction might be made in place of the entry No. 19. The net discount of $3,200 ($5,200–$2,000) is charged to the reserve for authorized expenditures in entry No. 22.

THEORY OF ACCOUNTS

May 19, 1949; 9:00 a.m. to 12:30 p.m.

No. 1 (12½ points)

During the course of the operation of a business acquisition costs are consumed in the production of revenue. If there is a substantial change in price level occurring between the time assets are acquired and the time the cost value of assets is considered to have expired or to have been used, the revenue and cost expired are stated in terms of dollars having different purchasing power. Therefore, there is an amount of income reported which from an economic viewpoint is a mixture of profit or loss from price level changes and of profit or loss from operations.

Because inventories and fixed assets are the assets usually involved where there is a long time lapse between purchase date and the time they are charged against revenue in the income statement as consumed costs, the income measurement problem arises chiefly in connection with those two groups of assets. The problem is frequently approached from the asset side. This presentation of the problem usually proceeds by pointing out that the amounts currently being charged against income are either in excess of (if price level has declined) or less than (if price level has increased) the present replacement cost of the goods or property consumed in producing revenue. Therefore, net income is either overstated or understated in comparison with the gain or loss from operations as determined by matching current replacement cost with revenue. While accountants recognize some validity in this argument, except for certain inventory methods which afford some correction, the usual basis of reporting net income has continued to be incurred cost rather than reproduction or replacement cost.

A basic difficulty in the way of satisfactorily accounting for variations in incurred cost and replacement cost of fixed assets has been that replacement cost will not be definitely known until some future date when replacement actually occurs. Such future replacement cost may not be subject to any reasonable estimate. The lack of objective evidence to support a depreciation charge that takes into consideration a changed price level has also been a major factor in preventing the recognition of the effect of price level changes in the income account.

No. 2 (12½ points)

a. The item would be valued at $9,300 at December 31, 1947, and also at December 31, 1948. Where goods have been written down below cost at the close of a fiscal period, such reduced amount is considered as the cost thereafter.

b. In a period of rising prices the FIFO method, since it charges the oldest prices to cost of goods sold, generally will charge less to current operations than will the LIFO method, which would charge operations with the most recent and, therefore, high-priced purchases. Correspondingly, the FIFO method generally will produce a higher balance-sheet valuation than will the LIFO method.

In a period of falling prices the opposite result will tend to be produced by the two methods, but there are other factors which may have a material effect. If the cost or market, whichever is lower, rule is applied it is possible that closing balance-sheet valuations might be identical using either LIFO or FIFO if market is below cost. At least they would be different from what would result without the cost or market rule. The income statement, unless LIFO were started just at the peak of a price cycle, would start a period of falling prices with a lower inventory valuation than FIFO, thus producing a lower income charge under LIFO than under FIFO.

No. 3 (12½ points)

a. Where land is used in the business it is common to follow the federal income-tax regulation and capitalize the cost of the assessments as paid. Care should be exercised to eliminate any interest charges which frequently are included in such payments. From the viewpoint of financial accounting this treatment is open to criticism in many instances because the "improvement" may add nothing to either the use value or the market value of the land. In some cases it is possible that a decrease in value might result from the levy. Frequently the assessment covers a much wider area than is directly benefited, and in that situation, too, the payments should not be capitalized by property owners receiving little or no benefit from the improvement. Because of the limited life of most improvements in contrast with the more permanent nature of land, it would appear logical to treat improvements as amortizable cost, separate from the land cost. Where a second assessment is made to replace or renew the original improvement, the advantage of having amortized the cost of the first assessment becomes apparent. If it has been amortized, the cost of the replacement can be set up as an asset. However, if the first cost was capitalized, the usual treatment is to consider the cost of the replacement as expense. Theoretically a correction in the cost should be made for the difference in the cost of the initial improvement and the cost of the replacement, but this is seldom done.

b. If land is held for future busines suse but is not currently in use, there is considerable authority for capitalizing all carrying charges, even current taxes, on the theory that the land was purchased with the expectation that it would be worth the cost plus carrying charges up to the time of its utilization. Clearly under this theory, special assessment levies are capitalizable. Where such levies were unexpected at the time of purchase or where utilization is indefinitely delayed, there is serious question about the desirability of continuing to capitalize such charges.

c. Land held for development, like land held for future business use, is usually considered to be properly chargeable with carrying charges of all kinds, if they are reasonable and if the development period is not too extended.

d. Land held for speculative purposes for an indefinite period sometimes is treated in the same manner as land held for development, but there does not appear to be adequate justification for such treatment, because the market value does not necessarily increase as a result of such charges. However, in support of capitalization, it is correctly argued that profit or loss cannot be determined on the final sale of the land without considering all such charges.

No. 4 (12½ points)

1) A consistent policy from period to period should generally be maintained in capitalizing or expensing expenditures. However, a basic change is not prohibited where conditions clearly indicate such a change is desirable in the long run or where there has been a substantial change in conditions.

2) Consideration should be given to the probable life of the item obtained by an expenditure. If it will not be of service beyond the end of the current accounting period, there may be little gained by capitalizing the expenditure regardless of its amount. This is true because the annual operating results are the same whether the item is capitalized or not. Items requiring recurring expenditures of approximate equal amounts frequently are not capitalized for the same reason.

3) Consideration should be given to the depreciation rates and policy of the company. If depreciation rates have been set relatively high, items of a replacement or renewal nature may be capitalized more freely than if a lower relative rate of depreciation were used.

4*) In deciding whether an item should be treated as a repair expense or as a capital addition, consideration should be given to whether the expenditure increases the capacity or serviceability of the asset. If it does increase capacity or efficiency over the original capacity or efficiency, the expenditure may be capitalized in whole or in part.

No. 5 (12½ points)

a. Federal income-tax regulations provide that a stock dividend is non-taxable in cases where, after the dividend is received, the proportionate interest of the stockholders is not essentially different from their interest before the dividend. The most usual situation meeting this test is a dividend paid on common in common, but there are other cases that meet the test. A stock dividend is taxable where it results in an essential change in the stockholders' interest. A dividend to preferred stockholders paid in common stock would be regarded as a distribution which resulted in income to the recipient.

b. Accounting theory supports the tax rule on non-taxable dividends. It is considered that until there is a distribution, division, or severance of corporate assets in the form of cash or its equivalent, the stockholder has no income. This rule follows from the acceptance of the separate entity theory of corporation accounting which separates the problem of determining the income of the corporation from that of determining the equity (and income) of the stockholders individually.

Accounting theory generally would disagree with the tax rules on taxable dividends and would consider such dividends as not being income. Even in the case of these dividends, there is ordinarily no change in the book value of the stockholders' interest. Such dividends may be the formal recognition of dividend rights (common to preferred to settle arrearage), but are not distributions in that there is no distribution or severance of corporate assets.

No. 6 (12½ points)

There are two common acceptable methods for disposing of the manufacturing expense underapplied, in this instance $34,432.

* Only three considerations are required by the question.

The first of these is to charge the entire amount of $34,432 to current year's operations through cost of goods sold, preferably as an identifiable separate item. This method is considered appropriate in instances where the underapplied amounts arose through subnormal operations. It assumes that the amount is an idle capacity charge, that is a waste or loss, and that, therefore, no part of it is properly carried forward through inventories. It is a simple method to use and, where the amount involved is small or where the inventories are small in relation to cost of goods sold, it is considered to be a satisfactory method regardless of how the underapplied amount arose.

The second method is to prorate the $34,432 underapplied expense to the two inventories and cost of goods sold, either on the basis of the amount of applied manufacturing expense in each at the year end, or on the basis of finished unit equivalents included in the inventories and cost of goods sold, or by working out a percentage correction of rates used and making corrections of the three affected accounts. This method arrives at a correction of the rates used for application of manufacturing expense, either by an actual correction and re-working of the cost figures, or by an averaging process under the first two alternate computations. It is especially appropriate where the amounts involved are substantial and the underapplication was caused by an error in rate computation or by unavoidable or uncontrollable increases in costs during the year. It assumes that the actual cost is the amount that should be carried forward through inclusion in inventories and that the underapplied amount is not loss or idle capacity cost. This method is usually difficult to apply because the detail records of the work-in-process and finished-goods inventories must be individually adjusted to bring them into balance with the control account.

No. 7 (12½ points)

The problem of accounting for returnable containers has two basic aspects. These are, first, the problem of properly accounting for the cash or receivable arising from the shipment of containers to customers as well as their subsequent return, and, second, the problem of accounting for the asset value of the containers as contrasted with the receivable arising from their use.

It is desirable to have the invoice show the charge for the container as a separate item. In some instances of this type the invoice indicates that the container charge is payable only in the event it is not returned within a specified period. In other cases there is no difference in the terms for the container charge and in the charge for the product. In either situation the company will ordinarily segregate the amounts receivable for containers from the amounts receivable for merchandise and credit a liability account for the returnable containers.

It appears to be generally accepted practice to reduce the liability for outstanding containers by the corresponding receivable to indicate the expectation that the receivables will be settled by offset and that cash will be used in settlement of the net liability. Periodically the amount for containers that will probably not be returned may be transferred out of the liability account. This amount may be determined from past experience or by aging of the individual items. Such amounts should not be included in regular sales even though there is a profit obtained when containers are not returned, because there would be a distortion of sales, cost of sales, and gross profit. A separate sales account may be credited when the liability is debited, in which event there is an entry to debit the cost of container sales and credit the asset account with the cost of $10.50 per unit less accumulated depreciation.

It also appears to be sound practice to credit a container expense account when the liability is adjusted. When the asset is adjusted the corresponding cost is debited to the same expense account.

In accounting for the asset value of the containers apart from the receivables, recognition is given to the fact that title is for practical purposes still in the company even though the containers are out on billing. Two methods are acceptable. The items may be treated on an inventory basis under which an inventory of containers on hand and of those probably to be returned is set up at the end of each period at depreciated cost, depreciation being calculated in this case at 40% per annum. The cost of the purchases plus last period's inventory less the present inventory is charged to a container expense account.

The other method is to treat containers as fixed depreciable assets with a reserve for depreciation based on their estimated life. Periodic adjustment to the asset and to the reserve for depreciation account must be made for containers scrapped and those not returned or not likely to be returned by customers.

Various combinations and modifications of the preceding methods may be used successfully, including such modification as arises from the use of memorandum billing instead of actual billing at date of shipment.

No. 8 (12½ points)

Except in the case of utilities and other enterprises which are expected to be self-supporting out of revenue received by them for specific service, it is not considered necessary or feasible to compute depreciation on property that would normally be considered as depreciable assets of a governmental unit for the following reasons:

a. The unit is not concerned with the determination of profit or loss. It does not try to render its services on a profit basis or even necessarily on a cost basis. Since this is true, depreciation expense would have no significance in the statements.

b. The capacity to raise revenue in the future is the basis of governmental credit. The depreciated value or the replacement value of the government's property has no significance as a basis for credit, and therefore there is no balance-sheet significance attached to providing a reserve for estimated depreciation.

c. The accounting records of governments are largely concerned with availability of resources and legality of expenditures. Unless a cash fund were set aside equal to the depreciation reserve, there is no effect from computing such a reserve. Ordinarily it would be illegal to set aside a cash fund. However, unless cash is set aside out of current revenues, depreciation cannot be included in the annual budget or in the appropriation made in connection therewith. If it were computed but not included in the budget, there would be a discrepancy between the budget and the statements.

No. 9 (12½ points)

1. The method which would be considered to be most appropriate would be to defer three-fourths of the total gross profit on the sales and take such deferred profit into income in proportion to the cash collected. This method, frequently called the installment basis of accounting for profits, is a compromise between the two methods described next; and, as a compromise, it is not in accordance with the usual theory of profit realization, which recognizes profits as realized upon a sale resulting in the receipt of cash or a collectible receivable. The method is usually justified on the grounds that the period of credit is long and risk correspondingly great, and that costs will continue to be incurred in connection with the sale, which expenses cannot easily be provided for by other means than to defer a portion of gross profits.

2. An extremely conservative method is to defer profit in full until all costs are recovered. Such a method does not consider the sale as being the point of revenue realization but rather considers the collection of cash as being the sole evidence of such realization. Until such time as the amount of cash collected exceeds cost, there is no revenue. The method is conservative and justifiable only where risk is great and recoverable value of goods is negligible.

3. A third method is to take the entire gross profit into income upon making the sale and to set up reserves for estimated losses, collection expenses, and repossession costs. This method conforms to the usual principles of accrual accounting and income realization. Theoretically it appears to be the most desirable method, but difficulty is usually encountered in making the estimates and in determining the amounts of expense that should be charged to the reserve.

Notation: Another method might be named by candidates. This method considers the gross profit to be realized by the first cash collections, costs being recovered thereafter. Such a method does not conform to the usual theory of income realization and it is criticized as not being conservative enough when losses are probable before final collection in full, and where costs will continue to be incurred over an extended period in handling the accounts. However, where the down payment equals or exceeds the gross profit, the method results in accounting for profit on the same basis as would be followed for ordinary sales on account.

No. 10 (12½ points)

a. 1) Current ratio:

$$\frac{\text{current assets}}{\text{current liabilities}}$$

2) Raw material turnover:

$$\frac{\text{net material issues at cost}}{\text{average raw material inventory at cost}}$$

3) Finished goods turnover:

$$\frac{\text{cost of goods sold}}{\text{average finished goods inventory at cost}}$$

4) Average collection time for accounts receivable:

$$\frac{\text{Average balance of receivables}}{\text{charge sales for period}} \times 365 \text{(or 360)days}$$

5) Book value per share of common stock:

Total stock and surplus (including surplus reserves)

Less a) liquidating value of all preference stocks

b) any treasury stock carried as an asset on the balance-sheet

Divided by outstanding shares of common stock.

b. 1) The current ratio expresses the relationship between current assets and current liabilities. It is a rough measure of the ability to meet current obligations. Alone it is far from entirely satisfactory because it does not show the liquidity and quality of the different items making up the current asset total.

2) The raw material turnover is a measure of the liquidity of the investment in the inventory. It frequently is expressed as an amount of inventory equal to a certain number of days of operations. (Turnover divided into the number of working days in the year will produce the figure showing number of days supply now on hand.) Generally a high turnover is desirable both as an indication of a high degree of liquidity, and because of less possibility of obsolescence. The ratio is subject to question if the average inventory used in the computation is not representative of the usual inventory or if the various items on hand are not proportionate to their relative use in making the final products. Also, because the figure is an average, there may be concealed in it some items with a very slow turnover offset by fast moving items. Year to year changes in the ratio are usually considered of more importance than is the ratio for a single year.

3) This ratio, like the raw material turnover, measures liquidity. It is subject to comments as to purpose and limitations similar to those for the raw material turnover. In an analysis of the turnover of finished goods it is important to observe the gross profit margin that is realized on each turn of the inventory.

4) The average collection period for accounts receivable measures liquidity of the accounts and, when considered in relation to the usual credit terms, indicates the effectiveness of the company's credit and collection efforts. If, for example, the usual terms are 30 days net, and sales are made uniformly throughout the month and year, a turnover of 12 would indicate that collections were being made, on the average, within the specified credit period of 30 days. The trend from year to year is considered to be an important measure of effective credit management. In computing the ratio, care must be given to determine that the average balance of receivables is representative of the balance throughout the year.

5) The book value of common stock is commonly supplied present stockholders and prospective purchasers of capital stock as information relating to the equity in the net assets represented by one share of common stock. It is used as one of the factors in evaluating common stock for which market quotations are not available. However, book value ordinarily has very little relationship to market value of stock and has little or no significance to creditors.

AUDITING

May 20, 1949; 1:30 to 5 p.m.

GROUP I

No. 1 (8 points)

a. The numbers make possible the identification of a specific certificate or bond and comparison with invoices of purchase or sale received from brokers and banks. Their use by an auditor may disclose unrecorded transactions in connection with those securities and substitutions of securities.

b. The auditor examines the endorsement and compares it with the name of the payee as a guide to possible irregularities. Except for payroll checks to employees, most checks would be expected to have only the endorsement of the payee. If the checks are not endorsed for deposit or if checks made to a business bear several endorsements, additional investigation of evidence supporting the disbursement is advisable because the possibility exists that the payments are based on fictitious invoices, or are otherwise improper. After the auditor has examined checks bearing more than one endorsement, and has noted those where the endorsements subsequent to the first one do not appear to be those of firms or persons who might be expected to come into proper possession of the checks, he will examine cash book entries, supporting vouchers, and postings to determine that such checks were properly issued and recorded. He will determine from various evidence that they were not used to cover shortages and that the payments were made to a legitimate creditor of the client, not to an employee of the client, either directly or indirectly.

Second endorsements of merchants and accommodation endorsees are commonly found on payroll checks. Such endorsements, especially by employees, may indicate payroll irregularities.

No. 2 (20 points)

Reconciliation of Cash Transactions for December and Cash Balances as of December 31, 1948

	Balance 11-30-48	Deposits	Withdrawals	Balance 12-31-48
Transactions per books:				
Totals per cash books	$2,631.74	$62,669.03	$60,989.53	$4,311.24
Error in addition of receipts	....	1,100.00	....	1,100.00
Error in addition of disbursements	....	....	(9.00)	9.00
Corrected book totals	$2,631.74	$63,769.03	$60,980.53	$5,420.24
Reconciling items:				
Outstanding checks	991.00	....	991.00	
			(4,110.50)	4,110.50
Bank service charge not recorded	(9.00)	.....	(9.00)	
			10.00	(10.00)
Undeposited cash	(210.89)	210.89	....	
		(100.00)		(100.00)
Customer's returned check not recorded	....	....	100.00	(100.00)
Shortage in deposits	....	(1,009.00)	.....	(1,009.00)
Understatement of checks in cash book	....	....	100.00	(100.00)
Transactions per bank	$3,402.85	$62,870.92	$58,062.03	$8,211.74

Parenthesis () denotes red figure.

Note: There is a shortage of $1,109.00 consisting of $1,009.00 shortage in the cash deposits and $100.00 understatement of checks issued. This shortage has been offset by underfooting the Cash Receipts book $1,100 00 and overfooting the Cash Payments book $9.00.

No. 3 (10 points)

(Only five items are required by the question.)

a. The methods that may be employed in the failure to account for cash receipts, and the recommended procedures to prevent and discover the fraud are as follows:

(1) METHOD: A theft of cash preceding the recording of the sales.

REMEDIES:

Internal Control: Employ "spotters"; use visible cash registers; prepare serially numbered sales slips; employ wrappers to check the sales slips against merchandise tag prices, use a central cashier, charge the inventory to the store manager or department manager at retail; separate the activities of the cashier and the bookkeeper; adopt an effective order and follow-up system.

Audit: The application of the "gross profit" test might indicate this theft if the amount is substantial. If not detected in this manner, it is not ordinarily discovered by audit procedures. The establishment of adequate internal control is recommended to prevent theft of this kind.

(2) METHOD: Underfoot the cash debits and abstract an amount of cash equal to the amount of the underfooting.

REMEDIES:

Internal Control: Separate the handling of cash from recording in the cash book. Have the cashier prepare a report of cash collections direct to the controller's office for tie-up with recorded cash in cash book.

Audit: Verify the footings for cash receipts; compare duplicate bank deposit tickets with entries in the cash receipts record.

(3) METHOD: Overstate sales discounts, and abstract an equivalent amount of cash.

REMEDIES:

Internal Control: Separate the duties of the cashier and the bookkeeper, have the person who opens the mail list the amount of the checks received and compare the listing with the cash receipts record entries. Require independent approval of discounts which do not conform to standard terms as to rate and period of payment.

Audit: Verify the discounts; compare the cash receipts record entries for checks received from customers with the duplicate bank deposit tickets.

(4) METHOD: Charge an account other than cash at the time of cash receipt from a customer.

REMEDIES:

Internal Control: Separate the activities of the cashier and the bookkeeper, have the person who opens the mail list the amount of the checks received and compare the listing with the cash receipts record entries.

Audit: Obtain approval of entries in the general journal (or on journal vouchers) which reduce account balances with debtors, inspect expense accounts and vouchers for non-cash credits; verify all credit postings to receivables and trace the debit; verify sales returns, allowances, and discount entries.

(5) METHOD: Charge off an inactive account receivable as uncollectible, when the account actually was collected.

REMEDIES:

Internal Control: Separate the duties of cashier and bookkeeper. Require approval by responsible official for all charge-offs. Institute a follow-up system on charge-offs.

Audit: Examine and obtain approval of journal entries which charge off accounts receivable, verify postings; obtain confirmation of unpaid balances of customer; trace the listing of cash remittances to the bank.

(6) METHOD: For record purposes, charge sales to fictitious customers, and abstract the remittance when it is received from the actual customer.

REMEDIES:

Internal Control: Separate the activities of the cashier and the bookkeeper.

Audit: Obtain confirmation of accounts receivable balances; obtain a list of customers from the sales (or credit) department, and compare with the names appearing in the customers' ledger.

(7) METHOD: Undercharge customers on the books and abstract the excess cash when paid.

REMEDIES:

Internal Control: Separate the duties of cashier and bookkeeper. Have statements prepared by some person other than the cashier.

Audit: Compare duplicate bank deposit tickets with the amounts received by customer check and the amount of currency collected; compare sales invoices with recorded charges; obtain confirmation of accounts receivable.

(8) METHOD: Lapping.

REMEDIES:

Internal Control: Separate the duties of the cashier and the bookkeeper; match recorded cash receipts with the credits to customers' accounts. Have a close follow-up of past-due accounts by the collection department.

Audit: Compare duplicate bank deposit tickets with the recorded cash receipts by days; obtain confirmations of accounts receivable balances.

No. 4 (10 points)

(Only five methods are required by the question.)

The methods that may be employed in the execution of fraudulent disbursements and the recommended procedure to prevent and discover the fraud are as follows:

(1) METHOD: Petty cash disbursement overstatements.

REMEDIES:

Internal Control: Effectively control and operate the petty cash fund, separate disbursement and approval for disbursement from the fund; mutilate used petty cash vouchers.

Audit: Examine petty cash vouchers.

(2) METHOD: Forging checks.

REMEDIES:

Internal Control: Prenumber checks and provide strict control over them; do not permit the cashier or persons handling checks to have access to returned checks until the bank balances have been reconciled.

Audit: Account for all checks; examine all documentary evidence in support of disbursements; foot the check register; compare returned checks with the authorization for disbursement.

(3) METHOD: The presentation of a voucher for payment more than one time.

REMEDIES:

Internal Control: Mutilate paid voucher.

Audit: Examine the voucher for each entry in the voucher register; compare each voucher with its corresponding payment; check or foot the voucher register and cash book and reconcile cash credit per cash book with bank withdrawals.

(4) METHOD: The preparation of false vouchers.

REMEDIES:

Internal Control: Officials who approve vouchers for payment also should examine the vouchers, compare the vouchers with original invoices and receiving reports where they are needed; the cashier should not have access to the unused vouchers; a purchase order system should be installed.

Audit: Analysis and comparison of expense accounts may lead to detection of the false voucher. Testing vouchers against independently maintained receiving reports may be feasible.

(5) METHOD: Kiting of checks.

REMEDIES:

Internal Control: Require two signatures on all checks transferring funds; use pre-numbered checks, to be controlled and prepared by a person other than authorized signers.

Audit: Compare cash deposits with credits to accounts receivable or with entries in the cash receipts book, investigate interbank transfers; examine returned checks, especially those for interbank deposits clearing immediately after the end of a month; foot the check registers; determine that all checks have been entered as credits to cash.

(6) METHOD: The understatement of purchase returns and allowances, and the abstraction of an equal amount of cash.

REMEDIES:

Internal Control: Do not permit the disburser of checks to prepare disbursement vouchers or have control over cash collections.

Audit: Compare bank deposits with cash receipts records to detect deposits of less than the receipts; watch for checks to unauthorized persons for an amount equal to the return; examine debit memoranda and determine that the memoranda have been applied against the proper invoice, and then compare the net invoice with the recorded disbursement.

(7) METHOD: The understating or the underfooting of purchase discounts.

REMEDIES:

Internal Control: Separate the handling of cash and the preparation of checks from recording payments in cash book.

Audit: Compare invoice terms with voucher register entries; foot the voucher registers, test-compute entries for the amount of discount.

(8) METHOD: Overfoot cash credits and abstract cash of an amount equal to the overfooting.

REMEDIES:

Internal Control: Separate cashier from bookkeeper and preparation of bank reconciliations.

Audit: Foot cash credits in all records of original entry; then follow the procedure used in the detection of the failure to account for cash receipts.

(9) METHOD: Payroll manipulation.

REMEDIES:

Internal Control: Separate the payroll accumulation and the function of payment; return unclaimed wages; pay by check.

Audit: Reconcile personnel department records and payroll records, foot payroll journals.

No. 5 (15 points)

a. Prepare analyses of the general ledger Construction in Progress, Buildings, and Machinery accounts. Tie in the debits to Buildings and Machinery with the credit to Construction in Progress. Trace any other credits to Construction in Progress to the accounts into which they were cleared.

b. Prepare or have the client prepare a list of all construction work orders (or all in excess of a specified amount with a summary of the smaller work orders). Such a list should show:

(1) Order number
(2) Description
(3) Date opened and date completed
(4) Authorized or estimated cost
(5) Actual cost
(6) Detail of cost as to:
  (a) Outside contracts or purchase orders
  (b) Direct labor
  (c) Store requisitions
  (d) Overhead applied

c. Add and tie in the list with general ledger analyses.

d. Tie in the orders open at the first of the year with the list of orders still in process per last year's papers.

e. Check from list to the minutes of the directors or executive committee for approval of the expenditures.

f. Investigate all orders showing substantial variation from estimated cost as to reasons for and approval of the variation.

g. Check all large expenditures under outside contracts or purchase orders to the invoice, voucher, contract, deed, or other supporting documents.

h. Test payroll charges and material requisitions to payroll records and to stores records.

i. Determine as to overhead the basis for the charge, the reasonableness of the charge and its consistency with respect to prior year's charges.

j. Test some of the smaller expenditures by procedures as set forth for large orders.

k. Review all construction order descriptions as to the reasonableness of the distinction between capital and revenue expenditures as to the consistency of the distinction this year with the prior year.

l. Review maintenance and repair charges as to reasonableness and consistency with last year of the distinction between capital and revenue expenditures.

m. If feasible, physically inspect the more important additions to determine their existence and their use in the business.

n. Obtain "representation" from officials of the company as to the usefulness and correctness of all asset additions and asset balance.

No. 6 (7 points)

a. Degree of risk in connection with the item to which the test is to be applied must be given consideration by the auditor. The degree of risk is affected by:

(1) The effectiveness of internal control affects the degree of risk. Where good internal control exists, the test may be more limited than where internal control is less satisfactory.

(2) Probability of irregularities in connection with the item being tested must be considered in deciding the extent of test.

b. The relative importance of the item being tested must be considered. Those items which are of material amount must be tested more thoroughly than similar items which are immaterial in relation to the client's financial status and operations. A higher degree of certainty is required for material amounts. Therefore a more extensive testing must be applied than where less certainty is required.

GROUP II

No. 7 (10 points)

The principal purposes served by preparing and preserving audit working papers are as follows:

a. Only by preparing working papers can a systematic program of verification be carried to completion except perhaps in the very small engagement. Points might be entirely omitted or never completed without adequate working papers.

b. The use of working papers enables the auditor to use a large number of persons on any audit and by a review of the working papers, coordinate the work and maintain a desirable standard of work.

c. Orderly and systematically prepared working papers save time in making many computations. Some form of working papers is essential for such computations.

d. Adequate working papers enable the auditor to save time and improve the efficiency with which subsequent audits of the same client are performed. They reveal procedures and tests which were not justified and reveal weaknesses in procedures followed which can be corrected in subsequent audits. Rotation of tests is possible only if there is an adequate record of past tests.

e. Audit working papers save time through elimination of work on subsequent engagements through not having to reëxamine many items in connection with the financial operations of the client.

f. Audit working papers afford the auditor a basis of exact information for discussions with the client.

g. Audit working papers may supply information for the preparation of additional reports other than the one for which they were prepared. Such reports as those made to the Securities and Exchange Commission can usually be prepared from the papers prepared for the annual audit.

h. Audit working papers afford evidence of work done in connection with any suit or other action in connection with the audit engagement.

i. Audit working papers are the basis for all suggested adjustments and reclassifications proposed by the auditor. They give the details of the items included in the financial statements that are being examined.

No. 8 (20 points)

a. It would be expected that there would be a vat production record, which should show the quantities (and perhaps values) of raw materials put into process, and the dates of their transfer from stores. This record would also show when operations were commenced with respect to each vat and the quantity of finished product produced.

b. The book value of the inventory of work in process of MZ should be verified by the following procedures:

(1) From the vat production record determine the last date on which each vat was emptied. Obtain a list of materials introduced at the various intervals and working from the production record determine the quantities of materials that should be in each vat. Price these material at recent store prices, thereby determining the theoretical cost of material in each vat.

(2) Since the manufacturing costs are incurred uniformly over the thirty-day period, the manufacturing cost of the inventory in each vat will be equal to the flat monthly charge per vat multiplied by a fraction, the numerator of which is the number of days that the first materials put into the vat have been in the vat at the inventory date, and the denominator of which is 30. Because approximately the same number of vats are refilled each day, the total of manufacturing cost applicable to the work-in-process inventory should be approximately one-half of the monthly rate times 90. The detailed computation could be checked against the total determined from this over-all computation or the over-all computation might be made first and, if the company figures agree with it, the detail computation might be omitted.

(3) Add to the computed material cost, the amount of the manufacturing cost applicable to the inventory in each vat. The total thereof represents the cost of the inventory in the vat. The sum of the cost of the inventory in all of the vats represents the total work-in-process inventory. This amount should be compared with the book value of the work-in-process inventory. If there is only a minor difference between the two amounts, the book value may be accepted as correct, unless errors are found in other inventory verification.

(4) It will also be appropriate to review the standard rate per vat used to transfer the finished product into the inventory of finished goods. Inasmuch as a standard rate is used, fluctuations in materials costs (which are charged to work in process at FIFO cost) may result in too much or too little being transferred from work in process unless the standard is adjusted accordingly.

(5) The cost of the materials put into the vats should be verified by test checks of perpetual inventory records of raw materials, requisitions, records of inventories in process, etc. The auditor should satisfy himself, for example, that the FIFO principle is being correctly applied. Test checks of materials cost to vendor's invoices should be made as a part of the verification of raw materials; at the same time, this check to invoices also constitutes a part of the verification of work in process.

(6) Verification of the manufacturing cost applicable to inventory in process includes a review and test check of the manufacturing costs for a representative period by reference to payroll records, invoices, and other original documents and a review of the flat rate per vat per month to determine the reasonableness of the basis used and the accuracy of the computations.

c. Suggested headings for a work sheet on which to assemble the data are as follows:

(1) Vat No.	(2) Date Operations Commenced	(3) Number of Days in Process	(4) Daily Operations Rate	(5) Pertinent Operation Cost	(6) Materials Charged	(7) Total Cost
				Col. 3 × 4		Col. 5 + Col. 6

No. 9 (10 points)

Loans Payable

1. Are borrowings limited:
   (a) By articles of incorporation?_____
   (b) By by-laws?_____
   (c) By other documents?_____
2. Are all borrowings from banks?_____
3. If not:
   (a) Are note brokers used?_____
   (b) Is money borrowed from trade creditors?_____
4. Are all borrowings authorized specifically by the board of directors?_____
5. If general authority is given to officers, are the sources of borrowings specified by the board of directors?_____
6. List names of persons having authority to sign notes (or acceptances) payable._____
7. How many signatures are required?_____
8. Are extensions of maturity of notes ever obtained?_____
9. How often are loans balanced with the control account?_____

Purchases and Related Disbursements

1. Where do requests for purchases originate? _____
2. Is purchasing department separated from:
   (a) Receiving? _____
   (b) Storekeeping?_____
   (c) Accounting?_____
3. Are all purchases made on written orders? _____
4. To what extent are bids requested before placing orders?_____
5. When bids are received are they preserved as part of the records?_____
6. Are purchase orders prenumbered?_____
7. Who approves prices and terms of orders? _____
8. Is receiving centralized?_____
9. Are pre-numbered receiving tickets used? _____
10. Are all materials inspected or tested? _____
11. What procedure is followed as to damaged goods, shortages, and substandard goods? _____
12. Are receipts posted to a copy of the purchase order?_____
13. Does the accounting department check out all invoices with purchase order?_____ with receiving report?_____with inspection report?_____
14. Who is responsible for checking freight charges?_____
15. Who checks extensions and footings? _____
16. Are all supporting documents available before a voucher is prepared?_____
17. Is voucher prepared by someone other than person who keeps the voucher record? _____
18. Does an official or responsible employee examine the voucher and supporting documents and indicate his approval?_____
19. Do the documents, including vendor's invoice, accompany the voucher until check is signed?_____
20. Upon payment, are voucher and invoice mutilated to prevent resubmission?_____
21. Who detaches check from documents? _____
22. Who mails checks?_____

COMMENT: Questionnaires on internal check may vary widely in their completeness as well as in form and the approach they take to the determination of the effectiveness of internal check. For instance, a question on a procedure can often be worded in such a way that an answer of "yes" would be regarded as favorable or it can be worded in such a manner that an answer of "no" would be favorable. Questionnaires can be designed in a form to permit all items to be answered either with a "yes" or "no." However, more elaboration of the answers may be desired and provision can be made for explanation by the person answering the questions.

No particular type of questionnaire appears to be better than others, and the examination question does not set any limitation as to the type; therefore, a number of different forms could be submitted as a satisfactory answer to the question. The above form should be adequate under usual circumstances.

No. 10 (10 points)

The auditor is not entitled to do any probing beyond that which is expressed in, or implied by, the terms of his agreement with the client. However, an auditor in expressing an opinion without qualification or reservation on financial statements ordinarily finds it necessary to investigate certain matters from the date of formation of the company (or business) up to the date of completion of his field work, or for registration statements, up to the effective date of the statements.

The investigation of transactions occurring prior to the period under audit is necessary to establish the basis on which various accounts are stated at the first of the period. All items that appear on a balance-sheet at the first of a period are either carried into the ending balance-sheet or reflected in the charges or credits to income or surplus during the period. The auditor, in reviewing those items, must trace the large items back to their inception to determine their nature and the propriety of the treatment given to them in the accounts. Examples of items which are ordinarily traced back to the beginning of the business are: (1) Fixed Tangible Assets, (2) Intangible Assets, (3) Capital Stock, and (4) all divisions of Surplus. The auditor, in tracing back a balance such as Capital Stock, determines that the stock was issued as fully paid stock, that consideration was received for it, that such consideration was correctly recorded in the records both as to the debit and the credit entry. Through this investigation, he is able to establish the basis for the value shown in the records at the first of the period under review.

Investigation of matters subsequent to the close of the period under review is required on a different ground from that which requires investigation prior to the period, and the exact responsibility of the auditor is less clearly defined. The events taking place subsequent to the close of the period under review with which the auditor is concerned, may be divided into two general groups.

First are those events which define more clearly the nature of, and perhaps the amounts involved in, transactions which arose prior to the close of the period under review. An example of such an event would be the determination after the end of the period of the amount of liability under a court action, the cause of which action arose prior to the close of our period. Auditors are expected to use such data in determining the fairness of the financial statements under review.

Second are those events which occur subsequent to the end of the period, but do not result in any change in the estimates or judgments expressed in the financial statements. This group might be subdivided into those events that will require direct accounting entries in the subsequent period and those which will not require such direct entries but will materially affect the future operations of the business. In the first of these subdivisions would be such events as the sale of a large amount of stock, the sale, destruction or abandonment of plant and equipment, or the incurrence of large inventory losses. In the second category would be events such as the passage of new laws affecting the business, technological changes appearing in the industry or even a sudden general downturn in business.

There is by no means a complete general agreement among accountants as to the responsibility for investigating matters occurring subsequent to the close of the period. As to the first group of items, accountants would generally agree that to the extent their occurrence is known to the auditor, he would consider them in the financial statements. Probably a majority of auditors would also agree that there is some responsibility to disclose or insist that the client disclose material items of the first division of the second group, but not as to the other division of the group.

COMMERCIAL LAW

May 20, 1949; 9:00 a.m. to 12:30 p.m.

GROUP I

No. 1 (10 points)

a. (1) No. The instrument E took was not complete and regular on its face, since it clearly indicated that C and D, E's endorsers, did not have title.

(2) No. A partial endorsement, or one which purports to transfer the instrument to two or more endorsees severally, does not pass title.

(3) Yes. Because E was not a holder in due course, he did not hold free from a defect of title of prior parties or defenses available to prior parties among themselves.

b. (1) No.

(2) When an instrument containing the words "I promise to pay" is signed by two or more persons they are deemed to be jointly and severally liable thereon.

No. 2 (10 points)

a. (1) When a seller is ready and willing to deliver goods and requests the buyer to take delivery, and the buyer does not within a reasonable time after such request take delivery of the goods, the buyer is liable to the seller for any loss occasioned by his neglect or refusal to take delivery.

(2) Yes. After notification to remove the bricks the buyer is liable to the seller for a reasonable charge for the care and custody of the goods.

b. (1) No.

(2) An affirmation of the value of the goods is not to be construed as a warranty.

c. (1) No.

(2) Unless otherwise agreed, the buyer of goods is not bound to accept delivery thereof in installments.

No. 3 (10 points)

a. (1) Yes.

(2) A contract of this kind is made for the benefit of Smith and other members of the union employed by Jones Co. Therefore, Smith may recover as an obligee beneficiary.

b. (1) No.

(2) The parties to an ordinary building contract do not contemplate that the building shall be erected by the contractor's own personal skill or labor. His duty is but to see to it that the building is erected in accordance with the contract specifications. Accordingly, the fact that the contractor is personally disabled does not excuse non-performance of his contract obligation. This type of contract should be distinguished from contracts which clearly call for personal performance, such as one whereby an artist contracts to paint a picture.

c. (1) Yes.

(2) Restitution is available as a remedy with respect to the performance by the plaintiff Allen, since it was a performance which the defendant Burt had bargained for and received.

No. 4 (10 points)

a. (1) No.

(2) An implied term of the suretyship contract is that the surety will be liable only for defaults by the principal while the principal has substantially the same responsibilities. Any significant change in the employee principal's duties, especially when the change results in increased risk, will discharge the surety unless he consents to continue to be bound.

b. (1) Yes.

(2) The workmen were creditors entitled under the Bankruptcy Act to priority as to certain prebankruptcy wages. In general a surety who pays his principal's debt is subrogated to the creditor's claim against the principal. And there is nothing to indicate that a different result would be reached in proceedings under the Bankruptcy Act.

c. (1) Yes.

(2) The assignment to the surety was only for his security. He is entitled to complete indemnity for expenditures occasioned by the principal's default, but to nothing more.

No. 5 (10 points)

a. (1) No.

(2) An agent has no authority to receive payment merely from the fact that he represented the principal in the transaction out of which the debt arose. If such authority is present it is only because of the existence of prior dealings between the agent and principal or circumstances indicating such authority.

b. (1) No.

(2) Asa was employed as a bookkeeper and paymaster only. In the absence of specific authority an agent is not authorized to borrow money unless such borrowing is usually incident

to the performance of acts which he is authorized to do for the principal.

c. (1) Yes.

(2) An agent is subject to a duty not to deal with his principal as an adverse party in a transaction connected with the agency. An agent appointed to buy at a fixed price violates his duty to the principal, if without the principal's acquiescence, he sells the specified article of his own to the principal at the specified price, even though it cannot be obtained elsewhere.

GROUP II

No. 6 (10 points)

a. (1) Allen.

(2) The deposit of the funds by Jones, the directions that the account be made out in trust for Allen, his subsequent conduct in notifying Allen and leaving the money there till death show an intent to establish this bank account as a trust enforceable by Allen on the death of Jones. Being a trust account, the bank account is not a part of Jones' estate subject to the control of the administrator of his estate.

b. (1) The employees.

(2) The corporation's action in designating the account as "special trust account" and its customary manner of using the account showed its intent to make itself trustee for its employees for their wage and salary account.

No. 7 (10 points)

a. (1) Yes.

(2) The receipts constituted a contract of storage binding the former warehouseman only. There was no mutual assent and hence no contract between the holder of the receipts and the new operator. Nor, under the terms of the judicial sale, did the new operator assume any obligations of the bankrupt. The new operator could enforce a quasi-contractual right to fair and reasonable charges even if they were higher than those enumerated in the receipts.

b. (1) Yes.

(2) No.

(3) Having clearly indicated on their face that the receipts he issued were negotiable, the warehouseman will not be heard to deny their negotiability as to him.

No. 8 (10 points)

a. (1) The making of a general assignment by an insolvent debtor for the benefit of his creditors is an act of bankruptcy, upon which proceedings in involuntary bankruptcy may be based if instituted within four months.

(2) If the assignment was made within four months of the date on which the bankruptcy petition was filed, title to the assigned property automatically vests in the trustee in bankruptcy. The trustee can compel the assignee to transfer the property to him; and, once transferred, it becomes part of the estate and will be administered and distributed in accordance with the Bankruptcy Act.

b. (1) In general any natural person, partnership, association, or corporation (except a municipal, railroad, insurance, or banking corporation, or a building and loan association) is entitled to the benefits of the act as a voluntary bankrupt.

(2) A bankrupt who has obtained his discharge may at any time file a new petition, but he cannot obtain a discharge in the second proceeding if the second petition was filed within six years of the date on which the discharge was granted.

No. 9 (10 points)

1 (b). 2 (c). 3 (a). 4 (c). 5 (c).

No. 10 (10 points)

1 (d). 2 (c). 3 (a). 4 (g).

No. 11 (10 points)

(1) False. (2) True. (3) False. (4) False. (5) True. (6) True. (7) False. (8) True (9) False. (10) False.

No. 12 (10 points)

(1) False. Old age and blindness exemptions do not apply to dependents.

(2) False. Non-taxability is restricted to exchange of like property held for productive use in a trade or business or for investments.

(3) False. A non-business bad debt is considered a short-term capital loss.

(4) True. It is deductible as a casualty loss.

(5) True.

(6) False. The premium is spread over the life of the bonds.

(7) True. Had the dividends been accumulated but undeclared, they would have been considered part of the redemption price.

(8) False. The transfer tax is imposed only on issues by corporations.

(9) True. There is continuous ownership in the partners.

(10) True. The value is considered to have been taken into consideration in fixing the sales price.

Examination Answers, November, 1949

ACCOUNTING PRACTICE—PART I

November 16, 1949; 1:30 to 6 p.m.

No. 1 (14 points)

Part A.

1. True	2. False	3. True
4. False	5. True	6. True
7. False	8. False	9. False
10. False		

Part B.

1. True	2. True	3. False
4. True	5. True	6. False
7. False	8. False	9. True
10. False		

Part C,

1. $4,074	2. $3,957.60	3. $99,979
4. $99,979.60		

Part D.

1. $540	2. $1,800	3. A's first wife
4. 0	5. no gain or loss	

Part E.

1. $240,000	2. $5,000	3. deduct $7,200 actually allowed

Part F.

1. 0	2. 0	3. $2,000
4. 0		

No. 2 (18 points)

P, R, AND B BALANCE-SHEET
JANUARY 1, 1949

Assets			Liabilities and Capital		
Cash		$ 37,000	Accounts payable		$ 43,200
Accounts receivable	$42,500		Notes payable		25,000
Less—allowance for loss	4,500	38,000	Accrued expenses		4,360
Notes receivable		6,000	Partners capital:		
Accrued income		475	B	$30,000	
Merchandise inventory		63,140	P	22,800[1]	
Prepaid expenses		872	R	37,200	90,000
Store fixtures	12,400				
Less—depreciation allowance	5,300	7,100			
Goodwill		9,973			
		$162,560			$162,560

[1] Net adjustment of capital of P and R computed as follows:

Total capital per agreement with B	$60,000
Capital before any adjustments	58,400
Net adjustment (shared equally)	$ 1,600

(*Continued on following page*)

Computation of Corrected Profit for 1947 and 1948

Item	Profit for 1947 Debit	Profit for 1947 Credit	Profit for 1948 Debit	Profit for 1948 Credit
Profit per books	...	$ 8,585	...	$10,497
Accrued expenses omitted	$ 2,472	3,201	$ 4,360	2,472
Prepaid expenses omitted	1,010	1,226	1,226	872
Accrued income omitted	...	250	250	475
Provision for loss on accounts	3,280	3,500	4,425	2,805
Write-down of inventory	...	...	860	...
Increase salaries	2,000	...	2,000	...
Total	$ 8,762	$16,762	$13,121	$17,121
Adjusted profit	8,000	...	4,000	...
	$16,762	$16,762	$17,121	$17,121

Computation of Goodwill

Average profit—($12,000 divided by 2) equal $6,000 which is capitalized at 10%				$60,00
Adjusted capital of partners per books			$58,400	
Deductions:				
Provision for loss on accounts		$4,500		
Write-down of inventory		860		
Set up accrued expenses		4,360		
Total		$9,720		
Additions:				
Set up prepaid expenses	$872			
Set up accrued income	475	1,347		
Net deductions			8,373	
Adjusted capital before goodwill allowance				50,027
Goodwill				$ 9,973

Payment by B

Capital to be allowed P and R	$60,000
Amount to be paid by B (½ of $60,000)	30,000
Total capital after all transactions	$90,000

No. 3 (18 points)

INSURANCE CLAIM

	Quantity		Book Value
Inventory of material 1/1/49	420,000		$ 474,000
Purchases	342,500		551,425
Total	762,500		$1,025,425
Used in production (Schedule 1)	303,106		488,000
Inventory at date of loss	459,394		$ 537,425
Value of 459,394 units at replacement price of $1.62		$744,218	
Salvage value of inventory		25,000	
Amount of insurance claim		$719,218	

(Continued on following page)

Proof of Book Value and Units on Hand

270,000 units @ .90 (LIFO price) =	$ 243,000
150,000 units @ $1.54	231,000
Value of 420,000 units at 12/31/48	$ 474,000
39,394 units acquired since 12/31/48 at price of $1.61	63,425
Total as above	$ 537,425

Material Used in Production (Schedule 1)

Cost of goods sold (Schedule 2)		$ 738,000
Finished goods and work in process—inventory variation		...
Direct labor	$132,400	
Manufacturing overhead	117,600	
Total		$ 250,000
Cost of material used		$ 488,000
Units of material used at price of $1.61		303,106

Cost of Goods Sold (Schedule 2)

Sales	$ 820,000
Cost of goods sold (90%)	738,000
Gross profit (10%) (Schedule 3)	$ 82,000

Computation of Gross Profit for 1948 (Schedule 3)

Sales		$2,100,000
Cost of goods sold:		
Finished goods inventory 1/1	$ 90,000	
Cost of goods manufactured (Schedule 4)	1,900,000	
Total	$1,990,000	
Finished goods inventory 12/31	100,000	
Cost of goods sold		1,890,000
Gross profit		$ 210,000
Percentage of profit on sales		10

Computation of Cost of Goods Manufactured—1948 (Schedule 4)

Work in process 1/1			$ 146,600
Direct labor		$ 344,000	
Material used:			
Amount per books	$1,217,000		
Additional material cost that would have been charged to cost of goods manufactured except for the reduction of 110,000 pounds in the inventory at LIFO price of $.90 per pound.	70,400		
Material used at market prices		1,287,400	
Manufacturing overhead		302,000	1,933,400
Total			$2,080,000
Work in process 12/31			180,000
Cost of goods manufactured			$1,900,000

(Continued on following page)

Comments:

(a) The replacement price of goods destroyed would be the basis of the claim because the insurance provides for indemnity against loss measured at date of the fire.

(b) In the determination of the gross profit percentage for 1948, the effect on profit of having used 110,000 pounds of the December 31, 1947, inventory carried at $.90 per pound instead of using material at the average market price of $1.54 per pound has been eliminated. The problem states that sales price is responsive to changes in material cost; therefore, current cost must be used in determining a percentage for 1948 that would also be applicable to 1949.

(c) The following solution also would appear to be reasonable:

(1) Determine the 10% gross profit rate as in the prior solution.

(2) Determine cost of material used, at market, by the computation in Schedule 1 of the prior solution or by the following solution:

	Debit	Credit
Finished goods inventory	$ 100,000	$ 105,000
Work in process	180,000	175,000
Direct labor	132,400	
Overhead	117,600	
Cost of goods sold		738,000
Total	$ 530,000	$1,018,000
Cost of material used	488,000	
	$1,018,000	$1,018,000

(3) State inventories of materials and purchases at market and the following computation results:

Inventory 1/1/49—420,000 @ $1.60	$ 672,000
Purchases @ $1.61	551,425
Total	$1,223,425
Cost of material used—computed	488,000
Inventory 3/30/49	$ 735,425
Salvage value of damaged material	25,000
Amount of insurance claim	$ 710,425

This may be reconciled with the prior solution by the following computation:

Amount determined by use of market prices	$710,425
Add:	
$.02 per pound for 420,000 pounds on hand 1/1/49 (bringing this up to present market of $1.62)	8,400
$.01 per pound for 39,394 pounds acquired during the period (bringing this up from $1.61 to $.162 per pound)	393
Corrected amount of insurance claim	$719,218

No. 4 (18 points)

CITY OF M

FUND BALANCE SHEET—JUNE 30, 1949

	Total	Current Fund	Endowment Fund	Water Fund	General Property and Indebtedness
Cash	$ 2,873	$ 2,373	$ ...	$ 500	$ ...
Taxes receivable	36,690	36,690	...	...	...
Accounts receivable	13,584	...	...	13,584	...
Investments	42,000	...	42,000	...	...
Prepaid expenses	5,374	...	...	5,374	...
Fixed assets	710,465	...	...	169,964	540,501
Total	$810,986	$39,063	$42,000	$189,422	$540,501
Warrants payable	$ 46,970	$38,220	$ ...	$ 8,750	$ ...
Bonds payable	480,000	...	...	90,000	390,000
Reserve for depreciation	25,800	...	...	25,800	...
Estimated loss on taxes	...	4,850[1]	...	...	...
Due other governments	...	4,300[1]	...	...	...
Surplus (or balance of fund)	258,216	[843 (9,150)][1]	42,000	64,872	150,501
Total	$810,986	$39,063	$42,000	$189,422	$540,501

[1] Adjustment for items not on books.

CITY OF M

ANALYSIS OF CURRENT FUND SURPLUS——YEAR ENDED JUNE 30, 1949

Balance June 30, 1948 (see computation)			$48,310
Deduct—Provision for loss on taxes receivable as of June 30, 1948			6,608
Corrected balance June 30, 1948			$41,702
Deduct:			
Excess of expenditures over revenue:			
Expenditures (see computation)		$149,642	
Revenue (see computation)		77,010	
Total deduction		$ 72,632	
Less—Income transferred from endowment	$ 1,200		
Cash transferred from water fund	21,423	22,623	
Net deduction for year			50,009
Balance June 30, 1949 (deficit)			$ 8,307

Computations Supporting Analysis of Surplus

Determination of Balance June 30, 1948

Cash ($20,485–$500)	$19,985
Taxes receivable	54,200
Total assets per books	$74,185
Warrants payable ($30,900–$5,025)	25,875
Surplus June 30, 1948	$48,310

Determination of Expenditures

Per given data	$153,400
Deduct:	
Loss on taxes receivable included incorrectly	3,758
Corrected expenditures	$149,642

Note: The income from the endowment fund amounting to $1,200 might be deducted here rather than be added into the surplus analysis as a separate item.

(*Continued on following page*)

Determination of Revenue

Taxes assessed		$64,300	
Less—Allowance for loss and abatement		2,000	
Tax revenue			$62,300
Other revenue collected		$20,210	
Less—Amount included for endowment fund	$1,200		
Amount for other governments	4,300	5,500	
Other revenue			14,710
Total revenue			$77,010

Determination of Amount Transferred from Water Fund

Net profit reported	$ 9,307
Add non-cash expenses, etc.:	
Depreciation provision	8,500
Decrease in prepaid expenses	1,113
Increase in warrants payable	3,725
Total	$22,645
Deduct—Increase in accounts receivable	1,222
Cash transferred from water fund	$21,423

ACCOUNTING PRACTICE — PART II

November 17, 1949; 1:30 to 6 p.m.

No. 1 (20 points)

SCHEDULE OF BALANCE OF MACHINERY AND RESERVE FOR DEPRECIATION AS OF DECEMBER 31, 1948, AND DEPRECIATION EXPENSE FOR 1948
(Revised Basis)

Machine	Cost	Depr. per Year	Date Acquired	Date Sold	Years Owned to 12/31/48	Depr. to Date of Disposal or 12/31/48	Depr. for 1948
1	$ 5,240	$524	1/1/44	6/30/46	$2\frac{1}{2}$	$ 1,310	$ ...
2	4,000	400	1/1/44	10/1/48	$4\frac{3}{4}$	1,900	300
3	4,400	440	1/1/44	1/1/47	3	1,320	...
4	6,200	620	9/30/44		$4\frac{1}{4}$	2,635	620
5	7,840	784	6/30/45		$3\frac{1}{2}$	2,744	784
6	9,300	930	6/30/46		$2\frac{1}{2}$	2,325	930
Total	$36,980					$12,234	$2,634
Disposals of 1, 2 & 3	13,640					4,530	
Balance 12/31/48	$23,340					$ 7,704	

Comments:

(1) The cost of Machine 4 should include installation and freight, but should not include the finance or interest charge where purchased on the installment basis.
(2) The cost of Machine 5 is the net cost ($8,000 less 2%).
(3) In the absence of information as to the fair cash value of Machine 1 at date of trade-in, the allowance of $4,300 has been used in computing gain or loss.

GAIN OR LOSS ON SALE OF ASSETS
(Revised Basis)

Machine	Date of Sale	Cost	Accumulated Depreciation	Cash or Allowance	Expense of Sale	Gain on Sale	Loss on Sale
1	6/30/46	$ 5,240	$1,310	$4,300	..	$370	..
2	10/1/48	4,000	1,900	1,200	..	..	$ 900
3	1/1/47	4,400	1,320	2,500	$125	..	705
Total		$13,640	$4,530	$8,000	$125	$370	$1,605

COMPUTATION OF CASH RECEIVED FOR MACHINE 10/1/48

Balance of 12/31/48 equals 80% of balance before depreciation; therefore,
80% = $10,644.40
100% = $13,305.50
Balance of 1/1/48 of $14,505.50 minus $13,305.50 = $1,200 cash received for Machine.

(Continued on following page)

Analysis of Machinery Account [*Not Required*]
(*Per Books*)

Item	Amount
Purchases 1/1/44	$13,640.00
Four $600 installments starting 9/30/44	2,400.00
Transportation	200.00
Balance before depreciation 12/31/44	$16,240.00
Depreciation at 20%	3,248.00
Balance 1/1/45	$12,992.00
Eight $600 installments	4,800.00
Cash payment (gross amount) 6/30/45	8,000.00
Balance before depreciation 12/31/45	$25,792.00
Depreciation at 20%	5,158.40
Balance 1/1/46	$20,633.60
Cash paid 6/30/46	5,000.00
Balance before depreciation 12/31/46	$25,633.60
Depreciation at 20%	5,126.72
Balance 1/1/47	$20,506.88
Cash received	2,375.00
Balance 12/31/47 before depreciation	$18,131.88
Depreciation at 20%	3,626.38
Balance 1/1/48	$14,505.50
Cash received	1,200.00
Balance 12/31/48 before depreciation	$13,305.50
Depreciation at 20%	2,661.10
Balance 12/31/48	$10,644.40

Alternate Schedule (*See first schedule*)
Analysis of Machinery and Reserve Account [*Not Required*]
(*Revised Basis*)

	Machinery			Reserve								
					Credits							
Mach.	Debits	Credits	Balance 12/31/48	Date Acquired	1944	1945	1946	1947	1948	Total	Debits	Balance
1	$ 5,240	$ 5,240	...	1/1/44	$ 524	$ 524	$ 262	..	..	$ 1,310	$1,310	..
2	4,000	4,000	...	1/1/44	400	400	400	$ 400	$ 300	1,900	1,900	..
3	4,400	4,400	...	1/1/44	440	440	440	..	..	1,320	1,320	..
4	6,200		$ 6,200	9/30/44	155	620	620	620	620	2,635		$ 2,635
5	7,840		7,840	6/30/45		392	784	784	784	2,744		2,744
6	9,300		9,300	6/30/46			465	930	930	2,325		2,325
Total	$36,980	$13,640	$23,840		$1,519	$2,376	$2,971	$2,734	$2,634	$12,234	$4,530	$7,704

No. 2 (30 points)

	Department 1 Process A			Department 1 Process B			Department 2		
	Finished Unit Equivalents	Cost	Cost Per Unit	Finished Unit Equivalents	Cost	Cost Per Unit	Finished Unit Equivalents	Cost	Cost Per Unit
Material	25,000	$ 4,250	$ .17	34,000	$ 2,720	$ .08		...	..
Labor	24,700	13,832	.56	34,600	14,878	.43	515	$ 53,560.00	$ 104.00
Overhead	24,700	13,832	.56	34,600	14,878	.43	515	80,340.00	156.00
Total		$31,914	$1.29		$32,476	$ .94		$133,900.00	$260.00
From prior department		...		34,000*	31,008	.912	450*	66,024.00	146.72
In process 10/1		1,284			5,384			70,001.20	
Total cost		$33,198	$1.29		$68,868	$1.852		$269,925.20	$406.72
Distribution of cost:									
In process 10/31		$ 2,190			$ 2,844			$ 49,475.20	
Completed units:									
In process 10/1—									
Balance 10/1		$ 1,284			$ 5,384			$ 70,001.20	
Cost to complete		1,344			1,376			32,500.00	
Started this month		28,380			59,264			101,680.00	
Shrinkage		...			...			16,268.80	
Total completed	24,000	$31,008	$1.292	36,000	$66,024	$1.834	500	$220,450.00	$440.90
Less—Units not transferred		...			...		100	44,090.00	
Total transferred		$31,008			$66,024		400	$176,360.00	
Total Cost		$33,198			$68,868			$269,925.20	

* The units transferred from process A amounting to 24,000 pounds were increased by the addition of 12,000 pounds in process B and decreased by 2,000 pounds lost in the process. The 36,000 pounds completed in department 1 amounted to only 450 units in department 2 because 80 pounds of the product of B are required to make one unit in department 2.

(*Continued on following page*)

Computation of Finished Unit Equivalents

Department 1

No. 1 Process A

		Material		Labor and Overhead	
	Units	*Amount Done This Month*	*Equivalent to Finished Units*	*Amount Done This Month*	*Equivalent Units*
In process 10/1	2,000	0	0	3/5	1,200
Started and completed	22,000	100%	22,000	100%	22,000
Total completed	24,000				
In process 10/31	3,000	100%	3,000	50%	1,500
Total	27,000		25,000		24,700

No. 1 Process B

		Material		Labor and Overhead	
	Units	*Amount Done This Month*	*Equivalent to Units*	*Amount Done This Month*	*Equivalent Units*
In process 10/1	4,000	0		2/5	1,600
Started and completed	32,000	100%	32,000	100%	32,000
Total completed	36,000				33,600
Shrinkage—not completed	2,000**	0		0	
In process 10/31	2,000	100%	2,000	50%	1,000
Total	40,000		34,000		34,600

Department 2

		Labor and Overhead	
	Units	*Amount Done This Month*	*Equivalent Units*
In process 10/1	250	50%	125
Started and completed	250	100%	250
Defective units	40	100%**	40
Total completed	540		415
In process 10/31	160	5/8	100
Total	700		515

** The shrinkage in process B of department 1 takes place during the process; therefore, the units lost are treated as though they were never started in the process, thereby assigning their cost proportionately over both the units left in process and the units completed. The units lost in department 2 were lost after completion in the department; therefore, cost is computed for them, which cost is all assignable to the good units completed.

(*Continued on following page*)

COMPUTATION OF COST OF WORK IN PROCESS

	Material	Labor	Overhead	Cost From Prior Department	Total Cost
Department 1—A:					
Equivalent units	3,000	1,500	1,500	.....	
Cost per unit	$ .17	$ .56	$ .56		
Amount	510	840	840	.....	$ 2,190.00
Department 1—B:					
Equivalent units	2,000	1,000	1,000	2,000	
Cost per unit	$ .08	$ .43	$ .43	$ .912	
Amount	160	430	430	1,824	2,844.00
Department 2:					
Equivalent units	.....	100	100	160	
Cost per unit	.....	$ 104	$ 156	$ 146.72	
Amount	.....	$10,400	$15,600	$23,475.20	49,475.20
Total					$54,509.20

SUMMARY OF COST AND INVENTORIES

Inventories 10/31	
In process Department 1—A	$ 2,190.00
In process Department 1—B	2,844.00
In process Department 2	49,475.20
Completed and on hand—Dept. 2	44,090.00
Total	$ 98,599.20
Transferred to finished	176,360.00
Total	$274,959.20

Cost To Be Accounted For	
In process 10/1	$ 76,669.20
Material	6,970.00
Labor	82,270.00
Overhead	109,050.00
Total	$274,959.20

THEORY OF ACCOUNTS

November 17, 1949; 9 a.m. to 12:30 p.m.

GROUP I

No. 1 (15 points)

(a) (1) A contingent liability exists as to federal income taxes whenever there is a controversy between the taxpayer and the Bureau of Internal Revenue involving the amount of taxes due, and where the controversy may result in the taxpayer having to pay more tax than has been provided for in the accounts or included in returns filed. Where a taxpayer is preparing financial statements for a part of a year or for a year not coinciding with the taxable year, the liability shown on the statements may be considered to be contingent upon future earnings and possible retroactive changes in tax rates, etc.

(2) Suits at law frequently give rise to a contingent liability to the extent that, if the case is decided against you, a liability must be recognized. Such suits may be for damages resulting from personal injury, from contracts, patent infringement, or violation of various laws.

(3) The liability existing under product guarantee is contingent upon the product proving to be defective and upon a claim being made against the guarantor. Usually the extent of the possible liability is defined in the guarantee; however, there are certain warranties that may exist with or without a guarantee that create a contingent liability.

(4) An accommodation endorsement is the signing of a negotiable instrument by a person who does not receive value therefor. Usually it is a means of "lending your credit" to another person. Such an endorser is liable for payment of the instrument if the maker or drawer does not pay it. While he has a contingent asset (he may attempt to collect from the persons primarily liable), it is not considered to offset his possible liability.

(5) A contingent liability exists under purchase orders that have been accepted by the vendor until such time as one party has either performed or has breached the contract, thereby causing the contingent liability to cease. In the case of the vendor, his liability is to deliver the goods or services, while in the case of the purchaser, the liability usually is to make payment. There is always a contingent asset consisting of the rights against the other party.

(6) A contingent liability exists in connection with mortgaged land which has been sold unless the mortgage note has been paid or unless the holder of the note has released the original maker. In borrowing on a property, the mortgage is for the purpose of affording security to the lender, but the debt is usually evidenced by a note on which the maker is liable. If the note is not paid at maturity and the property upon sale does not bring enough to settle the debt, the maker can be required to pay the deficiency.

(b) (1) Usually an attempt is made to estimate as nearly as possible the tax liability existing at statement date and to provide for it by setting up a current liability. However, where there is no reasonable certainty as to the amount of liability, a footnote is ordinarily used to disclose the existence of possible additional liability, if such liability might be material in amount. Frequently the amount set up is identified as Provision for Estimated Taxes or, by the use of some similar wording, the reader of the statement is informed of the uncertainty as to the final amount that will have to be paid.

(2) The contingent liability existing because of possible court awards against you is usually so indefinite that a footnote disclosure of the existence of the suit constitutes adequate statement presentation. However, where it seems probable that there will be some award made against you, an appropriation of surplus (or in certain situations an appropriation charged against income) may be made and identified as a Reserve for Contingencies or identified in some similar manner as an estimate of possible losses.

(3) Ordinarily the liability in connection with the guarantee of products is not sufficiently material in amount to require specific disclosure. That such liability exists in certain business areas is or should be recognized by the persons reading financial statements. Where there is an obligation to service products or replace them over a period of time, an amount may be set up in the liabilities to cover the possible cost of such servicing. If the liability is unusual, either for the type of business or because of the amount involved, a disclosure by use of a footnote would be adequate.

(4) The contingent liability under an endorsement would be disclosed by a footnote if the amount is material.

(5) The contingent liability existing under purchase orders is normally not reflected in financial statements. However, if the commitment is unusual in amount or period of performance, a full disclosure by the use of a footnote would be required. If a loss appears to exist as of the date of the financial statements, a charge against income should be made to provide for such loss.

(6) The contingent liability existing on a note given and still outstanding in connection with property which has been sold should be disclosed if there is a possibility of a loss resulting from the transaction. A footnote would be adequate.

No. 2 (10 points)

Accounting records, which are prepared in accordance with numerous principles and conventions, do not necessarily produce values that are current market values. The sale value of a business is presumably largely determined through capitalization of earning capacity, whereas book values are usually based on cost less amortization for the portion of cost that has expired. As a result of this convention of recording and continuing to carry assets at cost, they may be carried at amounts substantially different from the amount that would be determined by capitalization of their earning power.

Accounting conventions tend to prevent the recording of certain resources at any value. An example might be the value of an organization of capable and loyal employees. Such a resource is not recorded in the records, but to a purchaser of a business it may be a valuable item for which he willingly pays when buying the business. Also certain accounting practices arising from conservation may produce a substantial undervaluation of assets. The rule of providing for possible losses, but anticipating no gains, may result in undervaluation of assets. Practices such as capitalizing only substantial expenditures while charging to expense all minor and doubtful items may produce undervaluation of assets. Also, accounting entries frequently must be based on estimates. Subsequent events may establish that these estimates were in error.

Accounting does not purport to measure present market value of most individual assets and, even if it did, a going business may have some value apart from that assignable to the individual assets owned by it. The "goodwill," or reputation of a business with its customers, which enables it to earn an amount in excess of a normal return is frequently not on the books, but may have a sale value. Individual estimates of future earnings are another factor which may create diffierences between the sale price of a business as a unit and the book value. A similar factor is variation in the rate of return desired by different individuals.

No. 3 (10 points)

a. The usual items that would be included in material acquisition and handling cost in addition to invoice cost, commissions, duties, etc., are: Purchasing, Freight, Trucking, etc., Receiving, Inspection, Insurance, Storekeeping and Storeroom expense.

b. From a purely theoretical standpoint, the cost of material in a stores inventory should include all reasonable and necessary costs incurred in getting the material into the storeroom. It is logical to assume that when a business makes expenditures to purchase, receive, inspect, and store materials, the value of the materials to the business is expected to be at least equal to the costs so incurred. To treat purchasing, transportation, receiving, inspection, and storage as costs of the period in which they are incurred, even though the material for which the expenditures were made are still on hand, and even though it would cost as much to replace them as was spent, is no more justified on theoretical grounds than would be the pricing of the material at less than the vendor's invoice price. The acquisition and handling costs incurred up to point of material issuance are expenditures for the benefit of future production, having the same rank as does the vendor's invoice price, and as such could be considered as attaching to the material acquired.

c. However, there are numerous reasons why such costs are not usually added to the material cost. Some of these costs, such as purchasing, have some tendency to be fixed costs, and in periods of relative inactivity, there might be a substantial increase in the cost of making each purchase, thereby creating a serious question as to the total valuation of the inventory. A second practical difficulty is the assignment of cost to the individual items in the inventory. Some basis for allocation must be selected, and all of the acquisition and handling costs may not be logically assignable on the same, or on any, basis. Value, weight, and size are examples of such bases, but none of them is equally logical for all of the various costs. Purchasing, for example, might be best apportioned on the basis of the number of orders written, while cartage might be best apportioned on a weight basis, and storing might be apportioned on an area basis. A third difficulty may be encountered when issuing material from stores. The addition of cost to the invoice price will require additional computations and increase chance of error where pricing out issues is done by any procedure other than the weighted average method. A fourth practical consideration is the difficulty encountered in pricing a physical inventory on a basis consistent with the book inventory where the book inventory includes non-invoice costs.

Additional arguments against the inclusion of such costs are: The amounts are not often significant, and especially where there is a high turnover rate; the effect on the financial statements is negligible; the accurate accumulation of the type of cost involved is an expensive procedure requiring, at least in the cases of stores personnel, a split between costs incurred in issuing and costs incurred prior to issue; the addition to inventory of such costs is considered by some persons not to be sufficiently conservative; and, finally, it may be argued that selling, engineering and designing, production planning, accounts payable accounting, and perhaps in some situations other costs, are likewise incurred prior to material usage, but that these costs are not "inventoried" and there is no logical reason for inventorying a special group that relate more closely to material.

No. 4 (15 points)

a. *Common Treatment*

(1) Purchase discounts are usually considered as an income (or decrease of costs) of the period in which they are taken; however, under some systems they may be included in income when the invoice is recorded.

(2) Selling expenses are usually treated as expense of the period in which they accrued.

(3) Plant rearrangement costs are frequently charged over the period of the job for which they were incurred, if for a specific job. Otherwise, they are usually charged to expense of the period in which they were incurred.

b. *Matching of Costs with Revenue*

(1) Purchase discounts are a cost saving and not an income, and to the extent that the materials to which they relate are unsold at balance-sheet date, their treatment as income does not result in matching costs and revenue. While ordinarily the variation from year to year may be small enough not to be substantial in relation to the operation of the business, there is a continual anticipation of profit resulting from considering purchase discounts as income.

(2) To the extent that selling expenses have been incurred in one period for the benefit of a future period, the usual method of treatment results in understating income through the absorption of too much cost against the revenue of the period. The difficulty of determining the amount to be carried into future periods, and the questionable value of such procedure for many purposes, are the reasons usually advanced for treating the total of the selling expenses as "period costs."

(3) Where plant rearrangement costs are identified with a job and spread over that job, there is excellent matching of costs and revenues. Where such expenditures are general in nature and made for the purpose of improving efficiency, there may be reason to defer them over some future period. However, it can be argued that this expenditure is the result of inefficiency in the original installation, the cost of which was capitalized, and that the additional cost makes good the loss originally incurred but not recognized. This argument results in the conclusion that the original cost should be written off when it is determined that there was a loss and that the new cost should be capitalized.

If there has been a major rearrangement caused by new developments or technology, it appears logical to defer the cost and write it off over the revenues that are received in the future.

GROUP II

No. 5 (12½ points)

a. (1)-(b) $25,250.

Her trust income will include the appropriate proportion of $25,250 in respect of dividends. All of the income of the trust is "currently distributable" to B even though the trust instrument provides for payments "in at least quarterly installments" (*Charles S. Barrett, Jr.*, P.H.T.C. Mem. Par. 39.536 (12-12-39)), and the net income is thus taxable to B. All the $25,000 in cash dividends is taxable as is the value of the 25 Y shares. Even though the stock dividend was non-taxable in the hands of the trustee, the value of those shares must be included in B's taxable income when distributed to her as current income of the trust under state law. (*McCullough* v. *Commissioner*, 153 F. (2d) 345 (CCA 2, 1946)).

(2)-(b) $7,500.

Her trust income will include the appropriate proportion of $7,500 interest. The interest on the direct obligation municipal bonds is exempt from federal income tax (IRC, 22 (b) (4)), and retains its exempt character when distributed to the beneficiary. (IT. 2067 III-2 Cum. Bull., 78 (1924)). All the income being "currently distributable" is taxable to B and deductible by the trust.

(3)-(a) Long-term capital gain of $600.

Her trust income will include the appropriate portion of long-term capital gain of $600. The capital gain, being "currently distributable" income, retains its character when distributed to B. (*Commissioner* v. *Hopkinson*, 126 F. (2d) 406 (CCA 2, 1942)). The fact that B received the $600 in 1949 does not make that receipt taxable to her in 1949 because the trustee, having determined in 1948 to distribute it to her and, the income of the trust being "currently distributable," it is immaterial for tax purposes whether the income is actually distributed.

b. (1)-(a) $2,250.

Crane v. *Commissioner*, 331 US 1 (1947); *cf. Southeastern Building Corporation* v. *Commissioner*, 148 F. (2d) 879 (CCA 5, 1945), *cert. den'd*, 326 US 740 (1945).

(2)-(c) $13,600.

IRC 23 (c) (1). The $2,000 special assessment is not deductible. IRC 23 (c)(1)(E).

(3)-(d) 0.

General Utilities & Operating Co. v. *Helvering*, 296 US 200 (1935).

(4)-(d) 0.

IRC 24 (b)(1)(B).

No. 6 (12½ points)

The arguments against the retirement method are generally the same as those for depreciation reserve. Specifically, in answer to the arguments presented for the retirement method, they are as follows:

1. The mere fact that there are a large number of more or less similar units of property does not prevent the units from depreciating. While the loss of value may be obscured by the complexity of the entire property, it is nevertheless a real loss, as can be determined by considering each unit individually.

2. Historically, the theory of continuous and perpetual life for railroad or utility property is not borne out. Even if it were, it would not remove the fact that the property is always partly consumed and that such condition should be reflected in the accounts.

3. While estimates of service life are difficult to make, there has been enough experience with most kinds of property to enable competent persons to make reasonable estimates of service life. Such estimates are more likely to produce reasonable charges against revenue than will be produced by the use of replacement costs, which vary due to a large number of conditions, both physical and non-physical.

4. In the early years of the life of a property there are few retirements made and very little maintenance is required; therefore, there will be an overstatement of earnings if the retirement method is used.

No. 7 (12½ points)

The agreement providing for distribution of the profits of a partnership on the basis of the average capital of the partners is an equitable method in situations where the amount of personal service of the partners is a comparatively insignificant factor in the creation of profits. In such a case, because the amount of profit is determined primarily by the amount of capital in the enterprise, the average capital basis is appropriate. Even in instances where personal services by the members of the firm are a material factor in the business, average capital may be an equitable basis if the ratios of capital of the partners are the same as the ratios of the value of their personal service to the firm.

However, in general the profits of a partnership are the result of three elements. Part of the profits may be considered to be the result of the services of the partners; a second part may be considered as a return on the capital invested; and the remainder may be "true profit" in the economic sense of a return for the enterpriser. The distribution of profits on an average capital basis fails to take account of value of services and "true profits." It also is subject to the defect of not being quickly and easily computed and may not be fully understood by some partners. Unless provisions are made restricting withdrawals and additional investments, one or more partners may make large additional investments during a profitable year and/or withdraw large amounts during unprofitable years, thereby distorting the ratios and also causing the firm to have unnecessary capital or to be short of needed capital.

No. 8 (12½ points)

Before including a company in the consolidation, the following conditions must exist:

1. There must be effective control by the parent over the operations of the subsidiary. Such control is usually obtained through voting control but may be obtained through lease or other methods. This requirement is consistent with the theory of ignoring the separate legal entities and treating the companies in the consolidation as though they were a single operating unit.

2. The type of business of the parent and of the subsidiary must be similar and preferably identical or complementary. You would not consolidate a commercial bank and a manufacturing company because the consolidated figures would have no significance.

3. There must be sufficient equity ownership to prevent the minority position from being a major item on the consolidated statements. Accountants are reluctant to consolidate if there is more than a 25 per cent minority interest present, even where the dollar amount of the minority interest is not substantial in relation to the totals. If the minority interest is relatively large in dollar amount, more than a 75 per cent interest may be considered essential. This is consistent with the basic assumption in a consolidation, which is that the subsidiary's assets are in effect 100 per cent owned by the parent. A "correction" for lack of such ownership is made by the use of a minority account. If this "correction" is too large, the basic assumption is unsound.

4. There should be free flow of funds and goods between the parent and a consolidated subsidiary. If the subsidiary is in a country where transactions are "blocked" or restricted, it is fallacious to consider the subsidiary as a part of an economic entity such as consolidating implies it to be.

5. The individual statements should be prepared approximately as of the same date for all companies going into the combined statements. While some exceptions may be made as to minor subsidiaries, a consolidated statement is for a specific period or as of a definite date, and the components of that statement must be on the same basis if the statement is to be significant.

6. The consolidation must not show a material improvement in the financial condition of the parent as compared with the condition shown by its separate statement, unless a separate statement is also presented. To present only a consolidated statement in such a situation misleads the stockholders as to the position occupied by the company in which they have their investment.

No. 9 (12½ points)

The manufacturing company has four possible values to be considered. These are:

Stated value of stock issued	$125,000
Market value of stock issued	225,000
Par value of stock received	200,000
Market value of stock received	180,000

Except in the case of a newly organized corporation, the par or stated value of its stock is ordinarily not a satisfactory basis for use in recording assets acquired by a corporation through the issuance of stock. The stock acquired by the manufacturing company should be recorded at its "cost." This "cost" might be measured by either the fair market value of the stock received or by the fair market value of the thing given in exchange for it. In this case there is a discrepancy of $45,000 between the apparent value of the stock issued and the stock received. Such difference may arise because the market values, as given, would not hold for large purchases and sales. If the manufacturing company were to try to sell 5,000 shares of stock, it might well have to take less than $45 per share. Likewise, the buying of 2,000 shares of the supply company stock publicly might force the price of that stock up, with the result that the manufacturing company would have to pay more than $90 per share. Presumably the fair cash price of the stock acquired and of the stock issued is thought to be about the same; however, because of the manufacturing company's belief that it would gain some business advantage from ownership of the stock, it may have knowingly paid more than the fair market value of the stock it is to acquire.

In arriving at a decision, the reasoning of the manufacturing company's officials should be determined and given weight in setting the value to be placed on the stock acquired. If there is evidence that they could have sold their 5,000 shares of stock at $45 per share, it appears that the "cost" was $225,000 and the investment should be charged with that "cost." If the probable value of the stock issued was less, the lower value should be used as "cost." Because this is presumably a long-term investment, the market value of the stock acquired need not be given much weight in determining the valuation to be used.

AUDITING

November 18, 1949; 1:30 to 5 p.m.

GROUP I

No. 1 (12 points)

(a) The accountant should study the inventory instructions issued by the company. He should be present when the physical inventory is taken and recorded. He should observe the determination of quantities, and physically test the quantities. A record may be kept of certain items for later comparison with the detail inventory sheets.

(b) The inventory tags should be tested against the inventory summary sheets, and the grand summary of the inventory should be proven against the inventory summary sheets.

(c) He should see that all inventory tags are accounted for.

(d) The extensions and footings of the inventory sheets should be tested.

(e) Quantities of some of the items should be compared with the perpetual inventory records. Discrepancies should be accounted for and adjusted.

(f) Prices used in accumulating the value of the inventories should be compared with current invoices or quotations.

(g) He should ascertain that sales billed to customers, but on hand pending delivery, have been excluded from inventory.

(h) He should ascertain that damaged and obsolete goods are priced at an amount not in excess of their net realizable value, and investigate to ascertain that the quantities of obsolete and damaged goods are not unreasonable in relation to the total inventory.

(i) He should investigate to determine whether the inventory is pledged as loan security.

(j) The inventories at the beginning of the year and at the end of the year should be valued on the same basis. If a change in valuation method has taken place, the effect on profits should be determined and the situation should be explained in the audit report.

(k) The factory cost system should be investigated in order to determine its adequacy in producing accurate costs. Each element of cost for the current year should be compared with each element of preceding years. Tests should be made of the correctness of labor, material, and overhead charges going into work in process.

(l) Inventory carrying values should be compared with the cost of production records.

No. 2 (10 points)

(a) An examination of the minutes of the meetings of the board of directors and the executive committee, if one exists, may provide information as to retirement of fixed assets. Checking these authorizations to the retirement per books affords some check on the existence of unrecorded retirements.

(b) Frequently it is possible to make tests of the physical existence of fixed assets. Such tests may disclose unrecorded retirements.

(c) Examination of additions completed or in process may, if compared with recorded retirements, reveal the existence of unrecorded retirements.

(d) Examination of scrap income or miscellaneous income entries may lead to information regarding the sale or scrapping of retired assets.

(e) Consideration of changes in products and production methods may offer clues as to the abandonment of fixed assets formerly needed but now not used or useful.

(f) Analysis of maintenance expense may indicate changes in assets in use, particularly if certain maintenance expenses cease abruptly.

(g) Examination of tax bills may indicate the abandonment or possible sale of fixed assets.

(h) Abandonment, sale, or partial abandonment of major items of fixed assets may be indicated by changes made in insurance policies covering the assets.

(i) Scrutiny of the cash receipts book, especially for unusual items, may reveal sale of assets which have not been recorded as retirements.

(j) Requesting a representation from responsible officials of the client covering the existence and usefulness of the assets shown by the books may result in the disclosure of unrecorded abandonment of fixed assets.

No. 3 (15 points)

(1) Interest expense	$1,200.00	
Prepaid expenses and deferred charges		$1,200.00
To remove the total interest cost from the prepaid expenses and deferred charges account, and to set the total in an interest expense account.		
Prepaid interest	1,000.00	
Interest expense		1,000.00
To record the interest prepaid from December 31, 1948, to October 31, 1949.		

To audit: Obtain a letter of confirmation from the First National Bank covering the note and terms.

(2) Miscellaneous expense	476.20	
Prepaid expenses and deferred charges		476.20
To remove the charge to the account and transfer it to expense. (*Note:* A charge to surplus would be acceptable if income would be distorted by the charge to expense.)		

To audit: Reconcile the accounts receivable controlling account with the sum of the accounts receivable subsidiary balances.

(3) Loss from flood damage	4,765.00	
Prepaid expenses and deferred charges		4,765.00
To charge the flood loss to 1948 operations.		

To audit: Examine and investigate each individual item composing the total of $4,765; in the audit, care must be exercised to be certain that these losses resulted from the flood and that capital expenditures are not included in the charges.

(4) Unamortized bond discount	$5,000.00	
Prepaid expenses and deferred charges		$5,000.00
To remove the total bond discount and segregate it in the unamortized bond discount account.		
Bond discount amortized	250.00	
Bond discount amortized	250.00	
Unamortized bond discount		500.00
To charge off one-tenth (2 years) of the unamortized bond discount. The straight line method of amortization was employed. (A charge to surplus for the 1947 amortization would be acceptable if the charge to expense would distort income.)		

To audit: Examine the bond contract; verify the cash received from the issuance of the bonds on January 2, 1947, $195,000.

(5) Legal expense	$800.00	
Prepaid expenses and deferred charges		$800.00
To remove a revenue charge; the amount should not be deferred, as the costs were not incurred in connection with a corporate organization.		

To audit: Examine the payment vouchers, canceled check, and invoice from the attorney.

No. 4 (13 points)

The computation of taxable income and federal income-tax expense should be as follows:

Income per books, before federal income taxes		$64,000
Add:		
Provision for inventory reserve	$4,000	
Excess of book depreciation over allowable depreciation on machinery and equipment	2,500	
Provision to the reserve for bad debts	2,000	
Prior year real estate taxes refunded	2,000	10,500
		$74,500
Deduct:		
Bad debts charged off	1,500	
Book profit on sale of equipment	500	2,000
Income subject to income tax		$72,500
Tax thereon		$27,550

Comments

1. The company, on the charge-off basis for bad debts, is required to add back to book

income the provision of $2,000 to the reserve and may deduct the $1,500 of actual charge-offs.

2. The prior years' real estate taxes refunded of $2,000 credited to surplus constitutes taxable income of the year.

3. The excess reserve for contingencies credited to surplus in the amount of $15,000 does not constitute taxable income since provisions to such reserves are not deductible.

4. Since the company's rate of depreciation for tax purposes is half the book rate of 10 per cent, there is no profit on the sale of equipment to be considered for tax purposes.

No. 5 (10 points)

The verification work can conveniently be divided under two headings. These consist of tests of records for the year to determine that the account has been charged or accredited with proper amounts in accordance with the stated policy, and of tests to determine the reasonableness of the balance of the account at the end of the fiscal year.

The following steps would be appropriate for determining the correctness of the entries for the year.

1. Prepare summary analysis of the account for the year.

2. Tie in the credits to the account with the debits to expense, or with the debits to sales if the $5 provision is treated as a reduction of sales price.

3. Obtain from sales statistics the total number of machines sold, proving the credit to the reserve against this number of machines at $5 each.

4. Test the debits to the account by checking charges to work orders in instances where the company did the work, and test some work order charges on back to labor records and part requisitions. Determine the consistency and the reasonableness of any overhead charged to repair orders. Test freight charges as shown by the detail records into cash disbursements. For payments made to dealers under the guarantee, vouching of a reasonable number of payments and the determination that all payments have been approved by the proper company employee should be adequate verification.

For determining the adequacy of the reserve balance, the following procedures would be followed:

1. Determine the number of machines serviced and the cost of servicing for each of the past five years. Using these data determine the average cost per machine for each year.

2. Prepare an analysis of machines serviced in 1948 as to date of sale. Using these figures and the unit sales for each of the past six years, determine the percentage of machines sold that required servicing within 1, 2, 3, 4, and 5 years after sale.

3. Apply the percentages determined in step 2 to sales for the five years ending December 31, 1948, to determine the probable number of units that have been sold to date, which will require servicing within the next five years.

4. Inquire as to recent design changes or other innovations which might give rise to unusual service charges in the future.

5. Using the cost per unit for 1948 and making allowance for the trend of cost, if any is shown in step 1, compute the cost that will probably be incurred under existing guarantees.

6. Compare the amount determined in step 5 with the balance in the account December 31, 1948, to determine the reasonableness of the reserve balance.

GROUP II

No. 6 (10 points)

1. In the auditing of cash in bank it is usual to obtain a confirmation of the bank balances from the depositories. The inclusion in these requests of information as to any obligations of the client to the bank would disclose any unrecorded obligations to these banks.

2. Obtaining a bank statement subsequent to balance-sheet date and examining it would disclose any payments made of notes, which payments are not recorded in the cash book, while scrutiny of recorded transactions subsequent to balance-sheet date may disclose the payment of unlisted notes for which payments have been recorded.

3. Scrutiny of cash receipts and cash payments records for the last month of the year and examination for test periods within the year may reveal large receipts or payments in connection with unrecorded notes.

4. The counting of securities gives the auditor assurance that none of them is hypothecated in connection with unrecorded notes. The vouching of purchases and sales of securities also would disclose whether obligations had been properly recorded in the past.

5. In connection with inventory verification, the examination of purchase transactions prior and subsequent to balance-sheet date

would disclose purchases for which unrecorded note obligations were given.

6. In connection with verification of fixed asset additions, vouching the purchases and examination of contracts might disclose unrecorded notes or mortgages.

7. In connection with verification of prepaid interest and accrued interest and the tie-up of these accounts with interest expense, the existence of unrecorded notes or mortgages may be disclosed.

8. The inspection of insurance policies or of copies thereof might disclose the existence of a mortgage through the inclusion of the mortgagee's name in the policy.

9. The inspection of tax receipts covering property taxes may give an indication of the existence of a mortgage.

10. In connection with accounts payable verification, the examination of unusual debits might disclose notes or mortgages payable originating through accounts payable.

11. Obtaining confirmation of large, old, or unusual accounts payable might disclose notes held by those creditors.

12. Corresponding with the client's attorney regarding litigation and contingent liabilities might disclose the existence of notes or mortgages payable.

13. Reading the minutes of the board of directors meetings might disclose unrecorded notes or mortgages payable.

14. Examination of various contracts and agreements might disclose the existence of notes or mortgages payable.

15. In proprietorships or closely held corporations, the examination of the personal or drawing accounts of the owners might disclose the existence of notes.

No. 7 (10 points)

a. *Wages:* The accountant should familiarize himself with the system used to pay the employees. He should investigate the accuracy of the system of internal control covering the payroll procedure. Payrolls should be approved by properly authorized officials. He should ascertain that employment records exist for new employees and that records are kept of dischargees and changes in wage rates. A test period should be selected, and the time-clock records compared with the payroll record; extensions and footings must be checked, and the amount of the payroll checked to the cash disbursements records. A check of rates against any existing wage contract should be made. The accountant should trace the disposition of unclaimed wages. The accountant may watch one or more pay-offs of employees and might watch the clocking in and out of employees. The accountant might reconcile the wages with the federal insurance contributions (old age benefits taxes) and with the federal and state unemployment compensation taxes.

b. *Sales Allowances:* The accountant should ascertain that allowance memoranda are properly approved, and that an allowance voucher cannot be reused. All correspondence pertaining to the allowance should be examined. The sales allowances should be totaled, traced to the general ledger, and the entries should be checked to the accounts of the customers. The accountant should be alert to determine that deposits in the bank and credits to the accounts of customers do not match, which might indicate that allowance charges had been passed to a customer who actually had paid his balance in full and the proceeds misappropriated.

No. 8 (10 points)

Because of the great number of transactions of small amounts involved, the audit of the income from guest rooms of large transient hotels is usually restricted to an investigation of the internal control, with only such actual examination of the records as will convince the auditor that the system of internal control is properly carried out. Where internal control is not adequate, the audit procedure would be extended. Such an examination, assuming adequate internal control, should include:

(1) Comparison of the room count sheets (prepared by the night clerks from the room rack) with the list of room charges recorded on the transcript of guests' accounts or—where machine bookkeeping is used—with the machine tape and record of machine totals (prepared by the night auditors).

(2) Comparison of the room count sheets with the housekeeper's report of occupied rooms. The auditor should ascertain whether this is a regular internal audit procedure and whether all discrepancies are promptly investigated and the explanations recorded.

(3) Examination of the record of charges for part-day occupancy of rooms (day rates), and the tracing of such charges to the room count sheets.

(4) Make tests to determine that allowances and complimentary rooms are properly authorized.

(5) Proving of the totals of the room count sheets and the checking of the daily totals to the income journal.

(6) Proving of the totals of the "room sales" column of the income journal and checking to the general ledger.

(7) Testing the correctness of the daily and monthly statistical calculations of percentage of occupancy, percentage of double occupancy (percentage of the excess of number of persons accommodated over the number of occupied rooms, to the number of occupied rooms), and the average room rate obtained.

As to the extent of any part of such an examination, the auditor should be guided by the period covered by the audit and by the condition of the records.

No. 9 (10 points)

1. Election of directors.
2. Election of officers.
3. Setting salaries and establishing bonus systems for officers.
4. Setting salaries of various employees.
5. Establishment of general pension systems, insurance systems, and employee profit-sharing systems.
6. Approval or selection of depositaries.
7. Designation of officers or employees empowered to sign checks.
8. Authorizations for obtaining lines of credit and for borrowings.
9. Authorization for acquisition of assets.
10. Decisions as to basic changes in products or operating practices.
11. Decision to sell plants, or to sell entire business, or to reorganize or liquidate.
12. Decision to issue bonds or to retire bonds before their maturity.
13. Decision to purchase other companies.
14. Approval of plant write-down or write-up.
15. Approval of changes in depreciation policy.
16. Authorization of sale of stock.
17. Authorization of retirement of stock.
18. Authorization of reacquisition of stock.
19. Approval of major changes in accounting policies.
20. Declaration of dividends.
21. Appropriations of surplus.
22. Appointment of auditors.

No. 10 (10 points)

a. An insurance agent would be furnished with prenumbered policies in triplicate and with standard riders to be attached thereto. The original is given to the insured, one copy is sent to the company, and one retained by the agent. Agents are required to prepare daily reports for transmission to the company, which show policies written and policies canceled. The agent will retain a copy of this report. A monthly report or account current is prepared summarizing the transactions for the month. Agents will ordinarily have two card files in which the policies are listed, one being arranged by name of insured and the other by expiration date of policy.

b. The agent's liability to the companies for each month's business is presumably shown in the account current. These reports for the months immediately preceding the year end should be checked, and the remittances as shown thereon should be verified against a cash disbursement record. Confirmation of the balance due should be requested from the companies. Unused policies, as shown by the record of policies received and by the daily reports, should be accounted for unless internal control is good. Tests from card files to daily and monthly reports should be made to determine that the policies shown as in force by the card file were similarly reported to the companies as to amount, premium rate, etc. Refunds under canceled policies as reported to the companies should be tested to cash disbursements.

No. 11 (10 points)

1. Read minutes for ten months and extract important sections.
2. Tests could be made of the cash records including footings, postings, and computations of discounts.
3. Accounts receivable could be confirmed, ageing prepared or tested, and detail proved with control. Tests could be made of postings from cash and sales records. Unusual credits during the ten months could be investigated.
4. Taking of physical inventories could be observed, pricing tested, and tests of the cost system could be made. Tests of credits arising from shipments could be made.
5. Fixed asset accounts could be analyzed for the ten months and additions and retirements vouchered or otherwise tested.
6. Deferred charge accounts could be analyzed, charges vouched, and credits tied in with the related expense accounts.
7. Analysis and vouching of accrued liabilities such as taxes could be completed for the ten-month period.
8. Changes in fixed liabilities during the ten-month period can be determined and the examination completed as to such changes.
9. Analysis of stock and surplus accounts can be completed for ten months, all transactions being verified.
10. Income and expense accounts for the ten months can be scanned and otherwise verified to the extent that it is considered to be necessary to verify them.

COMMERCIAL LAW

November 18, 1949; 9 a.m. to 12:30 p.m.

GROUP I

No. 1 (10 points)

a. An agency is a relationship wherein one person, known as agent, acts for another, known as principal, in dealing with third parties. An agent is subject to the control and supervision of the principal who employs him. A principal is liable for the contracts and torts of an agent in the course of his employment.

An independent contractor is one who contracts to do something for another but is responsible to the latter only for the result, and has complete charge and supervision himself of the work that he does for the other. The person for whom he does the work is not liable for the torts or contracts of the independent contractor

b. An agency relationship may be created by:

(1) Appointment—that is, by contract.

(2) Ratification.

(3) Operation of law:

(a) Estoppel (acts of the parties, because of which they may not deny the relationship).

(b) Necessity. (*Example:* husband bound by his wife's purchase of necessities.)

Technically the result brought about by operation of law is not agency, because it is not based upon consent. However, the rights and duties created in this manner are those characteristic of the agency relationship.

c. Knowledge of the agent will not be imputed to the principal in the following situations:

(1) Where the subject matter of the notice is such that it is the agent's duty to some other person not to disclose it.

(2) Where the agent is acting adversely to his principal and entirely for another's purposes.

No. 2 (10 points)

a. A contract is an agreement based upon sufficient consideration to do or refrain from doing some lawful thing.

b. The essential requirements to make a contract enforceable at law are:

(1) The parties must have capacity to incur at least voidable contractual duties.

(2) There must be an agreement of the parties.

(3) There must be sufficient consideration.

(4) Performance of the contract must not violate any law.

c. Contracts calling for personal services may not be assigned.

d. The following contracts must be in writing in order that an action may be enforced thereon:

(1) Promise of administrator to pay damages out of his own estate.

(2) Promise to answer for debt, default, or miscarriage of another.

(3) Agreement made in consideration of marriage.

(4) Contract for sale of lands.

(5) Bilateral contract which cannot be performed within one year.

(6) Contract for the sale of goods or choses in action amounting to $...... (amount depends on law of particular jurisdiction) or more, except where there is:

(a) Acceptance and receipt by buyer of part of the goods.

(b) Part payment.

(c) Something given in earnest to bind the bargain.

No. 3 (10 points)

a. The rules of construction and interpretation are as follows:

(1) Where the sum payable is expressed in words and also in figures and there is a discrepancy between the two, the sum denoted by the words is the sum payable; but if the words are ambiguous or uncertain, reference may be had to the figures to fix the amount.

(2) Where the instrument provides for the payment of interest, without specifying the date from which interest is to run, the interest runs from the date of the instrument, and if the instrument is undated, from the issue thereof.

(3) Where the instrument is not dated, it will be considered to be dated as of the time it was issued.

(4) Where there is a conflict between the written and printed provisions of the instrument, the written provisions prevail.

(5) Where an instrument containing the words "I promise to pay" is signed by two or more persons, they are deemed to be jointly and severally liable.

b. Defenses which are available to the maker of a promissory note as against a "holder in due course" are:

(1) Forgery.

(2) Note incomplete and undelivered.

(3) Material alteration. However, a "holder in due course" may enforce payment according to the instrument's original tenor in spite of the alteration.

(4) Lack of authority to execute.

(5) Incompetence (contractual incapacity).

(6) Fraud in the execution.

No. 4 (10 points)

a. A bailment of goods is the transfer of *possession* (but not title) of personal property for some particular purpose other than as security for a debt, upon condition that the property be redelivered when the purpose has been served, or that it be kept until reclaimed, or that it be otherwise dealt with according to agreement.

(1) A mortgage is a transfer of *title* as *security* for a debt.

(2) A pledge is a transfer of *possession* of personal property as *security* for a debt.

(3) A sale is a transfer of *title* and *possession.*

b. Only personal property may be the subject matter of a bailment.

c. The bailee is liable for the *ordinary* expenses of the bailment. The bailor is liable for the *extraordinary* expenses of the bailment.

No. 5 (10 points)

a. A partnership which is continued beyond the definite term for which it was organized becomes a partnership at will, but the rights and duties of the partners remain the same.

b. A partnership may be dissolved by:

(1) Lapse of time or accomplishment of object.

(2) Mutual agreement of all the partners.

(3) Transfer of a partner's interest, either by his own act or by operation of law.

(4) The express will of any partner when there is no definite time for the termination of the partnership.

(5) The death of a partner.

(6) The bankruptcy of a partner.

(7) Judicial decree.

GROUP II

No. 6 (10 points)

a. (1) The payment will be applied to the barred debt of $500, which is the earlier and the more likely to be lost.

(2) Where neither the debtor nor the creditor exercises his right to apply a payment to one of several debts, the payment will be applied to the earliest matured debt to which the creditor might have applied it, or, if one is more precarious than the others, to that one. Ordinarily, where neither creditor nor debtor exercises his power of application, a payment will be applied in the manner most favorable to the creditor.

b. (1) Yes. Benjamin may be given a decree for specific performance ordering Abraham to give him a deed of conveyance.

(2) The expression "terms to be agreed upon" refers to the amount of credit to be allowed, dates of payment, and interest. There could be no terms to Abraham better than $50,000 in cash, so the uncertainty as to the terms became immaterial. The improvements made by Benjamin would give him an additional reason for specific performance, as otherwise he would lose what he had expended.

No. 7 (10 points)

(1) No liability. Losses caused by what are known as "acts of God" are excepted from the rule that a common carrier of goods is liable for the destruction of goods in its charge. A bolt of lightning would be characterized as an "act of God," since it is not caused by human agency.

(2) Liability. While the common carrier is not liable for goods destroyed by invasion or alien enemy, a riot does not fall within that category.

(3) Liability. A common carrier is liable for acts of third parties which injure or destroy the goods.

(4) Liability. A common carrier is liable for the negligence of its employees which causes damage to or destruction of the goods.

(5) No liability. A common carrier is excused from liability for destruction of goods when the fault rests with the shipper. Improper packing would fall within this exception.

No. 8 (10 points)

a. (1) Yes. Smith, the surety, can recover.

(2) The statute of limitations has not run against the surety on his right of recovery from Paul, which starts to run from the date the surety made his payment to Carr pursuant to his obligation as surety.

b. (1) No. D cannot obtain contribution from surety S.

(2) S and D are not co-sureties. One who becomes a surety in the course of proceedings against the principal will, upon his payment of the principal's debt, stand in the creditor's place only as against the debtor (the principal). As a subsequent surety he cannot claim to be subrogated to the rights of the creditor against a prior surety; rather the latter, if compelled to pay the debt, is subrogated to the creditor's rights against the subsequent surety.

c. (1) No. S, the surety, is not liable to E, the creditor, on the last extension of credit.

(2) The surety had agreed to be guarantor for the partnership A, B, & C. The change in the identity of the principals brought about by A's withdrawal from the partnership released the surety from liability arising from transactions which occurred after the withdrawal. Any change in the identity of the principal creates a possibility that the risk is varied and so releases the surety.

No. 9 (10 points)

a. (1) No.

(2) Under the usual corporation law, which confides the management of a corporation to its own officers and directors, a corporation has no power to enter into a partnership either with an individual or with another corporation.

b. (1) Yes. A transfer may be made by delivery of the certificate, endorsed either in blank or to a specified person by the person appearing by the certificate to be the owner of the shares it represents. A transfer also may be made by delivery of the certificate and a separate document containing either an assignment of the certificate or a power of attorney to assign the certificate or the shares it represents, the document being signed by the person appearing in the certificate to be the owner of the shares it represents; the assignment or power of attorney may be in blank or to a specified person.

(2) The Uniform Stock Transfer Act, adopted in 48 states and the District of Columbia, so provides. The rule is a recognition of the necessities of the financial world, in which many loans are made on stock certificates endorsed in blank.

c. (1) An existing stockholder has a pre-emptive right to purchase his ratable share of new stock issued for money pursuant to an increase in the corporation's capital stock, absent a provision to the contrary in a statute, the corporation's charter, or by-laws to which complaining stockholders have assented.

(2) Existing stockholders ordinarily do not have the pre-emptive right described in (1) as to stock previously issued but reacquired by the issuing corporation.

No. 10 (10 points)

a. (1) Yes, assuming that the buyer relied on the statement. An express warranty is any affirmation of fact or any promise by the seller relating to the goods, the natural tendency of which is to induce the buyer to purchase the goods and which is in fact relied upon by the buyer in purchasing the goods. The statement was a warranty, and, since it was untrue, damages may be recovered by the buyer.

(2). No. A statement purporting to be only a statement of the seller's opinion is not a warranty. Since this prediction as to the future performance of the article appears to be only an opinion, it is not a warranty.

(3) No. Unless the buyer purchases the goods relying on the affirmation, it is not a warranty. B, knowing S's statement to be untrue, could not have relied upon it. He cannot rescind or pursue any other remedy for breach of warranty.

b. The good or bad faith of the seller does not affect the existence of a warranty.

No. 11 (10 points)

(1) False. (2) False. (3) False. (4) True. (5) False. (6) False. (7) False. (8) True. (9) True (10) True.

No. 12 (10 points)

(1) False. (2) False. (3) False. (4) False. (5) False. (6) True. (7) True. (8) True. (9) True. (10) False.

Examination Answers, May, 1950

ACCOUNTING PRACTICE—PART I

May 17, 1950; 1:30 to 6 p.m.

No. 1 (12 points)

Schedule of Standard and Actual Cost for Production During March 1950

Cost Element	Standard for Production	Actual for Production	Variance Over (or Under) Standard
Direct labor for 8,500 units	$ 88,400	$ 88,440	$ 40
Material P for 9,000 units	24,750	24,440	(310)
Material Q for 8,500 units	27,200	27,690	490
Overhead for 8,500 units (see computation of overhead rate)	61,200	61,640	440
Total	$201,550	$202,210	$ 660

Computation of Overhead Rate

Total standard cost per unit		$ 23.55
Direct labor cost—8 hours @ $1.30	$ 10.40	
Material P—10 @	2.75	
Material Q—5 @ $.64	3.20	
Total		16.35
Overhead per unit for 8 hours labor		$ 7.20
Rate per hour		$ .90
Budgeted for a month (10,000 units of output)		$72,000

Analysis of Labor Variance as to Causes

	Hours	Rate	Amount
Standard	68,000	$ 1.30	$88,400
Actual	67,000	1.32	88,440
Variance	−1,000	$+.02	$ +40

Efficiency variance	−1,000 @	$ 1.30 equals	$−1,300
Rate variance	68,000 @	+.02 equals	+1,360
Efficiency and rate	−1,000 @	+.02 equals	− 20
Total			$ 40

NOTE: Rate and the combined efficiency and rate variance are frequently combined into a single computation.

(*Continued on following page*)

Analysis of Material Variance as to Causes Material P (9,000 Units)

			Units	Per Unit	Amount
Standard			90,000	$ .275	$24,750
Actual			94,000	.26	24,440
Variance			+4,000	$—.015	$ —310
	Quantity variance	4,000 @ $	.275 equals	$ 1,100	
	Price variance	90,000 @	—.015 equals	—1,350	
	Quantity and price	4,000 @	—.015 equals	— 60	
	Total			$ —310	

Material Q (8,500 Units)

			Units	Per Unit	Amount
Standard			42,500	$ .64	$27,200
Actual			42,600	.65	27,690
Variance			+100	$+.01	$ +490
	Quantity variance	100 @	$.64 equals	$ 64	
	Price variance	42,500 @	.01 equals	425	
	Quantity and price	100 @	.01 equals	1	
				$490	

NOTE: Price and the combined price and quantity variance are frequently combined in a single computation.

No. 2 (13 points)

X. B. MANUFACTURING COMPANY

Balance-Sheet December 31, 1949

Current Assets			Current Liabilities		
Cash		$19,000			$17,500
Accounts receivable		10,000			
Inventories:					
Raw material	$2,000				
Work-in-process	1,000		Capital Stock and Surplus		
Finished goods	4,000	7,000			
Prepaid expenses		500	Capital stock	$30,000	
Total current assets		$36,500	Surplus	15,000	45,000
Fixed Assets					
(Net of amount allowed for depreciation)		26,000			
		$62,500			$62,500

(*Continued on following page*)

X. B. MANUFACTURING COMPANY

Statement of Profit and Loss for the Year Ended December 31, 1949

Sales				$60,000
Cost of goods sold:				
Inventory of finished goods 1/1/49			$ 6,000	
Cost of goods manufactured:				
Inventory of work-in-process 1/1/49		$ 2,000		
Material used:				
Inventory 1/1/49	$ 4,000			
Purchases	15,000			
Total	$19,000			
Inventory 12/31/49	2,000	17,000		
Direct labor		9,000		
Overhead applied		9,000		
Total		$37,000		
Inventory of work-in-process 12/31/49		1,000	36,000	
Total			$42,000	
Inventory of finished goods 12/31/49			4,000	
			$38,000	
Overhead unapplied			2,000	40,000
Gross profit				$20,000
General expense			$ 9,000	
Selling expense			6,000	15,000
Net profit to surplus				$ 5,000

X. B. MANUFACTURING COMPANY

Worksheet for Transactions

	Balance 1/1/49		1949 Transactions		Balance 12/31/49		Profit and Loss		Balance-Sheet	
	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit
Cash	$ 5,000		(14) $60,000	(13) $46,000	$ 19,000				$19,000	
Accounts receivable	10,000		(1) 60,000	(14) 60,000	10,000				10,000	
Raw material inventory	4,000		(12) 15,000	(11) 17,000	2,000				2,000	
Work-in-process	2,000		(2) 9,000 (3) 9,000 (11) 17,000	(10) 36,000	1,000				1,000	
Finished goods inventory	6,000		(10) 36,000	(9) 38,000	4,000				4,000	
Prepaid expenses	500				500				500	
Fixed assets (net)	30,000			(4) 4,000	26,000				26,000	
Current liabilities		$17,500	(13) 46,000	(2) 9,000 (5) 8,000 (7) 8,000 (8) 6,000 (12) 15,000		$ 17,500				$17,500
Sales				(1) 60,000		60,000		$60,000		
Cost of goods sold			(9) 38,000 (6) 2,000		40,000		$40,000			
Selling expense			(8) 6,000		6,000		6,000			
General expense			(7) 8,000 (4) 1,000		9,000		9,000			
Manufacturing expense			(5) 8,000 (4) 3,000	(6) 11,000	—					
Manufacturing expense applied			(6) 9,000	(3) 9,000	—					
Capital stock		30,000				30,000				30,000
							$55,000	$60,000		
Net profit							5,000			5,000
Surplus		10,000				10,000				10,000
	$57,500	$57,500			$117,500	$117,500	$60,000	$60,000	$62,500	$62,500

(Continued on following page)

X. B. MANUFACTURING COMPANY
Explanation of Entries to Worksheet

(1) Record sales at 150% of $40,000 cost.
(2) Record direct labor cost.
(3) Record overhead applied.
(4) Record depreciation for the year.
(5) Record the balance of manufacturing expense computed as follows:

Applied expense	$ 9,000
Unapplied expense	2,000
Total	$11,000
Depreciation	3,000
Other expense	$ 8,000

(6) Close accounts and transfer balance to cost of goods sold.
(7) Record the remainder of general expense (15% of $60,000 equals $9,000 less depreciation of $1,000).
(8) Record selling expense at 10% of sales.
(9) Record the cost of goods sold computed as follows:

Surplus 12/31/48		$10,000
Increase from profits at 50%		$ 5,000
Sales		$60,000
Profits		5,000
Costs		$55,000
Deduct—		
General expense	$9,000	
Selling expense	6,000	15,000
Cost of goods sold		$40,000
Less overhead unapplied		2,000
Balance		$38,000

(10) Record the cost of goods manufactured ($38,000 less inventory decrease of $2,000).
(11) Record the material used in production ($36,000 work in process credit less $18,000 labor and overhead less $1,000 inventory variation).
(12) Record material purchases ($17,000 credit less $2,000 inventory variation).
(13) Record the payment of all liabilities except $17,500.
(14) Record the collection of all receivables except $10,000.

No. 3 (25 points) (Optional with Problem 4)

TOWN OF ELM SPRINGS HOSPITAL FUNDS

Balance-Sheets—December 31, 1949

GENERAL FUND

Assets			Liabilities and Capital		
Accounts receivable		$9,403	Cash—Due to endowment funds		$ 34,250.00
Less—Allowance for			Accounts payable		6,984.00
losses	500	$ 8,903.00	Accrued salaries and wages		5,234.00
			Accrued interest		2,500.00
Supplies		1,760.00	Due to capital fund		14,985.00
Prepaid expense		330.00	Total liabilities		$ 63,953.00
			Deduct—Deficit in fund		52,960.00
		$ 10,993.00			$ 10,993.00

ENDOWMENT FUNDS

Expendable

Cash		$ 1,862.50	Surplus—Johnson fund		$ 800.00
			Surplus—Jenkins fund		1,062.50
		$ 1,862.50			$ 1,862.50

Non-Expendable

Cash		$ 24,812.50	Johnson fund principal		$ 55,000.00
Due from general fund		34,250.00	Jenkins fund principal		83,562.50
Real estate	$30,000				
Less—Allowance for depreciation	500	29,500.00			
Bonds		50,000.00			
		$138,562.50			$138,562.50

CAPITAL FUND

Cash for equipment		$ 1,850.00	Bonds payable		$100,000.00
Unamortized bond discount		4,500.00	Capital contributions:		
Due from general fund for de-			Federal	$120,000	
preciation		14,985.00	County	25,000	
Building	$240,000		Town	35,300	
Less—Depreciation			General fund	27,250	
to date	4,800	235,200.00	Miscellaneous	22,650	
Equipment	$ 83,350		Total	$230,200	
Less—Depreciation			Less—Bond discount		
to date	10,185	73,165.00	amortized	500	229,700.00
		$329,700.00			$329,700.00

(Continued on following page)

Comments

The current expendable portion of the Endowment Funds might be shown in a separate special fund and the $1,850 cash for equipment shown in the Capital Fund might appropriately be separated. The exact significance of the provision as to depreciation is not clear in as far as it affects the balance-sheets, but if depreciation is charged to current operations, there must be an intent to charge the General Fund with the amount of such depreciation. Depreciation has been provided on Real Estate in the Endowment Fund. Where there is a gift of depreciable property, it is not required that the property be replaced unless the terms of the gift provide that there should be provision for replacement. In this instance, if depreciation charge is not considered to be necessary, it would result in an increase of cash and current surplus of the Johnson fund in the amount of $500 and a decrease of cash and an increase of Real Estate of the non-expendable funds of the same amount. Rents and interest on bonds owned by Endowment Funds might be accrued, but there is little significance attached to such a procedure for an expendable trust fund. The entire amount of Bond Discount might be written off against the capital contributions.

TOWN OF ELM SPRINGS
HOSPITAL FUNDS

Statement of Income and Expense of the General Fund
For the Ten Months Ended December 31, 1949

Income		
Room and meals		$113,564
Fees		7,265
Out-patient fees		5,199
Miscellaneous		515
Total		$126,543
Expenses		
Salaries, wages, etc.	$101,434	
Supplies	39,230	
Depreciation of equipment	10,185	
Depreciation of building	4,800	
Bad debts	500	
Miscellaneous	1,514	
Total operating expenses		157,663
Operating loss		$ 31,120
Non-Operating		
Expenses		
Interest on bonds	$ 5,000	
Purchase of equipment	27,250	
Total	$ 32,250	
Income—Contributions for general purposes	10,410	21,840
Total loss		$ 52,960

Statement of Income and Expense of the Endowment Funds
For the Ten Months Ended December 31, 1949

Income from rent of houses		$ 2,000.00
Miscellaneous expenses	$ 700	
Depreciation	500	1,200.00
Net income of Johnson fund		$ 800.00
Income from bonds of Jenkins fund		1,062.50
Total income		$ 1,862.50

NOTE: If depreciation is not computed on the houses for six months, there would be only $700 deduction for expenses and the balance would be increased by $500.

(Continued on following page)

Town of Elm Springs
Hospital Funds
Worksheet [*Not Required*]

	Transactions		Income and Expense		Balance-Sheet	
	Debit	Credit	Debit	Credit	Debit	Credit
General Fund Accounts						
Cash	(3) $127,550					
	(17) 34,250	(8) $161,800				
Accounts receivable	(9) 9,403				$ 9,403	
Reserve for loss on accounts		(9) 500				$ 500
Prepaid expenses	(11) 330				330	
Supply inventory	(11) 1,760				1,760	
Accounts payable		(10) 6,984				6,984
Accrued interest		(16) 2,500				2,500
Accrued salaries and wages		(10) 5,234				5,234
Due endowment fund—cash		(17) 34,250				34,250
Due capital fund—depreciation		(12) 14,985				14,985
Income from room and meals		(3) 106,254				
		(9) 7,310		$113,564		
Income from fees		(3) 6,170				
		(9) 1,095		7,265		
Income from out-patient department		(3) 4,201				
		(9) 998		5,199		
Miscellaneous income		(3) 515		515		
Contributions received		(3) 10,410		10,410		
Salaries, Wages, etc.	(8) 96,200					
	(10) 5,234		$101,434			
Supplies	(8) 34,180	(11) 1,760				
	(10) 6,810		39,230			
Equipment purchased	(8) 27,250		27,250			
Miscellaneous expense	(8) 1,670					
	(10) 174	(11) 330	1,514			
Interest expense	(8) 2,500					
	(16) 2,500		5,000			
Depreciation—building	(12) 4,800		4,800			
Depreciation—equipment	(12) 10,185		10,185			
Bad debt expense	(9) 500		500			
Net profit or loss				52,960	52,960	
Total			$189,913	$189,913	$64,453	$64,453

Town of Elm Springs
Hospital Funds
Worksheet [*Not Required*]

	Transactions		Income and Expense		Balance-Sheet	
	Debit	Credit	Debit	Credit	Debit	Credit
Endowment Fund Accounts						
Cash	(4) $ 25,000					
	(5) 32,500					
	(7) 3,425	(18) $ 34,250.00			$ 26,675	
Depreciation	(12) 500		$ 500.00			
Allowance for depreciation		(12) 500.00				$ 500.00
Real Estate	(4) 30,000				30,000	
Bonds	(5) 50,000				50,000	
Due from general fund	(18) 34,250				34,250	
Johnson fund principal		(4) 55,000.00				55,000.00
Jenkins fund principal		(5) 82,500.00				
Jenkins fund principal		(7) 1,062.50				83,562.50
Income from rents and interest		(7) 2,362.50		$2,362.50		
Net profit			1,862.50			1,862.50
Total			$2,362.50	$2,362.50	$140,925	$140,925.00

(*Continued on following page*)

Worksheet, Continued

	Transactions		Income and Expense		Balance-Sheet	
	Debit	Credit	Debit	Credit	Debit	Credit
CAPITAL FUND ACCOUNTS						
Buildings	(1) $240,000				$240,000	
Equipment	(2) 56,100					
	(13) 27,250				83,350	
Cash for equipment	(6) 1,850				1,850	
Bond discount	(1) 5,000	(15) $500.00			4,500	
Depreciation charged general fund	(14) 14,985				14,985	
Reserve for depreciation—Building		(14) 4,800.00				$4,800.00
Reserve for depreciation—Equipment		(14) 10,185.00				10,185.00
Bonds payable		(1) 100,000.00				100,000.00
Capital contribution—Federal		(1) 120,000.00				120,000.00
Capital contribution—County		(1) 25,000.00				25,000.00
Capital contribution—Town		(2) 35,300.00				35,300.00
Capital contribution—Misc.		(6) 1,850.00				
		(2) 20,800.00				22,650.00
Capital contribution—General fund		(13) 27,250.00				27,250.00
Amortization of bond discount	(15) 500				500	
Total					$345,185	$345,185.00

Summary Entries by Funds

[Not Required]

Capital Fund		
(1) Buildings	$240,000	
Bond discount	5,000	
Bonds payable		$100,000.00
Capital contributions—Federal		120,000.00
Capital contributions—county		25,000.00
Capital Fund		
(2) Equipment	56,100	
Capital contributions—town		35,300.00
Capital contributions—miscellaneous		20,800.00
General Fund		
(3) Cash	127,550	
Income from room and meals		106,254.00
Income from fees		6,170.00
Income from out-patient department		4,201.00
Miscellaneous income		515.00
Donation for general purposes		10,410.00
Endowment Funds—principal		
(4) Cash	25,000	
Real estate	30,000	
Johnson fund principal		55,000.00
(5) Cash	32,500	
Bonds	50,000	
Jenkins fund principal		82,500.00
Capital fund		
(6) Cash for equipment purchase	1,850	
Capital contribution		1,850.00
Endowment funds		
(7) Cash	3,425	
Johnson fund—income		1,300.00
Jenkins fund—income		1,062.50
Jenkins fund—principal		1,062.50

(Continued on following page)

[*Continued from preceding page*]

General Fund		
(8) Salary, wages, etc.	$96,200	
Supplies	34,180	
Equipment	27,250	
Miscellaneous	1,670	
Bond interest	2,500	
Cash		$161,800.00
General Fund		
(9) Accounts receivable	9,403	
Bad debt expense	500	
Allowance for loss on accounts		500.00
Income from room and meals		7,310.00
Income from fees		1,095.00
Income from out-patient department		998.00
General Fund		
(10) Salary and wages	5,234	
Supplies	6,810	
Miscellaneous	174	
Accounts payable		6,984.00
Accrued salaries and wages		5,234.00
General Fund		
(11) Prepaid expenses	330	
Supply inventory	1,760	
Miscellaneous expense		330.00
Supplies		1,760.00
General Fund		
(12) Depreciation expense—buildings	4,800	
Depreciation expense—equipment	10,185	
Due to Capital fund		14,985.00
Endowment Funds—Expendable		
(12) Depreciation expense	500	
Allowance for depreciation		500.00
Capital Fund		
(13) Equipment	27,250	
Capital contribution—general fund		27,250.00
Capital Fund		
(14) Depreciation charged general fund	14,985	
Reserve for depreciation—building		4,800.00
Reserve for depreciation—equipment		10,185.00
Capital Fund		
(15) Capital contribution	500	
Bond discount		500.00
General Fund		
(16) Bond interest	2,500	
Accrued interest		2,500.00
General Fund		
(17) Cash	34,250	
Due endowment funds		34,250.00
Endowment Funds		
(18) Due from general fund	34,250	
Cash		34,250.00

No. 4 (25 points) (Optional with Problem 3)

THE CAPITAL COMPANY

Statement of Application of Funds for the Year Ended December 31, 1949

Funds Provided By			
Profits			
Net profit per books		$83,485	
Corrections because of errors:			
Add—Profit on sale of land of $7,000 based on cost which was recorded as $3,000 loss based on appraisal value (Note 1)		10,000	
Excess provision for prior year's tax which was credited to surplus (Note 2)		5,000	
Total		$98,485	
Deduct items credited in error:			
Reduction of depreciation reserve	$45,000		
Write-up of land	25,000		
Application of inventory reserve against costs	8,000		
Dividends credited on treasury stock	300	78,300	
Corrected profit		$20,185	
Add items charged to profits, but which did not require funds:			
Depreciation expense	$13,150		
Amortization of patents	2,000		
Amortization of bond discount	840	15,990	
Total		$36,175	
Deduct items included in profits, but which did not provide funds:			
Earnings of stock taken up in excess of dividends	$ 4,775		
Gain on retirement of bonds at less than par	600	5,375	
Funds provided by profits			$30,800
Total funds provided			$30,800
Decrease in working capital (see schedule)			33,800
			$64,600

Funds Applied To	
Purchase of machinery	$21,000
Expenditure on patents and research	5,000
Retirement of bonds payable	9,400
Payment of damage award	5,000
Reacquisition of preferred stock	11,000
Dividends on preferred stock	1,200
Reacquisition of common stock	12,000
Total funds applied	$64,600

NOTES:

(1) The amount of profit of $7,000 corresponds to the amount of current assets received ($2,000 cash plus $5,000 of notes), therefore, there were no additional funds provided above the amount of profit.

(2) If this amount is considered to be so material as to result in a distortion of profit, it could be treated as a separate item below the corrected profit. The principal explanation of the decrease in working capital in spite of a large reported profit is to be found in the errors in reporting profit. Therefore it appears that a correction of profits is basic to the explanation and should be incorporated in this statement.

(Continued on following page)

THE CAPITAL COMPANY
Schedule of Working Capital

	Account Balance		Change in Working Capital	
	Dec. 31, 1948	Dec. 31, 1949	Increase	Decrease
Current Assets				
Cash	$25,000	$ 5,000		$20,000
Accounts receivable (net of reserve)	16,500	18,200	$ 1,700	
Inventory of materials	30,000	22,000		8,000
Inventory of finished goods	19,000	13,000		6,000
Inventory of supplies	2,000	2,500	500	
Current installment of note		5,000	5,000	
Prepaid insurance	1,000	1,500	500	
Total current assets	$93,500	$67,200	$ 7,700	$34,000
Current Liabilities				
Accounts payable	$48,000	$47,500	$ 500	
Notes payable	10,000	15,000		$ 5,000
Accrued expenses	15,000	18,000		3,000
Total current liabilities	$73,000	$80,500	$ 500	$ 8,000
Working Capital	$20,500	($13,300)	$ 8,200	$42,000
Decrease in Working Capital			$33,800	
			$42,000	$42,000

An examination of the data given in the problem shows that all changes, other than in working capital items, have been described in the "Explanations"; therefore it is possible to prepare the required statement directly from the "Explanations." A worksheet is not called for in the problem, but the following working papers might be helpful:

Reference to Explanation of Changes	Description	Source of Fund Items: Decreases of Profit	Source of Fund Items: Increases of Profit	Source of Fund Items: Other Items	Application of Fund Items
	Net profit as reported			$ 83,485	
(1)	No effect				
(2)	Earnings of S in excess of dividends	$ 4,775			
(3)	Reduction of depreciation reserve	45,000			
	Gain in value of assets	25,000			
	Loss on disposal	(3,000)			
	Depreciation expense		$13,150		
	Sale of land			27,000	
	Non-current portion of notes received			(20,000)	
	Purchase of machinery				$21,000
(4)	Amortization of patents		2,000		
	Expenditure on patents and research				5,000
(5)	Amortization of bond discount		840		
	Gain on retirement of bonds at 94	600			
	Retirement of bonds at 94				9,400
(6)	Income tax accrual not paid or payable			5,000	
(7)	Application of inventory reserve to cost	8,000			
(8)	Payment of damages				5,000
(9)	Reacquisition of preferred stock				11,000
	Payment of dividend on preferred				1,200
	Dividend on treasury preferred	300			
(10)	Reacquisition of common stock				12,000
	Total	$80,675	$15,990	$ 95,485	$64,600
	Increase			15,990	
				$111,475	
	Decrease			80,675	
	Net Source of Fund Items			$ 30,800	

ACCOUNTING PRACTICE—PART II

May 18, 1950; 1:30 to 6 p.m.

No. 1 (10 points)

a.1.(b) False, Sec. 24 (a)(2)(3).
2.(a) True, Sec. 23(a): 29.23(a)-5.
3.(a) True, *Dunn & McCarthy, Inc.* v. *Comm.*, 70 F.(2d) 255;13 AFTR 957.
4.(a) True, *Stoddard* v. *Comm.*, 152 F.(2d) 445.
5.(b) False, *Great Northern* v. *Comm.*, 40 F. (2d) 372.
6. (a) True, *Frank & Seder Co.* v. *Comm.*, 44 F. (2d) 147.

b.1.(a) Sec. 23(k)(4).
2.(c) Sec. 23(g)(2).
3.(b) Sec. 23(g)(4).
4.(c) Sec. 23(k)(2).

c.1.(b) $1,200. Internal Revenue Code, Sec. 23 (b). The interest paid on indebtedness incurred to purchase and carry tax-exempt municipal bonds is not deductible. *Id.*
2.(b) $500 ordinary income. The gain actually represents accumulated interest. The cases usually reach this result by holding the surrender is not a "sale or exchange" even though the policy may be a capital asset. See e.g. *Bodine* v. *Comm.*, 103 F. (2d) 982 (CCA 3, 1939), *cert. denied* 308 US 576 (1939); *Ralph Perkins*, 41 BTA 1225 (1940), *aff'd on other grounds* 125 F. (2d) 150 (CCA 6, 1942). Regulations 111, Sec. 29.22(b)(2)-1

d.1.(d) 0. *General Utilities & Operating Co.* v. *Helvering*, 296 US 200 (1935). The Treasury's attacks on this case have not yet been successful.
2.(a) $10,000. The fair market value of each lot.
3.(d) $1,000 long-term capital gain. The lot had a "cost" basis of $10,000, was a capital asset, and was held over six months.
4.(d) $1,000 long-term capital loss. See (3)

e.1.(d) 0. Internal Revenue Code, Sec. 24 (a) (4); GCM 8432, IX-2 Cum. Bull. 114 (1930); Regulations 111, Sec. 29.24-3.
2.(b) 0. That increase is just the form in which the investment factor of insurance is reflected in the asset account.
3.(c) 0. The amount of "loss" on surrender would be the cost of past insurance protection. No "loss" would actually be sustained. *London Shoe Company, Inc.* v. *Comm.*, 80 F. (2d) 230 (CCA 2, 1935), *cert. denied* 298 US 663 (1936); *Nichols Wire & Steel Company*, P-H TC Mem. par. 43,143 (3-22-43).
4.(e) 0. Internal Revenue Code, Sec. 22(b) (1); Regulations 111, Sec. 29.22(b)(1)-1.

THE SPECULATIVE REALTY COMPANY

STATEMENT OF INCOME AND EXPENSES

Year Ended December 31, 1949

Sales (Schedule 1)			$80,600.00
Cost of sales (43% of sales, see Schedule 2)			34,658.00
Gross profit			$45,942.00
Deduct—Sales commissions			2,210.00
Balance			$43,732.00
Less—Profit to be deferred on uncollected installments	($53,700) / (80,600)		29,136.58
Earned profit			$14,595.42
Expenses:			
Advertising		$7,300	
Sales manager's salary		9,000	
General office expense (1/4 of $23,600)		5,900	22,200.00
Net loss for year			$ 7,604.58

(Continued on following page)

Sales (Schedule 1)

	Total	Cash	Installments
A lots—26 @ $1,500	$39,000	$16,500	$22,500
B lots—32 @ $1,000	32,000	8,000	24,000
C lots—12 @ $ 800	9,600	2,400	7,200
Total	$80,600	$26,900	$53,700

Cost of Sales (Schedule 2)

Cost of Lots	
Land	$ 48,000
Legal fees, etc.	6,000
Grading	22,500
Water and sewerage	18,490
Paving	26,630
General overhead (3/4 of $23,600)	17,700
Total	$139,320

Sales Value of Lots			
Class	Number	Each	Amount
A	80	$1,500	$120,000
B	100	1,000	100,000
C	130	800	104,000
Total	310		$324,000

Cost of $139,320 divided by sales value of $324,000 = 43% that cost represents of sales value.

No. 3 (30 points)

THOMAS TRADING COMPANY

WORKING PAPERS FOR BALANCE-SHEET ACCOUNTS

Account	Balance per Books		Auditor's Adjustments		Balance as Adjusted	
	Debit	Credit	Debit	Credit	Debit	Credit
Cash	$ 57,000				$ 57,000	
Accounts receivable	47,000			(4) $ 5,000	42,000	
Advance to officer			(4) $ 5,000		5,000	
Surrender value of life insurance	8,000			(17) 5,000		
				(18) 500	2,500	
Marketable securities	13,000				13,000	
U. S. tax notes	2,000				2,000	
Inventories	50,000				50,000	
Investment in B (90%)	30,000			(7) 9,000	21,000	
Land	10,000				10,000	
Buildings	200,000				200,000	
Accumulated depreciation—buildings		$ 54,000				$ 54,000
Machinery	110,000				110,000	
Accumulated depreciation—machinery		61,000				61,000
Prepaid expenses	3,000				3,000	
Unamortized bond discount			(1) 5,000	(2) 1,000	4,000	
Goodwill (franchises)			(9) 13,000		13,000	
Accounts payable		20,000				20,000
Reserve for income taxes		2,200				2,200
Bonds payable		200,000				200,000
Unamortized bond premium			(3) 250	(1) 5,000		4,750
Reserve for losses		17,300	(15) 5,500	(9) 14,000		
			(16) 3,800	(11) 3,000		
			(19) 25,000			
Reserve for inventory price decline		10,000				10,000
Reserve for bad accounts		2,475		(8) 1,000		3,475
Surplus		121,000	(5) 30,000	(13) 100		
			(10) 20,000	(19) 25,000		
			(14) 11,700			
			(20) 30,000			54,400
Capital surplus				(5) 30,000		
				(6) 500		
				(14) 11,700		
				(20) 30,000		72,200
Net profit		1,125	(2) 1,000	(3) 250		
			(7) 9,000	(10) 20,000		
			(8) 1,000	(15) 5,500		
			(9) 1,000	(16) 6,000		
			(11) 3,000			
			(12) 100			
			(16) 2,200			
			(17) 5,500			
			(18) 500			10,075
Common stock		44,000	(13) 100			43,900
Treasury stock	3,100		(6) 500	(12) 100	3,500	
Total	$533,100	$533,100			$536,000	$536,000

(Continued on following page)

THOMAS TRADING COMPANY

WORKING PAPERS FOR PROFIT AND LOSS ACCOUNTS

	Balance per Books		Auditor's Adjustments		Balance as Adjusted	
Account	Debit	Credit	Debit	Credit	Debit	Credit
Sales		$190,000				$190,000
Purchases	$136,000			(10) $ 5,000	$131,000	
Expenses	37,000		(18) $ 500	(10) 15,000	22,500	
Depreciation expense	20,500			(15) 5,500	15,000	
Bad debt expense	475				475	
Recovery of accounts charged off		1,000	(8) 1,000			
Dividend and interest income		10,100	(7) 10,000			
			(12) 100			
Interest income				(7) 1,000		1,000
Interest on bonds	6,000				6,000	
Amortization of bond premium and discount			(2) 1,000	(3) 250	750	
Amortization of goodwill (franchises)			(9) 1,000		1,000	
Expense incurred as result of personal injury			(11) 3,000		3,000	
Income-tax expense			(16) 2,200		2,200	
Excess of prior years' tax provision over actual amount of expense				(16) 6,000		6,000
Adjustment of cash value of life insurance for prior years			(17) 5,000		5,000	
Net profit	1,125		(3) 250	(2) 1,000		
			(10) 20,000	(7) 9,000		
			(15) 5,500	(8) 1,000		
			(16) 6,000	(9) 1,000		
				(11) 3,000		
				(12) 100		
				(16) 2,200		
				(17) 5,000		
				(18) 500	10,075	
	$201,100	$201,100			$197,000	$197,000

Number **Journal Adjusting Entries**

		Debit	Credit
(1)	Unamortized bond discount	$ 5,000	
	Unamortized bond premium		$ 5,000
	To correct the netting of the premium on the new 20-year issue against the discount and expense on the old issue. The effect of the company entry was to spread the old discount over a twenty-year period.		
(2)	Amortization of bond discount and premium	1,000	
	Unamortized bond discount		1,000
	To write off $^1/_5$ of the unamortized balance of the discount. This discount may properly be spread over the remaining original term of the bonds retired or it might be written off immediately in full against the year's income (or if substantial, against surplus) in which case the entry would be for the full $5,000.		

(Continued on following page)

(3) Unamortized bond premium	$250	
Amortization of bond discount and premium		$250
To write off $^1/_{20}$ of the bond premium on the $200,000 issue of bonds.		
(4) Advance to officer	5,000	
Accounts receivable		5,000
To reclassify the amount due from company president from accounts receivable to a separate account.		
(5) Surplus	30,000	
Capital surplus		30,000
To take the excess of sales price of stock issued during 1949, over the amount assigned to the stock account out of surplus and segregate it as Capital Surplus. (Unless the directors approved the value of $1 per share, this $30,000 could properly be credited to the stock account rather than to Capital Surplus.)		
(6) Treasury stock	500	
Capital surplus		500
To credit capital surplus with the gain on the sale of 1,000 shares of Treasury stock and state the stock account at cost in accordance with the carrying basis adopted at date of purchase of the stock.		
(7) Dividend and interest income	10,000	
Investment in B		9,000
Interest income		1,000
To reduce the investment account by the dividend received, which was paid from earnings accumulated at date of purchase.		
(8) Recovery of accounts charged off	1,000	
Reserve for bad accounts		1,000
To transfer the recovery credit from income to the reserve account in accordance with company policy which is based on the provision being adequate for the "net uncollectible receivables."		
(9) Franchises	13,000	
Amortization of franchises	1,000	
Reserve for losses		14,000
To reverse the charge made to the reserve for losses and set up the franchise as an account subject to amortization over a 7-year period. (While under some conditions it might be appropriate to charge an intangible to surplus or to operations, such a charge could not be made to a reserve of this type under the existing conditions.)		
(10) Surplus	20,000	
Purchases		5,000
Expenses		15,000
To relieve purchases and expenses of the charges made for the purpose of increasing reserves for possible future losses. Such provisions are not a proper charge against income but may possibly be treated as appropriations of surplus. (These items might appropriately be reversed against the reserves rather than be charged to surplus, but see entry 19.)		
(11) Expense incurred as a result of personal injury	3,000	
Reserve for losses		3,000
To charge through current operations the payment made to an employee which had been charged to reserve for losses.		
(12) Dividend and interest income	100	
Treasury stock		100
To reverse the entry made to record the payment of a stock dividend on the Treasury stock. (See 13.)		

(*Continued on following page*)

(13) Common stock	$100	
Surplus		$100
To reverse the entry made for the stock dividend as to the shares held in the treasury. (See 12.)		
(14) Surplus	11,700	
Capital surplus		11,700
To transfer $3 per share on 3,900 shares issued as stock dividend from surplus to capital surplus. In declaring a stock dividend the market and book value of each share must be considered in determining the amount to charge to surplus. In this instance such values are about equal and are approximately $4 per share.		
(15) Reserve for losses	5,500	
Depreciation expense		5,500
To reverse the entry setting up additional depreciation because of price level change. Such provision is not appropriately made against current income. An appropriation of surplus could be made for the amount if the intent of the company is to do so. The entry would be a debit to surplus.		
(16) Income-tax expense	2,200	
Reserve for losses	3,800	
Excess of prior years' tax provision over actual amount of expense		6,000
To charge to current expense the tax cost of the year, reverse the credit to reserve for losses and take up through non-operating income (might be a direct surplus credit if the amount would result in income distortion) the excess of prior years' tax provision not needed.		
(17) Life insurance expense—prior years	5,000	
Surrender value of life insurance		5,000
To reduce the carrying basis of life insurance as of the first of the year down to its surrender value. The prior years' adjustment might be to surplus if the income charge distorts net income.		
(18) Expenses	500	
Surrender value of life insurance		500
To charge to expense the amount of 1949 premium paid on life insurance which did not increase the surrender value.		
(19) Reserve for losses	25,000	
Surplus		25,000
(*Optional entry*)		
To transfer the reserve for losses (as adjusted) to surplus. There is no apparent justification for this reserve. While it may be within the authority of the board of directors to appropriate surplus for such a reserve, there is no evidence that there is any probable need for the reserve. If a justification exists for the appropriation, the reserve can be left as an appropriation surplus.		
(20) Surplus	30,000	
Capital surplus		30,000
To transfer the surplus paid in on the original 30,000 shares of common stock to a separate account. This, together with other adjustments, leaves the former surplus account clear of all except earned surplus items. (This amount might appropriately be transferred to the stock account rather than to capital surplus.)		

THEORY OF ACCOUNTS

May 18, 1950; 9 a.m. to 12:30 p.m.

GROUP I

No. 1 (10 points)

The definition of current assets given in Accounting Research Bulletin No. 30, issued by the committee on accounting procedure of the American Institute of Accountants is as follows:

> For accounting purposes, the term 'current assets' is used to designate cash and other assets or resources commonly identified as those which are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business.

In the same bulletin the following statement appears as to items included by the definition:

> . . . and prepaid expenses such as insurance, taxes, unused royalties, current paid advertising service not yet received, and other items which, if not paid in advance, would require the use of current assets during the operating cycle.

The concept of current assets which supports the definition is not a liquidating concept, but rather it is a going concern concept which relates the definition of current assets to "working capital." Working capital is viewed as ". . . the relatively liquid portion of total enterprise capital which constitutes a margin or buffer for meeting obligations to be incurred and liquidated within the ordinary operating cycle of the business." Both current assets and current liabilities are defined in terms of the normal operating cycle, and in terms of the normal circulation of capital within the current groups. Cash has been expended (or liabilities incurred) for the prepaid items which are normally consumed during the operating cycle. Therefore the unconsumed portion of such expenditures is properly includable in the current group for purpose of determining working capital.

No. 2 (15 points)

a. While many accountants recognize that revenue may be earned in an economic sense by production they ordinarily hold that revenue is not realized until there has been a sale, or until there has been a billing for services, which is more in line with the legal concept.

The objections to taking up any revenue prior to sale are:

(1) There is usually no objective evidence as to the amount that should be taken up.
(2) There is no conversion of the asset into a different type of asset through transfer of the original asset.

Upon making a sale there is evidence available as to the amount of revenue that has been realized. Also there is a change in form of the asset. Ordinarily a relatively liquid asset such as cash, accounts receivable, or notes receivable is obtained. While these assets, except for cash, may never be converted into cash, there is a reasonable presumption that they will be converted except to the extent provided for in a bad debt allowance. An important practical objection to taking up revenue prior to sale has existed in the use of statements by creditors. Historically, credit grantors have objected to possible overvaluations but not to possible undervaluations.

b. There are a number of objections to the sales basis. The sale is but one of the many steps that may take place in a business. The entire operation of the business must be carried on efficiently for the business to make a profit. There can be no doubt that efficiency in purchasing and processing does produce the condition that results in the realization of profits. The sales function may be a very minor function of a business. Logically, it may be concluded that each function performed contributes its part to the final profit, and that such profit is realized as the functions are performed. As a result of strict adherence to the sale rule, there is a continual lag in taking up "earned profit" and this lag may be very material in amount. In some instances, the actual making of a sale may be routine, the market being so broad as to insure the possibility of a sale at any chosen date.

Where these objections appear to be material, accountants have not adhered to the sales basis. Examples of the pricing of inventories at market for products of extra-active industries—agriculture products, etc.; the use of percentage of completion as a basis for construction contractors and the use of the installment basis for some businesses. However, in general, the completed sale has been the usual basis for revenue recognition, with the result that inventories are usually valued at cost and profit on service performed is not recorded until a billing is made to the customer.

In the case of businesses providing services, the provision of an acceptable service is usually taken as a basis for revenue realization, especially where the service rendered is chargeable without the obligation to render additional service. For example, a public accountant (who keeps his own books on the calendar-year basis) in making an audit for 1949 might do part of the work in December of that year. Ordinarily, the outlay for such time will be carried at cost and the profit on the engagement will not be taken into account until the work has been completed and the report delivered.

No. 3 (10 points)

a. The term "Quasi-Reorganization" has been loosely applied to material adjustment of the asset values and capital accounts of a corporation without creating a new corporation or formally reorganizing under court jurisdiction, but in effect achieving the same result as though a new corporation were created. However, the term has primarily been used in connection with the concept of a "fresh start" for a corporation having a deficit. The Securities and Exchange Commission in 1940 used the following description of a quasi-reorganization: "Corporate procedure in the course, of which a company, without the creation of a new corporate entity, is enabled to eliminate a deficit and establish a new earned surplus account for the accumulation of earnings subsequent to the date selected."

The concept of a fresh start has recently been advocated by some writers as a possible justification for writing up assets in a period of rising prices. However, no general use of this type of quasi-reorganization has been approved by most accountants.

b. The procedure of eliminating an "earned deficit" against paid-in capital and not requiring that such deficit be made up from subsequent earnings, has imposed on the accountant an obligation to disclose the fresh start that was taken by the corporation. Because the quasi-reorganization is made effective while the corporation is continuing as a going business, and because revaluation of certain assets may be included in the adjustment, the accountant has the problem in some cases of estimating and providing for potential losses, the exact amount of which may not be determinate as of the date of the restatement. To prevent the gross understatement of assets upon readjustment, which would result in subsequent overstatement of earned surplus, the American Institute of Accountants, committee on accounting procedure, in Research Bulletin No. 3 proposed the following:

> . . . Assets should be carried forward as of the date of readjustment at a fair and not unduly conservative value, determined with due regard for the accounting rules to be employed by the company thereafter. If the fair value of any asset is not readily determinable a conservative estimate may be made, but in that case the item should be described as an estimate and any material difference in value subsequently shown (by realization or otherwise) to have existed at that date should not be carried to earned surplus.

The SEC does not consider a quasi-reorganization to be effected unless the assets are restated in terms of present conditions and there is no reason to believe the adjustment is not sufficiently complete to prevent the recurrence of the condition giving rise to the reorganization.

No. 4 (15 points)

The base stock method of valuing an inventory divides the inventory into two parts. First, there is a normal stock or quantity which may be defined as the minimum amount of stock needed to insure uninterrupted production and to meet customers' needs. This base quantity is valued at a long-run "normal price" which usually is the lowest price which has been paid (or quoted) over a period of several years. The second part of the inventory is the excess on hand above the normal stock. This quantity is valued at lower of cost or market, cost being determined on an average cost or a first-in-first-out basis, or market alone may be used.

As to the base stock, the assumption is that this amount of inventory is in the nature of a fixed asset and it may be excluded from the current section of the balance-sheet. If a deficiency in quantity exists at any time in the base stock, the excess of cost to replace over the base price is charged to operations. The method results in current operations being charged with current cost of material used except for some variation which may occur if there are stocks in excess of the base quantity.

The last-in-first-out method differs from the base-stock method in that it does not require the determination of a normal quantity or of a normal price for a portion of the inventory. It may be described as a method for costing out inventory on the assumption that issues are to be considered to be made at the cost of the last goods received. There is no assumption that a portion of the inventory is of a fixed asset nature such as the assumption made as to the base stock. LIFO involves an assumption as to flow of costs rather than assumption as to the status of the inventory on hand.

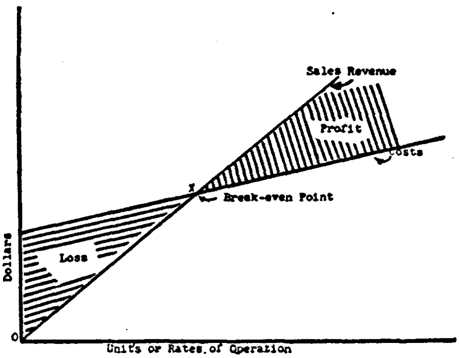
In spite of the differences in the methods, the two methods do tend to charge current costs against revenue and they could produce identical results as far as the income account of any one year is concerned. Also under certain special conditions, the balance-sheet valuations might be identical.

As the LIFO method has come into wider use, some base-stock features have frequently been applied by companies, resulting in what they call the LIFO method being hardly distinguishable from the base-stock method.

GROUP II

No. 5 (12½ points)

The term "break-even point" refers to the rate of operation at which costs exactly equal revenue. Such a point must be determined under certain assumptions as to the sales price and costs. With costs regarded as known, there would be a different break-even point for a range of possible prices. Usually the break-even point is determined graphically but might be determined in a tabular matching of costs and revenues at different levels of operation. An illustration of such a graph is shown below:



The existence of such a single break-even point is occasioned by the fact that certain costs are assumed to be, if they are not actually in fact, fixed. If semi-variable costs are recognized the curve of costs may rise in steps or in a number of possible ways, but only if it crosses the revenue line at a single point can there be a single break-even point. Obviously any change in the revenue curve will change the point just as any change in the cost curve would change it.

The curve is ordinarily determined by assuming a fixed sales price. Costs are analyzed into fixed and variable and the probable cost determined at several levels of operation. These cost points are located on the graph and then joined by a line which becomes the cost curve. It will always start on the vertical (dollar) axis at the amount of the fixed cost.

No. 6 (12½ points)

The following depreciation methods could be suggested to this client as a means of overcoming his objection to the straight-line method:

(1) Diminishing-balance method—

This method contemplates the application of a constant depreciation rate to the diminishing balance of cost of the building. The rate should be one that would reduce the cost to salvage value by the end of the building's estimated useful life. This method produces a lower depreciation charge each succeeding year but the rate of decrease would probably be much greater than the rate of decrease in revenue and there is no reason to assume that the decrease would match the increase in maintenance plus the decrease in revenue. (A general disadvantage of this method is that it is cumbersome when there are a large number of units for which separate rates must be determined and applied.)

(2) Sum-of-the-years'-digit method—

The sum-of-the-years'-digits method would charge as depreciation 50/1275 the first year and reduce the charge by 1/1275 for each year thereafter. This method results in a very sharp reduction in charges for depreciation for each year, the last year being only 1/50 of the first year.

There is little reason to believe it would produce results comparable to the anticipated change in revenue and the increase in maintenance costs.

(3) Use of arbitrary diminishing rates—

This would be a variation of method (2) described above in which arbitrary diminishing rates would be adopted. In selecting such rates, an estimate of the rent income by years that it is expected will be obtained during the life of the asset might be used. This method is somewhat similar to the units-of-output method sometimes used for machinery. It would correlate the charge with the estimated revenue (but unlikely with the actual revenue) and would have more merit in overcoming the client's objections to straight-line depreciation than either of the two previous suggestions.

(4) Combined provision for depreciation and estimated maintenance—

Another method which would overcome only a part of the client's objection would be to consider depreciation and maintenance together as a single problem. The estimated cost of maintenance over the 50-year period could be added to the amount to be depreciated and the total thus obtained could be apportioned over the life of the building. As to the actual maintenance charge, a reserve would be credited which would be charged as repairs were made. This apportionment of cost could be made on a straight-line basis, which would not overcome the objection as to depreciation not being related closely enough to revenue, or it could be made on some other basis such as one of those described above. The use of a reserve for equalizing repair expense is not accepted for income-tax reporting and many accountants would find it objectionable because of the uncertain accuracy of such an estimate.

No. 7 (12½ points)

A balance-sheet in which every figure is presented as a percentage of the total offers two principal advantages over the mere use of the figures.

First, it makes comparison between statements of different companies much easier. Second, it facilitates study of the changes in the relative distribution of total assets as between different groups of assets (current, fixed, etc.) and correspondingly it facilitates study of changes in the distribution of liabilities and proprietorship.

In perparing a percentage profit and loss statement, sales are taken as 100 per cent. Such a statement offers about the same advantages to the analyst as does the "common size" balance-sheet. Comparison of companies of different size is facilitated and a comparison of the statements of a single company for two or more years is possible without considering the changes in volume of sales.

The principal limitations of the statements are the following:

(1) The statements do not explain why the changes occurred. A change may have been due to a change in the individual item, or it may have been due to a change in other items (which changes the total), or it may have been due to changes in both.

Since the percentages have a new base as 100 per cent each year, they do not measure total growth or shrinkage. If each element changes proportionately, there would not be any reflection of change in the percentages.

(2) Since common-size statements are presumed to be most valuable in permitting comparisons of different companies or of the same company over several periods, they are subject to the limitations affecting all ratios when used for that purpose. The accounts may not be classified consistently, and the business policies as well as the accounting treatment of items may be inconsistent as between companies and as between various periods of operation of a single company. Finally it is generally true that a change in and of itself cannot be judged as either favorable or unfavorable. There is no abolute criterion of what condition is good and what condition is bad. For instance, an expense which has decreased in relation to sales may be higher than it should have been if the decreased percentage was due to an increase in sales price rather than a change in quantity. Price level changes may not affect all elements of cost and income equally, thereby resulting in misleading inferences.

No. 8 (12½ points)

There are a large number of costs that are "common" to the sales departments of a self-service grocery. Most fixed costs such as rent come under such a heading. Examples of other costs are:

Superintendence
Cashiers and check-out department
Trucking
Advertising

Common costs are usually apportioned on various arbitrary bases to the sales departments, but for numerous managerial decisions such apportionments produce misleading results. Decisions as to discontinuing a department, adding a department, enlarging a department, or decreasing a department, cannot be made on the data produced from the apportionments. For example, if a department is discontinued because it appears to be unprofitable, it may be found that the costs of other departments increase through having to absorb more of the common costs, and that the over-all operating results are less favorable than before discontinuing the "unprofitable" department. These common costs are usually semi-variable in nature rather than variable in nature. For large changes in volume, they may change (though not necessarily in proportion to changes in volume), but for small changes in volume, they may not change at all. Management must attempt to estimate the cost changes that a particular policy will cause, but because many costs are common, no accurate determination can be made from the usual accounting data. For management decisions on such policy matters, the "differential cost" concept is most appropriately used, but determining differential costs requires computations beyond those usually included in the records.

No. 9 (12½ points)

Ordinarily a substantial part of the assets of a stockbroker are amounts due from customers for whom the broker has purchased stock without receiving payment in full. The stock is not delivered by the broker to the customer, but is either retained in the possession of the broker, pledged by him as security for a bank loan, or perhaps loaned to other brokers. While the usual ledger accounts show a receivable from the customer, the broker is responsible for delivering to the customer upon payment of the balance due, the securities held. By showing in the balance-sheet not only the usual ledger accounts, but also the securities valued at current market, a complete presentation is given of the equity of the broker and his customers, whereas showing only the ledger accounts would present only a part of the existing situation of the broker and his customers. A similar need for security values in addition to usual ledger accounts exists as to accounts involving short sales, loans, etc.

As a result of the need for security values in the statements, the broker's balance-sheet will present the usual accounts and two additional columns for market value of Securities Long and market value of Securities Short, Pledged, and In Box. These two additional columns must be equal because all securities held for the account of customers (long securities) are accounted for in the other column as being Pledged, In Box (on hand), or Short.

No. 10 (12½ points)

a. In the purchase of a group of assets for a lump sum, the cost must be properly and reasonably assigned to the various classes and units of property acquired in order to permit correct accounting thereafter. In some instances, cost to the vendor may afford a basis of making such an allocation of the price paid, but is seldom as satisfactory a basis as present value. There are two approaches that might be taken in this instance. The best approach is to have the entire property appraised. It may be that the net value of the land together with the value of the machinery differs from the purchase price by a substantial amount. If that is the case, the $30,000 price would be assigned to machinery and land in relation to their present values. A less satisfactory approach would be to assume that the $30,000 does represent present value. Since the machinery is worth $15,000 ($25,000 less needed expenditure of $10,000), the land must be worth $15,000. In view of the fact that the building will be torn down, the $15,000 for land and building should be assigned to land, except for the net value of use for the period to demolition, plus salvage less demolition cost.

b. The cost of rehabilitating machinery that is acquired in a rundown condition is a proper capital charge and, when made, would be added to the cost of the machinery as previously determined. When used machinery is purchased, the purchase price is set on a basis which contemplates an expenditure to rehabilitate the machinery. Such rehabilitation cost thus becomes a part of the investment in the machinery. It is not maintenance cost applicable to the period of ownership by the purchaser, nor does it make good the depreciation of the assets during the period of ownership. This expenditure of $10,000 should be capitalized whether the machinery is usable without making the expenditure or not.

AUDITING

May 19, 1950; 1:30 to 5 p.m.

GROUP I

No. 1 (15 points)

a. An imprest fund is one which is established and maintained at a fixed amount. Disbursements are made from the fund as required, but are not recorded in the general books until the cash therein has been reduced to the reimbursement point (or until a prescribed period of time has elapsed) at which time the fund is reimbursed for the accumulated total of disbursements by check on the general funds of the business and the entries made distributing the charges. At all times the cash in the fund plus evidence supporting unreimbursed disbursements should equal the fixed amount of the fund.

b. An important requirement of an internal control system is the depositing intact of daily cash receipts. To enable a business to do that, and still be in the position of having some cash; a petty cash fund is needed. If such a fund is not under the imprest system, the control of the fund is difficult because the amount of the fund fluctuates and the recording of the operations under the fund becomes difficult. The existence of an imprest fund permits the use of checks to record all disbursements, the distribution to the proper account of minor expense items in groups thereby decreasing the number of entries required, and the easy verification of the fund at any date. It provides a clear measure of accountability not provided by other methods of operating petty cash or working funds.

c. A questionnaire that might be appropriate for appraising the effectiveness of control over a petty cash fund follows:

1. Is the imprest system in use?
2. Is the responsibility for the fund in only one person?
3. Is the custodian independent of persons handling cash receipts?
4. Does the custodian have access to general accounting records?
5. Is the fund limited to an amount not in excess of needs?
6. Are the expenditures only for minor items with a fixed maximum?
7. Is a voucher required for all disbursements?
8. As to the vouchers:
   - (a) Are they prenumbered?
   - (b) Prepared in ink or otherwise prepared to make alteration difficult?
   - (c) Are the amounts spelled out as well as written in numerals?
   - (d) Approved by a department head or some employee of equal rank?
   - (e) Signed by the recipient of the payment?
   - (f) Canceled upon reimbursement?
9. Is there provision for adequate audit of:
   - (a) The fund by internal auditors or others?
   - (b) Regular audit of the vouchers supporting reimbursement requests?
10. Are the checks for reimbursement made out to the custodian?
11. Is approval of an executive required for any checks cashed out of the fund?
12. If the fund is represented by a bank account, has the bank been instructed not to accept checks made out to the company?

No. 2 (16 points)

1. a. No information needed other than whether a reserve should be provided for possible loss.

b.

Notes receivable-officers, current......	$30,000	
Notes receivable-officers, non-current...	45,000	
Installment notes receivable........		$75,000

To separate the loan to an officer from the trade notes receivable and segregate the current from the non-current portion.

c. Following the balance-sheet captions there should be explanations as follows:

"Payable in installments of $2,500 per month. Secured by stock having a market value of $48,500 as of December 31, 1949." This information could also be set forth in a footnote to the balance-sheet.

2. a. It would be necessary to know whether the company has been using the lower of cost or market or some other basis for inventory valuation. It also would be necessary to know whether there are items in the inventory where cost is below market in order to determine the lower of cost or market. It is also necessary to know whether selling price less anticipated selling expense is below market and whether selling

price less normal profit and anticipated selling expense is above market.

b. Assuming that $310,500 is the lower of cost or market and that the company is using that basis.

Loss due to decline in inventory value........	$57,000	
Merchandise inventory...........		$57,000

c. As part of the Inventory title in the balance-sheet, the basis of valuation would be stated.

3. a. Same as 2. *a*.

b. Assuming the lower of cost or market is used in valuing inventory and that it is $210,000.

Loss due to decline in value of purchase commitments..............	$35,000	
Reserve for loss on purchase commitments............		$35,000

c. None.

4. a. It would be desirable to know the effect on 1948 Net Profit and on 1949 Net Profit if the company had been following the present method prior to July 1, 1949, or to know the effect on 1949 Net Profit if there had been no change in method in 1949.

b. The method of crediting earned income back to sales does not seem to be satisfactory. The following adjusting entry should be made:

Gross Profit on Sales.....	————	
Sales.......................		————

To restate sales at their original amount before the debits and credits made in connection with Unearned Income. The deduction for the transfer to Unearned Income should be from the Gross Profit.

c. There has been a change in accounting principle which will result in a qualification of the auditor's opinion. Following the phrase, " . . . accounting principles applied on a basis consistent with that of the previous year," a statement should be added along the following lines: "Except that starting as of July 1, 1949, the company has been deferring the gross profit on all sales made on an installment basis and is taking such profit into income as earned in proportion to the cash collected on the installments. If that procedure had been followed prior to July 1, 1949, the Net Income for 1948 would have been decreased (or increased) $—— and the Net Income for 1949 would have been increased (or decreased) $——." If a statement for 1949 only were presented, the qualification might be as follows: "Starting as of July 1, 1949, the company has been deferring the gross profit on all sales made on an installment basis and taking such profit into income as earned in proportion to the cash collected on the installments. If the company had continued to take up profit on the same basis used in 1948, the profit for 1949 would have been increased by $——." A similar statement could be used as a footnote to the Balance-Sheet and Income Statement with only a reference thereto in the certificate.

No. 3 (15 points)

a. Confirmation of receivables would be either impracticable or unreasonable where it has been found that replies will not be received. This situation has existed as to receivables due from government agencies as well as corporations which do not maintain records showing their payable balances to vendors at a given date. Some instances may also be found of receivables which are, in effect, accruals not yet represented by formal billings to the customer. The customer could not confirm these amounts. Confirmation also may be impracticable if too much time has elapsed between the date of the statement and the time when the work is being performed.

b. Under the conditions stated, the auditor should follow all normal verification procedure other than confirmation, and in addition he should extend the verification procedure to attempt to establish the substantial accuracy of the receivable balances. In some circumstances this might be done by control and examination of cash receipts and other records of subsequent payment of the accounts, supplemented by verification of evidence supporting the original billing.

The scope paragraph of the report should disclose the fact that receivables were not confirmed. If it is felt that the receivables have been satisfactorily verified by other means, a statement to that effect should be included in the scope paragraph, but no exception need be included in the opinion paragraph. If there has not been satisfactory verification, there should be an exception in the opinion paragraph unless it either alone or in combination with other exceptions, is so material as to raise a serious question as to the significance of the financial statements, in which case no opinion should be expressed.

c. In selecting the individual accounts to be confirmed the following should be considered:

1. Size and materiality of the item.
2. Unusual features of any item.
3. Current status of the item in relation to credit terms.

4. Other evidence bearing on validity of the item such as:

   (a) Adjustments and collections subsequent to date as of which confirmation is sought.

   (b) Evidence of a poor year-end cut-off having been made by the client.
5. Items tested in previous years.
6. Probability of a response being received.
7. Statistical sampling techniques of the other items not selected for any specific reason.

No. 4 (15 points)

a. The net income-tax purposes would be determined as follows:

Net income per books		$67,500
Add:		
Insurance premium on life of officer		1,500
Depreciation on books in excess of amount allowable		2,000
Excess of capital losses over capital gains		3,000
Contributions in excess of 5% limitation		3,925
		$77,925
Deduct:		
Non-taxable interest State of California bonds		500
Net income per tax return		$77,425
Tax computation:		
Net income	$77,425	
Less dividends received credit	850	
Normal-tax net income	$76,575	
Normal tax 24%		$18,378.00
Surtax 14%		10,720.50
Total tax		$29,098.50

b. The following reconciliation would be prepared:

Total distributions to stockholders charged to earned surplus during taxable year:	
(a) Cash	$ 30,000.00
Contributions (excess over 5% limitation)	3,925.00
Federal income taxes	29,098.50
Insurance premiums paid on life of officer where corporation is directly a beneficiary	1,500.00
Excess of capital losses over capital gains	3,000.00
Depreciation per books in excess of depreciation allowable for tax purposes	2,000.00
Earned surplus at close of taxable year	108,401.50
Total	$177,925.00
Earned surplus at close of preceding taxable year	$100,000.00
Net income per return	77,425.00
Non-taxable interest on:	
(a) State of California bonds	500.00
Total	$177,925.00

NOTE: There might be a credit because of foreign income tax withheld by the foreign government. However, there is no information available as to the amount of any such credit.

No. 5 (12 points)

Accounts not having a balance either at the beginning or end of a year may still be of interest to the auditor. Evidently the company is charging all expenditures for contributions, dues, development expense and building expense to deferred accounts and writing them out of such accounts to either expense or asset accounts over the year.

An analysis should be made of the accounts at least to an extent that will permit the identification of the major debits. Write-offs should be tied in to the appropriate expense or asset account to determine the correctness of the classification and the basis of the write-off. The principal debits should be tested back to supporting records to determine their source and correctness. There would be no essential difference between the audit procedure for these accounts and for those deferred items having year-end balances, except that there is no closing balance to be substantiated. Where a company is charging expenditures through a deferred account, the expenditure can be satisfactorily analyzed and verified only from the entries in the deferred accounts.

No. 6 (7 points)

Verification of profit and loss accounts is normally accomplished in conjunction with the audit of the related balance-sheet accounts. In general then, the Net Gain or Loss on Disposal of Fixed Assets would be verified when fixed assets are audited.

The detailed procedures to be used might be as follows:

1. Examine the accounting system for control of fixed assets. In particular determine if there is an established accounting routine to handle dispositions of fixed assets.
2. If the system is weak, determine that all retirements have been recorded, by tests of physical existence, analysis of maintenance expense, scrutiny of cash receipts book, making inquires of responsible officials, etc.
3. Analyze the Gain or Loss on Disposal account and relate this analysis to analyses of fixed asset and depreciation reserve accounts to determine that proper accounting procedures have been followed and that the account is complete.
4. If a system of work orders for retirements is in use, select major retirements for testing to the records. If a work order system is not in use, select items shown by the analysis to be significant. Test these work orders or items as follows:
   a. Check for approvals or authorizations in minutes, vouchers, and other documents or records.
   b. Determine basis for amount credited to fixed asset account by reference to the plant ledger, prior working papers, invoices, or other sources.
   c. Determine correctness of debit to the depreciation reserve by independent calculation and by reference to plant ledger or prior working papers.
   d. Tie-in to cash receipts or accounts or notes, all amounts shown as received from the assets sold.
   e. Check the reasonableness of the scrap income. Check market prices or bids, if available, and, in some cases, consider confirming directly from the purchaser. If material salvaged is taken into stores, test to the stores records.
   f. If any of the dispositions are trade-ins, determine if the methods followed are suitable for tax purposes; if not, incorporate the data needed for tax purposes in your working papers.

GROUP II

No. 7 (12½ points)

Any or all the following items, which would be of interest to the auditor, might be found in a trust indenture:

a. An exact description of the bonds, including the authorized issue and the exact title given the bonds. This would be of interest in determining that the bonds outstanding do not exceed the authorized amount and to fully describe the issue on the balance-sheet.

b. Interest rate and interest provisions. This information is desirable in determining the amount and correct treatment of accrued interest. Also it is necessary for determining the correctness of the entry separating interest at date of sale from principal.

c. The trust indenture will state the maturity date of the bonds and the conversion or redemption features if any. The auditor determines that the significant parts of such data have been disclosed on the balance-sheet and he would use the data on conversion or redemption to determine the acceptability of any transactions entered into in accordance with such provisions.

d. The trust indenture will contain any existing provisions as to the establishment of a sinking fund for redemption of the bonds, for surplus reservation, if any, and will state the manner in which final repayment of the bonds must be carried out. The auditor uses this information in connection with his verification of sinking fund and surplus reserve transactions and balances. The information as to final repayment is needed to determine the proper accounting treatment of deposits made for purpose of repayment.

e. The name of the trustee and the duties and rights of the trustee are included as part of the agreement. The auditor corresponds with the trustee as of each audit date for confirmation of bonds outstanding and status of the issue.

f. Any special reports that must be prepared for the trustee are enumerated in the indenture as well as any special provisions as to methods of accounting. The auditor uses this information to assist the client in complying with the terms of the indenture.

g. The indenture will contain the description of any property pledged as security for repayment of the bonds. The auditor must disclose the existence of such pledge or hypothecation.

h. The indenture may contain provisions as to expenditures for maintenance and/or replacement of property. The auditor must determine the correctness of the classification of entries to such accounts as made by the company.

i. The indenture may include provisions as to amounts of working capital, definitions of inclusions in working capital and ratios of short-term borrowings to various other balance-sheet amounts. The auditor will assist the client in properly reporting under such requirements.

j. The indenture may contain restrictions on dividend payments. The auditor must disclose the existence of such covenants when certifying to financial statements.

k. The indenture may contain provisions as to insurance coverage. The auditor will determine the compliance with such requirements and report on any failure to comply.

The following items would normally be included in a confirmation obtained from a trustee under a bond indenture:

a. The amount of bonds authorized and outstanding at the balance-sheet date together with changes during the year. This procedure affords evidence as to the correct liability and would disclose certain kinds of unrecorded transactions.

b. The status of interest payments, if the trustee acts as paying agent. The auditor considers such information as a part of his evidence supporting the accrual of interest.

c. Status of sinking fund, if any such fund is provided for by the agreement. This is the auditor's principal evidence as to the balance and operation of such a fund.

d. Information as to the date, due date (or term) and description of the issue may also be obtained from the trustee. These items have been included previously under the indenture.

e. Information as to any default under the agreement. A default may subject the company to various penalties which might require disclosure.

No. 8 (10 points)

a. Where advertising is placed through an agency, the following records might be examined:

1. Agreement with agency.
2. File of advertisements.
3. Invoices or vouchers.
4. Confirmation of amount payable under the contract.

b. Where advertising is placed direct in newspapers the evidence would consist of the file of advertisements, published rates, invoices, and possibly a confirmation. Verification might include a test of the account by determining the space used for a period at the quoted rates and the examination of invoices or vouchers. The cut-off at the year end might be verified by examination of the subsequent billing.

c. Royalty expense would ordinarily be verified at the same time as Advances on Royalties or as Accrued Royalties. The evidence would ordinarily include a written contract, production or sales records and reports, and invoices or vouchers evidencing past payments. A confirmation from the licensor would be obtained in most instances.

d. Repair expense may arise from utilization of labor and supplies or from engaging outside contractors to do work. A review would be made of the policy followed by the company in distinguishing between capital additions and repairs. Verification might include examination of contracts with outsiders and test of invoices or vouchers from contractors and examination of payroll records and material or supplies records for work performed by the client's employees. If the company uses a system of work orders for controlling repairs, examination would be made of the orders to determine that they were properly authorized and that the description of the work indicated that they were proper expense charges.

No. 9 (20 points)

The division of work between interim and year end might vary slightly. The basic division would be along the following lines:

a. **Program for Interim Work:**

Accounts Receivable:

1. Obtain from the client a trial balance of the customers' ledger as of October 31st.

2. Prove the footing of the trial balance, tie-in the subtotals with the section controls and the final total with the general ledger.

3. Make tests of the individual items on the trial balance to the detail ledger to determine that the items on the trial balance are in agreement with the ledger.

4. From the items on the trial balance, select

accounts for confirmation so as to obtain a representative sample.

5. Have the client prepare confirmation requests. Check these to the items selected, determine that they are properly addressed, carry your return address, and have an envelope enclosed which is addressed to you. Mail or supervise the mailing of the requests.

6. Investigate, obtain correct address, and remail all undelivered requests. Mail second requests to customers who have not replied to the first request within a reasonable time.

7. On all confirmations received, check them to the list, investigate all differences and discuss them with the client's employees where necessary.

8. In all instances where a confirmation is not received upon second request, investigate the supporting records for the charges and investigate the source of all recent credits to the accounts.

9. Prepare a summary of the results of the circularization of the accounts.

10. Prepare an analysis of the accounts receivable general ledger account for the ten months ended October 31st. Tie up the debits with sales. Investigate all unusual credits in the account, and reconcile the write-offs with charges to bad debt reserve. Prove the cash credits for a test period to the cash book. Scan the discounts shown in the cash reports for a test period.

Sales:

1. Obtain monthly sales figures by principal products and investigate any variations between months that appear unusual.

2. Test from shipping notices to the sales register all items and account for all numbers for a selected period.

3. Test to price lists or quotations, the prices on a number of invoices.

4. Make tests from shipping records to stores records to determine that the inventory was credited and test from store credits to shipping notices to determine that items removed from stores were shipped.

b. Program for Year-End Work:

Accounts Receivable:

1. Continue the analysis of the control account through December 31st, and tie up the debits with sales. Investigate unusual credits and reconcile write-offs to bad debt reserve debits.

2. Obtain an aged trial balance as of December 31st. Foot and cross-foot the schedule.

3. Test the balances and the ageing to the accounts receivable detail ledger.

4. List on the schedule all cash payments after December 31st and test these to the cash records.

5. Review large balances with the credit manager and estimate the probable loss because of uncollectibility.

6. Compare the trial balance with the trial balance used in the preliminary work. Confirm any large new balances or substantial increase in balances by direct confirmation from customer.

7. Examine sales returns and allowances for the two months and for the first few days of January listing and investigating those that appear unusual. Look for any unusual credits either immediately before or after December 31st.

8. In view of the weakness of control over payments received in cash, examine the cash records for the last few days of December and the first few days of January to determine that there was no lapping of receipts. Tie-up of the receipts with shipping notices on all cash sales should be made.

Sales:

1. Complete the schedule of monthly sales and examine variations.

2. Examine all sales records for the last few days of December to determine that inventory was credited, that the shipments were actually made in December, and that all debits to accounts receivable were credited to sales. The same procedure may be applied to the transactions for the first few days of January to establish the accuracy of the cut-off at the year end.

COMMERCIAL LAW

May 19, 1950; 9 a.m. to 12:30 p.m.

GROUP I

No. 1 (10 points)

a. (1) Mutual mistake as to the meaning of words or other acts manifesting the intention of either party in the formation of a contract, or mutual ignorance of facts existing at the time a bargain is made when rendering its performance impossible, make a contract void. Mutual mistake regarding a fact assumed by the parties as the basis on which they entered into the transaction makes a contract only voidable.

(2) Undue influence makes a contract voidable.

(3) Duress makes a contract voidable. Where, however, duress compels one party to manifest assent to a contract against his will or when he neither knows nor has reason to know the nature of the contract, the contract is void.

(4) Fraud in the inception or procurement of a contract renders it void.

(5) Fraud in the consideration or inducement of a contract renders it voidable.

b. A contract may be discharged in the following ways:

(1) Performance according to its terms.

(2) Occurrence of a condition subsequent.

(3) Breach by the other party or failure of consideration.

(4) Release or contract not to sue.

(5) Rescission by agreement of the parties.

(6) Renunciation, rejection of tender or executed gift.

(7) Accord and satisfaction.

(8) Account stated.

(9) Assignment, novation, or contract for the benefit of a third person.

(10) Exercise of the power of avoidance if the duty is voidable.

(11) Cancellation or surrender, if the contract is formal.

(12) Alteration of a written contract.

(13) Merger.

(14) Adjudication by a court.

(15) Marriage of the parties to each other in states where husband and wife cannot contract with one another.

(16) Acquisition by the debtor of the correlative right.

(17) Impossibility.

(18) The rules governing discharge of joint debtors.

(19) The rules governing discharge of sureties.

(20) Illegality of the contract or of its enforcement.

In addition, bankruptcy or the expiration of the statutory period of limitation will bar the remedy on a contract.

No. 2 (10 points)

a. A person is deemed to be an endorser of a negotiable instrument when he writes his name with or without additional words, either on the instrument itself or upon a paper attached thereto, an allonge.

b. To be a "holder in due course" of a negotiable instrument, the holder must have taken the instrument under the following conditions:

(1) That it is complete and regular upon its face;

(2) That he became the holder of it before it was overdue, and without notice that it had been previously dishonored, if such was the fact;

(3) That he took it in good faith and for value;

(4) 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.

c. Every endorser who endorses a negotiable instrument without qualification warrants to all subsequent holders in due course:

(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;

(5) That he engages that on due presentment, it shall be accepted or paid, or both, as the case may be, according to its tenor, and that if it be dishonored, and the necessary proceedings on dishonor be duly taken, he will pay the amount thereof to the holder, or to any subsequent endorser who may be compelled to pay it.

No. 3 (10 points)

a. "Marshalling of assets" is an equitable doctrine used by the courts when the partnership is insolvent, whereby firm property will first be taken to satisfy firm creditors and individual property will be taken to pay individual debts, before either group of creditors can look to other property.

b. (1) An outgoing partner is liable for firm debts contracted while he was a partner and for those contracted after he withdrew unless he gives actual notice to former dealers with the partnership of his withdrawal and a constructive notice to those who had not dealt with it.

(2) An incoming partner is liable for all obligations of the partnership arising before he came into it, but these liabilities shall be satisfied only out of partnership property.

(3) A secret partner is liable for all partnership liabilities incurred while he is a partner. He need not give notice of his withdrawal except to those who knew of his connection with the firm.

(4) A limited partner is liable for partnership liabilities up to the amount of his partnership contribution, but is not liable as a general partner unless he takes part in the control of the business or unless his surname wrongfully appears in the partnership name.

No. 4 (10 points)

a. The general requirements of the Statute of Frauds are that a contract to sell or a sale of any goods or choses in action of the value of $\$$——— (amount depends on law of the jurisdiction) or more shall not be enforceable by action unless some note or memorandum in writing of the contract or sale be signed by the party to be charged or his agent in that behalf.

b. A sale of personal property will be taken out of the requirements of the Statute of Frauds if the following circumstances are present:

(1) The buyer receives and accepts part of the goods or choses in action so contracted to be sold or sold, and actually receives the same; or

(2) The buyer gives something in earnest to bind the contract; or

(3) The buyer gives something in part payment; or

(4) The subject matter of the contract is goods to be manufactured by the seller especially for the buyer and not suitable for sale to others in ordinary course of seller's business.

c. (1) A sale by auction is complete when the auctioneer announces its completion by the fall of the hammer, or in other customary manner.

(2) The auctioneer represents both the buyer and the seller for purpose of complying with the Statute of Frauds.

(3) The auctioneer's making and signing of a memorandum of sale immediately after the fall of the hammer satisfies the Statute of Frauds.

No. 5 (10 points)

a. A contract of suretyship is a contract by which one person agrees to answer for another's debt, default, or miscarriage of duty.

b. (1) Exoneration is a remedy afforded the surety (when the principal's debt has matured and is unpaid) of bringing an action in equity to compel the principal to pay his creditor the debt, thus exonerating the surety.

Example: S is surety for P. Upon maturity of the debt, S may bring suit in equity to compel P to pay the creditor.

(2) A surety who discharges more than his proportionate share of the principal's duty is entitled to contribution from his co-surety or co-sureties.

Example: X, Y, and Z are co-sureties on a \$3,000 debt of P. If X makes good \$1,000 out of the principal amount, he can recover no contribution from Y or Z because \$1,000 is his ratable liability in any event; but if he pays \$2,000, he can compel contribution of \$1,000 or the excess over his proportionate share from Y and Z; and if he has paid the entire principal amount, he can compel Y and Z to contribute \$2,000 or the amount of the excess over his own ratable liability.

(3) When a surety pays the debt of his principal, he becomes entitled to indemnity, or reimbursement, from the principal in the amount of his loss in making good the principal's default.

Example: A is surety for B on a debt owing to C. On maturity B defaults and A is obliged to pay the debt to C. At this point A has a right to be reimbursed for the amount of the debt from B.

(4) Subrogation is the term that describes the equitable remedy by which the surety, having discharged the obligation of the principal, is placed in the position of the creditor or obligee to whom payment of the obligation was made. In addition to the rights of the creditor against the principal and against co-sureties, the surety is subrogated to the security held by the creditor for the principal's performance and to the rights of the creditor against persons other than the principal whose negligence or willful conduct has made them liable to the creditor for the same default.

Example: A is indebted to C in the amount of \$5,000, and C, as part of the negotiations, requested A to obtain a surety and also to deposit collateral with C as security for the loan. A obtained B to act as his surety and also deposited the required collateral with C. Upon maturity of the debt, A defaulted and B was required to pay the debt to C. At this time B, the surety, has a right to receive the collateral which was given to C at the time the debt was incurred.

GROUP II

No. 6 (10 points)

(1) Negotiable. An instrument must be payable on demand, or at a fixed or determinable time, to be negotiable. "On or before" satisfies this requirement.

(2) Non-negotiable. An instrument to be negotiable must contain an unconditional promise to pay. A promise to pay out of a particular fund violates this requirement.

(3) *Negotiable. An instrument is negotiable* when the name of the payee does not purport to be the name of any person. The instrument here is payable to bearer.

(4) Non-negotiable. An instrument to be negotiable must be payable in money. If the *maker* is given an option to pay in money or some other medium of payment, this requirement is violated. If the *holder* has the option, the instrument is negotiable.

(5) Non-negotiable. An instrument, to be negotiable, must contain an unconditional promise or order to pay a sum certain in money, and it must be payable to order or to bearer. An acknowledgment of a debt is not a promise.

(6) Non-negotiable. An instrument, to be negotiable, must be payable to order or bearer.

No. 7 (10 points)

(a) No. Under the Uniform Conditional Sales Act, when goods are delivered under a conditional sale contract and the seller expressly or impliedly consents that the buyer may resell them prior to performance of the condition—as the facts here tend to establish—the reservation of property is void against purchasers from the buyer for value in the ordinary course of business, and as to them the buyer shall be deemed the owner of the goods.

(b) Yes. The unpaid seller under a conditional sales contract has the right to retake possession of the goods after the buyer's default.

(c) No. The vendor under the conditional sales contract has no lien on the proceeds received from a sale of the goods originally sold under a conditional sale. He is now a general creditor of the conditional vendee.

No. 8 (10 points)

(a) (1) P is responsible to T for A's action. An act performed by an agent which falls within the usual scope of his agency powers is binding on the principal. Even though the particular act has been forbidden, an innocent third party will be protected if the act done by the agent is the usual practice. In this case, the hiring of clerks was a normal incident of a manager's position and T, the clerk, was unaware of the limitation.

(2) P has a right of action against A. An agent is obligated to follow his principal's in*structions, and failure to do so subjects the agent* to liability for damages caused his principal by his disobedience.

(b) P should have the benefit of the lease. An agent must be loyal to his principal. If the agent violates this duty any resulting gain to the agent must be held as a trust for the principal's benefit.

No. 9 (10 points)

(a) Only the first and third claims suggested should be treated as liabilities; namely, wages of $1,800 and sales taxes of $1,800. The Bankruptcy Act stipulates that certain claims will carry over against the bankrupt's new estate even though he has obtained a discharge. Among these are taxes, wages earned within the three months immediately prior to bankruptcy, and willful or malicious tort claims. Nothing is said about judgments, leases, or torts based on ordinary negligence.

(b) (1) Only judgment liens which are obtained in the four months immediately prior to bankruptcy are voidable. This lien, being five months old, was not affected by the bankruptcy. C's judgment will be satisfied, in so far as possible from the proceeds of the sale of the land.

(2) A person who has received a preference within four months of bankruptcy is obligated to return it if he had reasonable cause to believe the debtor was insolvent at the time payment was received. If A had no knowledge of B's insolvency and no reasonable cause to believe him insolvent, he may retain the payment.

No. 10 (10 points)

(a) C may recover judgment against the partnership. Partners have apparent authority to bind the partnership and each other in what appears to be the firm's business. C as a holder in due course of the partnership note may enforce it.

(b) Initially C must sue the partners jointly since they are only jointly liable for contract claims. However, the judgment against the partnership could be satisfied out of Y's individual property.

(c) Under the general rule, Y can maintain no action at law for contribution against his partner Z until there has been an accounting and settlement of the partnership accounts. A partner paying a judgment against the partnership has the right to bring such payment into account upon a settlement. X would, of course, be chargeable with the amount of the note wrongfully signed by him. Assuming that X is insolvent, the general rules for distribution would require that partnership assets, including contributions of partners necessary for the payment of liabilities, be applied to the satisfaction of liabilities owing to first, creditors other than partners; second, partners other than for capital and profits, such as the amount here owing to Y; third, partners in respect of capital; and fourth, partners in respect of profits. Partners must contribute the amount necessary to satisfy the liabilities according to their share in the profits and if any partner is insolvent, the others contribute the additional amount in the relative proportions in which they share the profits.

No. 11 (10 points)

(1) False. (2) False. (3) True. (4) False. (5) True. (6) False. (7) True. (8) True. (9) False. (10) True.

No. 12 (10 points)

(1) True. (2) False. (3) True. (4) True. (5) True. (6) True. (7) True. (8) False. (9) True. (10) True.

Examination Answers, November, 1950

ACCOUNTING PRACTICE—PART I

November 8, 1950; 1:30 to 6 p.m.

No. 1 (10 points)

a. 1. $600. Sec. 22(b)(2)

2. (b) Long-term capital gain. *Allan S. Lehman* v. *Comm. of Internal Revenue*, 7 TC 1088, and cases cited therein.

3. (b) Short-term capital gain. Sec. 117(g)(2).

4. (a) Yes. *Comm. of Internal Revenue* v. *Stockholms Enskilda Bank*, 293 US 84.

5. $1,000. Sec. 22(b)(2)(a).

6. $600, Reg. 111, Sec. 29.23(o)–1.

7. (a) Fee for preparation of return. Reg. 111, Sec. 29.23(a)-15.

b. 1.(a) $2,000. Reg. 111, Sec. 29.113(a)(7)-1.

2.(a) $500. The basis for depreciation of both buildings is the same as in the hands of the transferors. Reg. 111, Sec. 29.113(a)(7)-1.

3.(c) $375. The lump-sum cost basis must be allocated between land and building on the basis of their respective fair market values on the date of purchase. The basis of the building then is $37,500. Depreciation is allowable at 2 per cent for one-half year. Reg. 111, Sec. 29.23 (1)-4.

c. 1.(a) $40,000. Reg. 111, Sec. 29.23(e)-2.

2.(c) $33,000 computed as follows: IRC Sec. 122(a)(1) and (2).

1949 net income............		$40,000
1946 net income............	$20,000	
1947 loss..................	14,000	
	$ 6,000	
Less 1948 loss..............	13,000	
Balance of 1948 loss to 1949		7,000
		$33,000

3(c) $8,500 computed as follows: IRC Sec. 113(a)(10); Sec. 118. Reg. 111, Sec. 29.113(a)(10); Sec. 29.118-1.

Original 100 shares........	$8,000
100 shares @ $5 additional as a result of the sale at $60 and repurchase at $65....	500
	$8,500

No. 2 (10 points)

ARTHUR JACOBS
Statement of Profit and Loss
For the Year Ended December 31, 1950

Sales		$108,782
Cost of goods sold:		
Purchases	$120,430	
Inventory 12/31/50	16,710	103,720
Gross profit		$ 5,062
Expenses:		
Salaries	$ 590	
Utility services	554	
Real estate taxes	350	
Insurance	234	
Supplies, etc.	100	
Advertising	50	
Depreciation on building	400	
Depreciation on fixtures	700	
Estimated loss on accounts	123	3,101
Net operating profit		$ 1,961
Interest and finance charges		225
Net profit		$ 1,736

Reconstructed Ledger Accounts—Principal Items

Cash in Bank

Investment	$ 20,000	$ 5,000	Notes
Notes	10,000	100	Interest
From cash	100,500	5,600	Fixtures
		3,150	Balance 12/31
		116,650	Suppliers
Given total	$130,500	$130,500	
Balance 12/31	$ 3,150		

Cash on Hand

From accounts	$107,512	$100,500	To bank
		4,800	Drawings
		1,878	Misc. expenses
		334	Balance 12/31
	$107,512	$107,512	
Balance 12/31	$ 334		

Accounts Receivable

From sales	$108,782	$107,512	To cash
		1,270	Balance 12/31
	$108,782	$108,782	
Balance 12/31	$ 1,270		

Accounts Payable

From bank	$116,650	$120,430	Purchases
Balance 12/31	3,780		
	$120,430	$120,430	
		$ 3,780	Balance 12/31

No. 3 (10 points)

Adjusting Journal Entry

Consignments out—A	$ 3,566.50	
Consignments out—B	2,577.50	
Freight and packing	86.00	
Commissions on consignment sales	3,600.00	
Cost of consignment sales	8,000.00	
Sales	16,800.00	
Consignment sales		$14,400.00
Finished goods inventory		14,000.00
Consignee's deposit		750.00
Accounts receivable—A		2,605.00
Accounts receivable—B		2,875.00

To correct the accounts arising out of consignment transactions by adjusting to the balances shown in the following accounts. (The entries to Sales, Consignment Sales and Cost of Consignment Sales might be netted if it is not desired to report consignment sales gross.)

Account Balances

Accounts	Debit Balance	Credit Balance
Cash	$9,886.00	
Consignments out—A	3,566.50	
Consignments out—B	2,577.50	
Consignee's deposit		$ 750.00
Accounts receivable—B	1,350.00	
Finished goods inventory		14,000.00
Freight and packing	170.00	
Sales commissions	3,600.00	
Cost of consignment sales	8,000.00	
Consignment sales		14,400.00

Accounts Showing Entries Made by Company

Accounts Receivable

Debit	Credit
(a) $16,800	$ 9,970 (c)

Sales

Debit	Credit
	$16,800 (a)

Cash

Debit	Credit
(c) $ 9,970	$ 84 (b)

Freight and Packing

Debit	Credit
(b) $ 84	

Accounts Showing Correct Entries

Consignments Out—A

Debit	Credit
(a) $10,000.00	$ 123.50 (e)
(b) 60.00	6,500.00 (f)
(d) 130.00	

Finished Goods Inventory

Debit	Credit
	$10,000.00 (a)
	4,000.00 (g)

Cash

Debit	Credit
(c) $ 4,000.00	$ 60.00 (b)
(d) 5,395.00	24.00 (h)
(i) 575.00	

Consignee's Deposit

Debit	Credit
(d) $ 3,250.00	$ 4,000.00 (c)

Consignment Sales

Debit	Credit
	$11,700.00 (d)
	2,700.00 (i)

Sales Commissions

Debit	Credit
(d) $ 2,925.00	
(i) 675.00	

(Continued on following page)

Freight and Packing

(e) $ 123.50	
(k) 46.50	

Cost of Consignment Sales

(f) $ 6,500.00	
(j) 1,500.00	

Consignments Out—B

(g) $ 4,000.00	$ 1,500.00 (j)
(h) 24.00	46.50 (k)
(i) 100.00	

Accounts Receivable—B

(i) $ 1,350.00	

No. 4 (10 points)

Statement of Income and Expense

For the Year Ending December 31, 1949

	P Co.	S Co.	Adjustments and Eliminations Debit	Adjustments and Eliminations Credit	Consolidated
Sales	$630,000	$340,000	$180,000 (1)		$790,000
Cost of goods sold:					
Inventory 1/1/49	$105,000	$ 51,000			$156,000
Purchases	485,000	300,000		$180,000 (1)	605,000
	$590,000	$351,000			$761,000
Inventory 12/31/49	80,000	45,000	4,500 (2)		120,500
Cost of goods sold	$510,000	$306,000			$640,500
Gross profit on sales	$120,000	$ 34,000			$149,500
Operating expenses	92,000	70,000			162,000
Net operating profit	$ 28,000	($ 36,000)			($ 12,500)
Non-operating expenses	$ 22,000	$ 15,500	150 (5)	2,500 (3)	
			500 (4)		$ 35,650
Less—Non-operating income	12,800		11,500 (3)	150 (5)	
				50 (4)	1,500
	$ 9,200	$ 15,500			$ 34,150
Net profit for year	$ 18,800	($ 51,500)			($ 46,650)
Less—Minority interest in loss of S Co.					5,150
Consolidated net loss for year					$ 41,500
Adjustment of P Co. profit for dividends	9,000				
Corrected profit of P Co.	$ 9,800				

Explanation of eliminations:

1. To eliminate intercompany sales and purchases.
2. To reduce the inventory to cost to P Co. as follows:
   Three-fifths of inventory of S Co. was acquired from P Co. at 120 per cent of their cost.
   3/5 of 45,000 = $27,000
   1/6 of 27,000 = $ 4,500
3. To eliminate the interest on $50,000 of S Co. 5% bonds from expense and income and 90 per cent of S Co. dividends of $10,000 from income.

(*Continued on following page*)

4. To eliminate the excess of premium paid on bonds over the amount applicable thereto on books of S Co. and to increase income by the amount of the excess amortization recorded for 1949.
5. To eliminate 1/4 of the 1949 amortization of bond premium on the books of S against the amortization of premium on the books of P. It appears that in each instance the amortization was netted against interest expense or interest income.

NOTE: Under one common method of accounting for investment in a subsidiary, P Co. would also adjust its profit for 90 per cent of the loss incurred by S Co. rather than adjust for only the dividend received out of surplus at date of acquisition.

No. 5 (10 points)

Teller's Proof

A. M. cash balance	$ 1,200	Checks on depositors	$ 4,500
Deposits	5,500	Checks on other banks	3,600
Loans redeemed	5,000	Loans granted	1,000
Interest	200	Remittance to F.R.B.	2,000
Checks certified	300	Cashier's checks redeemed	500
		Certified checks redeemed	400
		Expenses paid	100
		P. M. cash balance	100
TOTAL	$12,200	TOTAL	$12,200

No. 6 (10 points)

1. A	4. A	7. E	10. A	either A or G)
2. C	5. A	8. E and G	11. A and B	13. A and D
3. A	6. A and G	9. A and F	12. E, F(and	14. D

November 9, 1950; 1:30 to 6 p.m.

No. 1 (8 points)

Adjusting Entry

Baker	$512.50	
Charles	166.67	
Day	170.83	
Adams		$850.00

Computation of the Adjustment

	Total	Adams	Baker	Charles	Day
Amount charged as a result of division of the year's profits	$9,000.00	$3,600.00	$2,700.00	$1,800.00	$ 900.00
Amount chargeable under partners' agreement	9,000.00	2,750.00	3,212.50	1,966.67	1,070.83
Net adjustment	$ —	$ 850.00	($ 512.50)	($ 166.67)	($ 170.83)

Computation of Correct Charge

	Total	Adams	Baker	Charles	Day
Premium for policy on Adams	$3,500.00	$ —	$1,750.00	$1,166.67	$ 583.33
Premium for policy on Baker	1,400.00	800.00	—	400.00	200.00
Premium for policy on Charles	2,300.00	1,150.00	862.50	—	287.50
Premium for policy on Day	1,800.00	800.00	600.00	400.00	—
Total	$9,000.00	$2,750.00	$3,212.50	$1,966.67	$1,070.83

No. 2 (12 points)

a. *Investment Account per Books*

Debits				Credits			
Date	Explanation	Shares	Amount	Date	Explanation	Shares	Amount
1/7/42	Purchased for cash	200	$22,000	1943–44	Cash dividends received	—	$ 5,000
4/1/43	Exercise of rights	50	5,000	June '49	Proceeds of 250 shares	250	23,000
Dec. '48	Two-for-one split	250	27,500		To balance	250	26,500
		500	$54,500			500	$54,500
	Balance	250	$26,500				

b. *Corrected Investment Account*

Debits				Credits			
Date	Explanation	Shares	Amount	Date	Explanation	Shares	Amount
1/7/42	Purchased for cash	200	$22,000	4/1/43	Exercise of rights	—	$ —
3/1/43	Receipt of rights	—	—	Jan. '48	Sale for cash	125	9,000
4/1/43	Exercise of rights—cash	50	5,000	June '49	Sale for cash	250	9,000
Dec. '47	Stock dividend	125	—				
Dec. '48	Stock split	250	—		To balance	250	9,000
		625	$27,000			625	$27,000
	Balance	250	$ 9,000				

(*Continued on following page*)

c. ***Journal Entries***

Investment	$ 2,500	
Profit and Loss—1943		$ 2,500
To remove the credit to investment account for the cash dividend received.		
Investment	2,500	
Profit and Loss—1944		2,500
To remove the credit to investment account for the cash dividend received.		
Profit and Loss—1948	9,000	
Investment		9,000
To credit investment with one-third of the account balance which is applicable to the 125 shares of stock sold.		
Profit and Loss—1948	27,500	
Investment		27,500
To credit investment account with the amount debited thereto upon the split of the stock on a two-for-one basis.		
Investment	14,000	
Profit and Loss—1949		14,000
To reduce the credit to investment to the applicable cost of $9,000.		

No. 3 (30 points)

MARCH MANUFACTURING COMPANY
Statement of Income and Expense
For the Year Ending December 31, 1949

Sales of merchandise	$840,000	
Discounts allowed	1,600	
		$838,400
Cost of goods sold (Schedule 1)		525,840
Gross profit on sales		$312,560
Income from contract work:		
Charges for processing	$ 54,000	
Cost of processing (Schedule 1)	37,026	16,974
Total gross profit		$329,534
Selling and general expenses		126,732
Profit from operations		$202,802
Interest expense		4,902
Net profit before income taxes		$197,900
Provision for taxes based on income:		
Federal income taxes	$ 69,000	
State income taxes	13,000	82,000
Net profit for year		$115,900

(Continued on following page)

(Schedule 1)

Statement of Cost of Goods Sold

Material:		
Purchases		$418,052
Less—Inventory 12/31/49		40,000
Cost of material used		$378,052
Labor and expense		224,104
Total		$602,156
Deduct:		
Sale of scrap material	$ 9,900	
Cost of work done under contract	37,026	46,926
Net cost		$555,230
Work-in-process inventory (Schedule 2)		20,000
Cost of goods manufactured		$535,230
Finished goods inventory (Schedule 2)		9,390
Cost of goods sold		$525,840

(Schedule 2)

Cost Statement

Processing Department

	Units	Amount	Cost per pound
Material put in process	1,880,000	$376,000	$ .20
Labor	2,200,000	88,000	.04
Expense	2,200,000	132,000	.06
Total		$596,000	$ .30
Sale of scrap material	90,000	9,900	
Net cost incurred		$586,100	
Cost assignable to:			
Work done under contract	360,000	$ 36,000	$ .10
Work in process—material	80,000	16,000	.20
Work in process—labor and expense	80,000	4,000	.05
Transferred to baling department	1,710,000	530,100	.31
Total as above		$586,100	

Baling Department

	Units	Amount	Cost per bale
Transferred from processing	4,275	$530,100	$124.00
Material used	5,130	2,052	.40
Labor and expense	5,130	4,104	.80
Total		$536,256	$125.20
Cost assignable to:			
Work done under contract	855	$ 1,026	$ 1.20
Bales sold	4,200	525,840	125.20
Bales on hand	75	9,390	125.20
Total as above		$536,256	

(Continued on following page)

Supporting Computations

Processing Department

	Units	Amount
Material:		
Purchases	2,080,000	$416,000
Inventory 12/31/49	200,000	40,000
Put in process	1,880,000	$376,000
Labor and Expense:		
Company owned	1,880,000	
Contract work	360,000	
	2,240,000	
Less 80,000 units ½ completed	40,000	
	2,200,000	
Transferred Units:		
Units transferred to baling department—4275 bales of 400 pounds each	1,710,000 pounds	
Completed in processing department	1,800,000 pounds	
Loss at end of processing department	90,000 pounds	
Percentage of loss	5	
Transferred Cost:		
Units completed of 1,800,000 @ $.30 =		$540,000
Scrap which is applicable to company production of completed units		9,900
Cost of 1,710,000 units transferred		$530,100

Baling Department

Units:	
Bales sold	4,200
Bales on hand	75
Total company material	4,275
Contract work (360,000 pounds divided by 400 equals 900 bales less 5% loss)	855
Total	5,130

Cost of Contract Work

Processing—360,000 pounds at labor and expense rate of $.10	$ 36,000
Baling—855 bales at labor and expense rate of $1.20	1,026
Total	$ 37,026

THEORY OF ACCOUNTS

November 9, 1950; 9 a.m. to 12:30 p.m.

GROUP I

No. 1 (15 points)

a. To identify the cost of the specific items sold might be impossible, impractical, or misleading. If similar goods were purchased at different times and at different prices, it would be difficult to identify the specific goods which were sold. Even if perpetual inventory records were maintained, individual items would not normally be identified except in the case of goods such as autos, pianos and expensive jewelry. Except for such costly items, identification would be expensive and of little value. In some cases, specific identification could be misleading, since the particular item sold out of a group of similar items is often a matter of chance or accident. A consistent assumption might, therefore, result in financial statements which could be better interpreted than those reflecting the effect of an undisclosed accidental circumstance.

b. A major consideration in the selection of a method should be the accuracy with which it matches cost with current revenue. The decision would be based primarily on the responsiveness of selling prices to changes in cost of reproduction or replacement. If a change in cost is promptly reflected by a change in selling price, LIFO might be the appropriate method. The nature of the goods is also a consideration. LIFO has been thought by some accountants to be more appropriate for fungible or similar goods than for such items as ladies' hats. Some weight might also be given to the practices of other companies in the same industry.

c. It is not a generally accepted accounting principle to restate historical costs in terms of current dollars, but that would be necessary for the clearest presentation of current position. In the case of inventories, the FIFO method assigns the earlier purchases to the cost of goods sold and, therefore, the inventory on the balance-sheet reflects cost in terms of more current dollars but not necessarily present market. The LIFO method, however, assigns the more current costs to the income statement and shows inventory on the balance-sheet in terms of dollars of earlier dates. Stating inventory at former rather than current costs is not the clearest way to bring out current position. The average method will tend to be in-between the other two methods with the current costs assigned in part to the income statement and in part to the balance-sheet. Except in situations where prices are stable, none of the three methods is likely to accurately disclose the current value of the inventory. Where market is lower than cost and lower of cost or market is used to value inventory, we may have current values used, but not as a result of the three inventory methods.

No. 2 (15 points)

The appropriation of retained earnings should have been made. This is true whether the sinking fund is used to reacquire the company's own bonds or is invested in other securities. Requiring a reserve is intended to restrict the amount of surplus available for dividends, thereby tending to prevent an impairment of working capital through forcing temporary retention of a portion of earnings in the business. The retention of earnings should make possible the accumulation of the sinking fund amounts without impairing the operating position of the business; whereas the setting aside of cash in a fund without placing a restriction upon retained earnings (or obtaining some source of new equity) might drain the company of its earning assets, thereby reducing the bondholders' probability of being repaid.

The provision of the bond indenture as to the reserve will require the stockholders to increase their equity by $1,000,000 during the 20 years the bonds are outstanding (assuming that there are earnings each year of as much as $50,000). This increase in equity will permit the retirement of the bonds without having to reduce the assets used in the regular operations of the business. This increase in equity is required for all of the bondholders and is not made unnecessary by the retirement of some bonds.

The sinking fund assures that the increase in stockholders' equity is devoted to paying off the bonds rather than invested in assets not readily convertible into cash when the bonds mature.

The analyst's reasoning is unsound. He seems to fail to distinguish between charges against income and transfers of cash into a restricted fund. The purpose of a statement of net income is to explain the increase in stockholders' equity from operations. A statement of ability to pay dividends is incompatible with that purpose. The $50,000 charge should be treated as an appropriation of profit or surplus (retained earnings), and not as an expense. Stockholders' equity was not reduced by the transfer of $50,000 from free cash to a restricted fund. The analyst is correct in concluding that some restriction should be shown on the amount available for dividends, but his reasoning is unsound.

No. 3 (15 points)

The offset to the increase in patents of $250,000 is an increase in common stock of $200,000 and an appraisal surplus of $50,000. When the patent has expired and the company has liquidated any inventory values based on amortization of the patent write-up, earned surplus will have been charged with amortization of the appraisal write-up of $250,000. Prior to that time, inventory values may be increased by portions of the amortization charge attached to items included in inventory, although under some base stock or LIFO methods, the entire amount amortized each year would be charged to costs of the year.

The write-up is a departure from the generally accepted accounting principle that the value of an asset for a going concern, in the absence of extreme changes in the value of the monetary unit, should be based on cost. While there are important exceptions to this rule, the situation stated in this question does not fall within the usual exceptions. The basis for the write-up is merely "cost saving." A potential saving in cost does not constitute a proper basis for a write-up.

When appreciation has been recorded, even though it does not appear that it should have been recorded, amortization charges should be based on the higher value. Having represented that the patent is worth an additional $250,000, the Plaza Company implies an intention to maintain the larger equity of the stockholders intact by proper charges against income.

If the write-up is made, the capitalization of a part of the resulting credit would appear to be acceptable. It indicates that the company expects to maintain the additional amount as a permanent part of its capital. However, the source of the dividend should be clearly indicated to all stockholders. The remaining $50,000 of surplus arising from the write-up should be properly identified in the balance-sheet, and an explanation should be included in the first balance-sheet subsequent to the write-up, stating the facts as to the complete transaction. Thereafter, disclosure might be desired as to the amount of the write-up not yet amortized through the income account. This may be done by showing the unamortized balance separate in the asset account, or by a parenthetical explanation or by a footnote.

No. 4 (16 points)

a. 1. The corporation followed generally accepted accounting principles. A balance-sheet is not a legal document, but a statement of financial position. Legal title is not the only criterion for inclusion of an asset on the balance-sheet.

It is important to consider the usefulness of the financial statements in contrast to their usefulness if alternative methods were followed. Exclusion of the asset would prevent systematic depreciation charges, and the income statement would not show the financial results of operations in a way which would permit useful comparison with the results of other years. Exclusion of the asset from the body of the balance-sheet would mean that the liability under the purchase contract is also excluded. Footnote disclosure would not be as satisfactory.

The business assumption of a "going concern," which is accepted by accountants, indicates that inclusion is reasonable because, in the normal course of events, title to the machinery will be acquired by the corporation. The corporation does have an equitable interest in the asset.

2. The corporation followed generally accepted accounting principles:

Bond discount may be considered to be not an asset at all, but its classification as a deferred charge can nevertheless be supported. If interest is defined as the excess of the amount paid to the lender over the amount received from the lender, there can be no such thing as prepaid interest, and discount is not really an asset. However, the balance-sheet has been viewed as simply the connecting link between successive income statements. As such it contains items to appear in future income statements, such as bond discount.

The acceptability of showing bond discount as a deferred charge can be supported by citing prevailing practices of accountants, since most of them do show it as a deferred charge.

On the other hand, there is substantial authority and logic supporting the presentation of discount as a deduction from the bond liability on the balance-sheet. This treatment has not been generally followed although it has been recognized as valid in special cases. An example might be a U. S. Series E bond which is issued for $75 and has a maturity of $100 in ten years. No one seems to suggest that the government has a $100 liability at the date of issue.

b. In the usual case, the calculation of income taxes is substantially based on amounts reflected in the income statement. Occasionally however, there is a difference between generally accepted accounting principles and the appropriate tax treatment which materially distorts net income. When this is true it calls for an adjustment or proper disclosure of the factor causing distortion.

In this case it appears that a loss was chargeable to surplus in accordance with the rule that an extraordinary item should be excluded from the determination of net income if including it would impair the significance of the net income figure. The loss was currently deductible for tax purposes, however, and the tax reduction itself would have distorted net income. Accordingly, only the loss in excess of the tax reduction was charged to surplus. In other words, both the extraordinary loss and its tax consequences have been excluded from the determination of net income. The effect of this treatment is to arrive at a net income figure which is comparable with other years and therefore may be more significant to users of the statements.

GROUP II

No. 5 (13 points)

The indication here is that July 31 would be the most satisfactory date for the company's fiscal year.

The most difficult problem in the determination of periodic income is the decision as to the amount of cost that should be carried forward to a future period instead of being charged against current revenue. The use of a July 31 closing date offers the following advantages in determining income:

1. The determination of the amount of cost of designing and tooling-up for new models that should be deferred is simple. The entire amount of such cost should be deferred. There would be no cost to defer for the previous model since it is now out of production and its cost has been charged to revenue (or to inventory).

2. The valuation of inventories is easier than at any other date. There will not be any work-in-process inventory. The inventory of finished goods would be small and its disposition taking place at a rapid rate. Inventory of materials will be large but would be principally for the new model. The effect of obsolescence can be better determined than at any date prior to July 31.

3. Because of the cycle in sales, the estimation of loss on accounts should be easier than at other dates.

The presentation of a balance-sheet at July 31 should likewise be more accurate than at other times. Receivable balances are low. Payables and accrued expenses are probably near their minimum at July 31, and inventories are likely to be low. Since this is the end of a production cycle, the figures for one year should be more comparable with other years than at any other date.

The principal disadvantages of the July 31 date are the following:

1. The items in the balance-sheet are not typical of the financial position throughout most of the year.

2. Sales are still being made of the old model, making the cycle not quite complete.

3. There might be a very large inventory of raw material on hand to be counted.

4. A considerable amount of advertising, promotion and selling expense applicable to the new model may have been incurred and would present a problem as to the best treatment on the statements.

No. 6 (13 points)

There are a number of criteria which can be used to test each of the proposed methods of dealing with past-service benefits. These criteria include:

a. Matching of costs with revenue—Here different interpretations are possible.

b. Materiality of the amounts involved and related questions of adequate disclosure and avoidance of distortion in the income statement —Here questions of fact and judgment are involved.

c. The reasonableness of the results, the simplicity of the method and the extent to which assumptions (as to social security rates, number of employees retiring, etc.) are necessary.

Arguments for one method may be arguments against another and vice versa. Some of the possible arguments are as follows:

a. (1) The cost of past-service benefits "accrued" in prior years and should not be charged against current or future income, which will be charged with the cost of the pensions arising from services in each year.

(2) The cost of past-service benefits could

be material in amount if the company previously had no pension plan. To prevent distortion of the income statement, the charge to surplus would be desirable.

b. (1) The liability becomes fixed and determinable only when the employee retires. The costs should, therefore, be charged to income at that time.

(2) On the reasonable assumption that the pension plan will be renewed indefinitely, there will be additional past-service benefits to be borne for at least ten or twenty years in the future. Each year should bear its own share and deferral will accomplish no useful result.

c. (1) The contract was probably negotiated with the future in mind. The cost of past-service benefits was probably accepted as the price of future industrial peace. This treatment is similar to the treatment of major plant rearrangement costs. The costs are carried as a deferred charge to be written off against income in the future years to which the benefit attaches. The write-off is fast enough to be conservative, yet slow enough to minimize distortion of the income statement.

(2) A cost such as this may best be taken up on a cash basis because there are too many assumptions, such as the rate of Federal Social Security benefits, to permit a really significant accrual before the actual payments are made.

No. 7 (13 points)

The retail method of inventory valuation is frequently used by department stores. Its use involves recording all merchandise stocked (including opening inventory) at retail sales price as well as at cost. A record must be kept of all changes in sales price and an accurate record of sales must be available. The closing inventory at retail is obtained by deducting the sales and net markdowns from the total of the opening inventory and purchases at sales price plus additional markups. The relationship between the retail price of opening inventory, purchases and additional markup and the cost of opening inventory and purchases is expressed as a percentage. This percentage is then used to reduce the closing inventory at retail price to a "cost" figure.

The method will ordinarily produce a value for the closing inventory that is less than cost because of the exclusion of all markdowns from the determination of the computed percentage of mark-on. Merchandise has been marked down below original sales price, but the percentage used to reduce its value from retail to "cost" is the same as when it was originally recorded. The resulting value is a kind of theoretical market value, in that presumably the merchandise can be sold at its reduced price and now produce the same gross profit percentage as it was hoped to obtain when the items were originally purchased.

No. 8 (13 points)

A.	8	C.	4	E.	2	G.	9	I	6
B.	7	D.	5	F.	1	H.	3		

No. 9 (13 points)

a.	1. (a)	4. (b)	7. (b)	b.	1. (a)	3. (a)	6. (a)
	2. (b)	5. (b)	8. (b)		2. (b)	4. (b)	7. (a)
	3. (b)	6. (b)	9. (a)			5. (b)	

AUDITING

November 10, 1950; 1:30 to 5 p.m.

No. 1 (15 points)

a. A correct reconciliation will show the cash which should be on hand:

Balance per books, Nov. 30, 1949			$18,901.62
Add—Unrecorded bank credit			100.00
			$19,001.62
Balance per bank, Nov. 30, 1949		$15,550.00	
Deduct—Outstanding checks:			
# 62	$116.25		
183	150.00		
284	253.25		
8621	190.71		
8623	206.80		
8632	145.28	1,062.29	
Adjusted bank balance			14,487.71
Accountability for cash on hand			$ 4,513.91
Accountability for cash, as above			$ 4,513.91
Actual cash on hand			3,794.41
Shortage			$ 719.50

The cashier attempted to cover the shortage by making the following errors in his reconciliation:

Omission of old outstanding checks			$ 519.50
	# 62	$116.25	
	183	150.00	
	284	253.25	
		$519.50	
Underfooting of outstanding checks included in the reconciliation			100.00
Omission of unrecorded bank credit from reconciliation *between* book and bank balances			100.00
TOTAL			$ 719.50

b. The bank reconciliation should be made by someone who has nothing to do with other cash procedures. Cash on hand should be controlled by means of the imprest system. Receipts should be deposited intact daily.

c. Count cash on hand on December 5 and reconcile back to November 30. Trace cancelled checks returned by the bank with the November statement to the list of outstanding checks at October 31. Reconcile bank and cash on hand balances as of November 30 to the book balance.

Compare duplicate deposit slips with the cash book for the last few days of November and the first few days of December. Count cash on hand again, say on December 15, and obtain a cut-off bank statement for the period to December 15. Reconcile again as of this date and work back to November 30.

No. 2 (12 points)

a. Where internal control is good, the primary purpose of circularization is usually to test the functioning of the system of internal control rather than directly to substantiate the amounts involved at the balance-sheet date. If internal control is weak, confirmations are considered to be excellent evidence as to the validity of the asset balance. In either situation, the procedure is followed as a part of accepted auditing procedure, and the possession of a confirmation is reassurance to the auditor as to the validity of the accounts.

Other purposes of confirmation procedures might include:

1. Where disputes, errors, or irregularities in the accounts are believed to exist, confirmation may be the only means by which the auditor could satisfy himself as to the correctness of the accounts.

2. Where other means exist to determine the correctness of the accounts, some of the accounts may be so material in amount that the auditor desires the additional assurance of direct confirmation in substantiation of these particular accounts.

b. The usefulness of the replies will vary because responses vary in reliability. Where the accounts are with individual consumers rather than commercial establishments, the confirmation requests are less likely to be understood and records of the debtor may not be adequate. In other instances the kind of records maintained by the debtor may not enable them to reply. The usefulness of the replies will also vary according to the need for evidence and the other forms and amounts of evidence available.

c. In arriving at a decision as to whether the receivables should be confirmed on a test basis and the extent of such a test, if only a test is made, the auditor would consider the following:

1. The degree of internal control known to exist.

2. The materiality of the aggregate of receivables and the number and materiality of the individual balances.

3. The work done on receivabes in prior audits and the conclusions therefrom.

4. The purpose to be served.

5. The extent to which replies can be expected and the reliability of those replies.

6. The gain from confirmations compared with the time and expense involved.

7. The nature of other evidence as to the validity of the book balances.

8. The number and amount of unusual or old and apparently uncollectible items included in the balance.

No. 3 (12 points)

Two special problems which exist in connection with the physical inventory in a jewelry store are:

1. Identification of each item counted.

2. Because of the nature of the inventory, providing (as for cash and security counts) that the employee held accountable for the inventory is present throughout the count.

The perpetual inventory records should contain data to facilitate identification. In the case of watches, for example, the record should show case and movement numbers, manufacturer's name and model number, number of jewels, and whether ladies' or men's style. Each item should also be assigned an inventory number to appear on both the perpetual record and on the tag which bears the retail price and which is attached to the item.

In taking the count, enough of the above data should be noted to enable positive identification. The person who takes the count should be technically qualified. In the case of precious stones, he should be able to identify the kind of stone, the manner in which it is cut, its quality, and its genuineness.

Responsibility for stock is normally established by assigning each employee to specific display cases which he keeps under his personal control.

Except for the foregoing special considerations, the procedures for the physical inventory would follow the customary outline:

1. One person, perhaps the owner-manager, should have general responsibility and authority for the inventory.

2. Duties should be clearly assigned and the counters should be given careful instructions.

3. The count should be taken in the presence of the person responsible, and quite feasibly by one of the other salesmen. So far as possible the same salesman should not count the same section of the inventory each month.

4. Prenumbered inventory tags should be attached to the individual items, or to trays and drawers, noting information previously suggested.

5. Taking of the inventory of jewelry left with the store by customers for repair, for appraisal, for safekeeping, or for sale should be separated from taking the store-owned inventory, but should be done at the same time. A tie-up of outstanding receipts with the items on hand should be made.

6. The inventory supervisor should then see that all items and groups are tagged, and he should test the count before taking up the tags.

7. All tags should be accounted for and compared with the perpetual inventory records. Suitable cut-off precautions should be followed. Any differences should be promptly investigated.

8. If tags are not used, but instead a list of the items on hand is used, similar tests should be made to determine the accuracy of the count.

No. 4 (8 points)

a. Good records should have the same flow or sequence as the transactions which are recorded. If cash is received and disbursed through the same hands and periodically the balance is deposited, there can be little assurance of an effective record of receipts and disbursements. The possibility of fraud or error is large, but the means of detecting fraud or error are inadequate.

A good system will provide for evidence to support the records. Only if receipts are deposited intact, will the bank record support the books record of receipts and disbursements. Prompt deposit of receipts more closely aligns the bank and book records and reduces the chances of loss or misappropriation.

b. The imprest bank fund is used to limit and control disbursements by the individual or branch in charge of the fund. If any check received by the company could be deposited in the imprest account, it would be more difficult to limit or control the disbursements. For example, collections on accounts receivable might be deposited in and disbursed from the account, without being recorded on the books and without knowledge on the part of anyone other than the person in charge of the account. Only checks made payable to the individual in charge or to the fund should be accepted by the bank for deposit in the imprest account.

c. If bad debts may be written off without approval, there is the danger of receipts being misappropriated and the fraud concealed by writing off the accounts to which the receipts should have been applied. If an officer is required to approve such write-offs, it is expected that he will make sufficient investigation to warrant his approval. Such investigation should include steps to discover payments by the debtors if such had been made. Knowledge that fraud will be detected is a strong deterrent against the commission of fraud.

d. From the viewpoints of both materiality and relative risk of misstatement, payroll disbursements are significant in most businesses. Use of an imprest bank account for payroll disbursements gives added control and better records. Undisbursed balances are readily determinable, responsibility and control is fixed on those authorized to sign payroll checks, and the bank record is parallel to and in support of the company records.

No. 5 (6 points)

One characteristic of business life is the existence of what may be called "opposing interests." For example, it can be to a debtor's advantage to obtain an extension of credit and, at the same time, to the creditor's disadvantage to grant the extension. The creditor must base his decision as to the extension, in part at least, on accounting statements prepared by the debtor. Since accounting statements are largely reflections of opinions or judgments as to the facts, it is clear that statements prepared by one party cannot be fully acceptable to a party with "opposing interests."

The main economic function of the certified public accountant is to appraise accounting statements from an independent point of view and give them added credibility in the eyes of those who use them. To do this the accountant must be free from prejudice; he must give consideration to the legitimate interests of all parties concerned. In other words he must be completely independent.

In a court case, or the drafting of a lease, there are also opposing interests. The function of an attorney, however, is to advance the interests of his own client as is indicated by the name "advocate." It is the attorney's function to be staunchly partisan, not independent or judicial.

No. 6 (15 points)

a. The following are the usual procedures followed in connection with the audit of an endowment fund:

1. Read the will or other document under which the fund was created, including any significant supplementary papers, and make a record of the following:

(*a*) Original amount and form of the fund.

(*b*) Purpose of the fund and of the fund income.

(*c*) Any special directions as to use of the fund income.

(*d*) Any directions as to the distinction between income and principal, and any provisions as to making good impairment of principal.

(*e*) The names or positions of the trustees.

(*f*) The termination date, if any, of the trust agreement.

2. Analyze the fund principal account from the inception of the fund to the first of the current year for the purpose of determining the correctness of the opening balance. Investigate all major changes in the fund principal as to their cause and as to their propriety under the fund agreement.

3. Analyze the fund principal account for the current year and vouch all changes.

4. Count or reconcile cash balances, tying the results in with the ledger control.

5. Obtain or prepare a list of the securities on hand at the first of the year, and vouch all changes per books.

6. Inspect all securities, comparing them with

the detail schedule. Note the serial numbers and, in the case of bonds, the existence of future interest coupons.

7. Determine that all changes in securities during the year were authorized by the proper persons.

8. Determine that investments appear to be within the terms of the fund agreement or within the applicable state law.

9. Determine the market values of all securities at the year-end.

10. Analyze the income fund balance (if income unexpended does not become a part of principal) to determine the changes during the year.

11. For income, tie in reported income with the computed income from securities owned during the year. If the fund provides for accrual of income, verify the correctness of the accrual both at the first and last of the year. Amortization of premiums or discounts should be verified if such amortization is required or provided for by the trustees.

12. Analyze and vouch expenditures, determining that all expenditures were properly authorized and are within the limitations as to purpose as specified by the donors.

b. The principal worksheets should provide a detailed list of securities on hand and the transactions during the year. Market value should be shown as well as identification for use in inspecting the securities. The worksheet for Interest and Dividend Income should relate the income to the individual securities. Gain and loss on sale of securities should be detailed. These data can be combined in various ways in worksheets. Three schedules including the following columns appear to include the essential information.

Detailed Schedule of Securities
And Transactions During the Year

Description of Security
Identification Number
Balance First of Year
  ·ace Value or Number of Shares
  Cost or Book Value
Added During Year
  No. of Shares or Par Value
  Cost
Sold During Year
  No. of Shares or Par Value
  Cost
Balance End of Year
  No. of Shares or Par Value
  Cost or Book Value
End of Year Market Value
Inspected
Date of Next Attached Interest Coupon

Detailed Schedule of Interest
And Dividend Income

Description of Security
Face Value or Number of Shares
Interest Dates
Accrued First of Year
Accrual During Year
Collected During Year
Accrued Interest
  Purchased
  Sold
Accrued End of Year
(Premium) or Discount
  Original Amount
  Amortized to First of Year
  Amortized this Year
  Balance

Schedule of Gain or Loss on Sale of Securities

Description
Face Amount
Sale Date
Sale Price
Brokerage and Expense
Net Proceeds
Cost or Book Value
Gain
Loss

No. 7 (22 points)

a. 1. Making inquiries of officers and employees might lead the auditor to discover existence of the contract.

2. An auditor would frequently examine the contract file and thereby might discover the contract.

3. Review of invoices for legal expenses might disclose charges in connection with the contract.

4. Other expenses in connection with the contract might appear on the books, such as for grievance or arbitration procedures.

5. An accrual for vacation pay might already appear on the books.

6. The minutes might contain a reference to the contract.

7. The audit of payroll or medical expenses, etc., might reveal existence of the contract in connection with provisions of the contract other than those relating to vacation pay.

8. Analysis of vacation expense for the current period might lead to discovery of the contract.

9. Analysis of payroll records might disclose records of vacations taken in advance, as pro-

vided in the contract paragraph V-3. It might also disclose vacation payments under paragraph V-7.

b. The existence of such a contract does not normally require disclosure in a short-form report. The provisions of the contract would be given effect to in the financial statements or disclosed in footnotes to the statements. Since the contract is not unusual in any material respect and does not impose an unusual future financial obligation, there would be no need to disclose its existence.

c. An accrual at December 31, 1949, is desirable, even though no exact amount of liability can be determined until June 1, 1950, for employees who may be eligible under the contract. The assignment of the cost of vacation payments should be to the period in which the vacation is earned, to the extent it is subject to reasonable determination. A portion of the liability may be considered as reasonably determined on December 31, 1949, by the provisions of the last paragraph (V-7) quoted from the contract. The remainder of the liability could be reasonably estimated.

d. An over-all test of the accrual might be made by determining the number of employees at the first of the year and reducing that amount to allow for estimated discharges based upon prior years' personnel records and predictions of officials as to the following five months. This number at the average weekly wage would be an approximation of the year's vacation cost.

A more complete verification of the amount of the accrual might be made as follows:

1. Read the contract and obtain a copy or prepare extracts from the contract.

2. Determine the employees who have qualified for a vacation in a prior year, and who are still employed by the company on December 31, 1949. See paragraph V-7.

3. Classify these employees as called for in paragraph V-1 to determine which will be entitled to six days and which to twelve days vacation.

4. Determine the employees who did not qualify for a vacation in a prior year, but who will qualify under paragraph V-1 if their employment continues until June 1, 1950. Adjust for estimated shrinkage due to severance of employment before June 1, 1950.

5. Calculate the vacation pay for the above groups in accordance with paragraph V-6. Rates in effect at December 31, 1949, should be used unless the contract calls for a change in rates before June 1, 1950.

6. Estimate any adjustments called for by absences in excess of those provided for by paragraph V-2. Subtract this estimated amount from the amount calculated in step 5 above.

7. The pro-rata portion (7/12) of the amount determined in step 6 above would be the accrual.

8. Compare the results with prior years to determine reasonableness of calculation.

No. 8 (10 points)

Adjustments

Net profit per books	$13,305
Amounts on partnership records not deductible as business or personal expenses:	
Add: Federal income tax—Colmer	600
Federal income tax—Dane	500
Adjusted profit	$14,405
Add: Political campaign contribution not deductible for tax purposes	100
Balance	$14,505
Add: Deductions that should be reported separately:	
Long-term capital loss	3,000
Contributions	100
	$17,605
Less partially tax-exempt interest that should be reported separately	185
Ordinary income	$17,420

Income as Reported on Return

	Colmer & Dane	Dane's share at 40%
Ordinary income as above	$17,420	$ 6,968
Partially tax-exempt interest	185	74
Long-term capital loss	3,000	1,200
Contributions	100	40

Note: The taxpayer may make an election as to whether the $15 of bond premium is to be amortized for tax purposes. If he does not elect to amortize, the ordinary income would be $17,405. Long-term capital loss may be deductible only in the amount of $1,000.

COMMERCIAL LAW

November 10 1950; 9 a.m. to 12:30 p.m.

GROUP I

No. 1 (10 points)

a. Generally the contracts of a minor may be disaffirmed by him but where so-called "necessaries" have been contracted for, disaffirmance will not relieve a minor of liability. Under the Uniform Sales Act, where necessaries are sold to a minor he must pay a reasonable price therefor. Accordingly, recovery on a *quantum meruit* basis may be had for the reasonable value of goods supplied. "Necessaries" are goods suitable to the condition in life of the minor and to his actual requirements at the time of delivery. In a few states, by statute or otherwise, a minor cannot disaffirm a contract if (1) the other party relied on the minor's false affirmative representation that he was of age, and (2) it was reasonable for the other party to believe the minor was of age.

In the given factual situation, therefore, Carl as a minor probably can disaffirm his contract with the merchant. But, because clothing is a "necessary," Carl would be liable in a *quantum meruit* action. Recovery by the merchant would be limited to the fair market value of $75. (R. Contracts #13; Infants 31 C.J. #169; U.S.A. #2; Williston on Contracts, #245)

b. A minor may disaffirm his contracts within the following time:

1. As to personalty—at any time during his minority and within a reasonable time after majority unless a state statute provides otherwise. (Williston #235)
2. As to real estate—within a reasonable time after the minor reaches his majority unless a state statute provides otherwise. (Muncey v. Norfolk & Western Ry. Co., 106 W. Va. 348, 145 S.E. 581 [1928])

c. The liability of a minor in a partnership in which he is a member extends to the amount of his capital contribution to the partnership.

d. A minor cannot give a power of attorney for the following purposes:

1. To convey real estate.
2. To confess judgment against himself.
3. To have himself represented in judicial proceedings.

The general rule is that whatever a principal may do he can delegate to be done by an agent through a power of attorney. Since a minor's conveyance of real estate may be repudiated and since he has no regular capacity to confess judgment against himself, it follows that the minor has no legal capacity to delegate such power to another. (2 C.J.S. Agency #13)

No. 2 (10 points)

a. In a sale of goods the implied warranties of the seller are:

As to title

1. That the seller has a right to sell the goods.
2. That the seller can give good title to the goods.
3. That the goods are free of any charge or incumbrance other than those disclosed.
4. That the buyer shall have quiet possession against any lawful claims existing at the time of sale. (1,2,3, & 4—U.S.A. #13)

As to description

5. In a sale of goods by description, that the goods shall correspond with the description. (U.S.A. #14)

As to sample

6. In a sale of goods by sample:
   (a) That the bulk shall correspond with the sample in quality.
   (b) That the buyer shall have a reasonable opportunity of comparing the bulk with the sample.
   (c) If the seller is a dealer in goods of that kind, that the goods shall be free from any defect rendering them unmerchantable which would not be apparent on reasonable examination of the sample. (U.S.A. #16)

As to sample and description

7. In a sale by sample as well as by description, that the bulk of the goods corresponds with both the sample as well as the description and it is not sufficient that the bulk of the goods correspond with the sample if the goods do not also correspond with the description. (U.S.A. #14)

As to fitness of goods for a particular purpose

8. In a sale of goods for a particular purpose (either made known by the buyer to the seller, or where the purpose should have been known by the seller from the nature and circumstance of the purchase) where the buyer relies on the seller's skill or judgment, there is an implied

warranty that the goods shall reasonably fit such purpose. (U.S.A. §15)

b. 1. When an unpaid seller delivers goods to a common carrier, and the buyer is or becomes insolvent while the goods are in transit, the seller may stop the goods. In other words, the seller is entitled to repossess goods and to exercise the same rights over these goods as he would have had if he had never parted with possession. (U.S.A. §57)

2. The right of stoppage in transitu arises solely in cases where:

(a) Goods are sold on credit and the unpaid seller delivers the goods to a common carrier.

(b) The buyer is insolvent or becomes insolvent while the goods are in transit.

(c) The goods are still in transit. (U.S.A. §57 & §58)

No. 3 (10 points)

a. A corporation is distinguished from a partnership in the following ways:

1. In limitation of liability of its members.

A shareholder in a corporation has limited liability while a partner in a partnership has unlimited liability. A shareholder is not liable for the debts of the corporation while a partner is liable for the debts of the partnership.

2. A corporation is a legal entity while a partnership is not.

A corporation may sue or be sued in its own name, while at common law a partnership may not sue or be sued in its own name. Instead, the partners must sue or be sued as individuals.

3. A corporation is not affected by the death of a member while a partnership is dissolved. Therefore, a corporation may have perpetual existence while a partnership is dissolved on death of a partner.

4. In the absence of a restrictive agreement, a shareholder may readily transfer his interest in a corporation while a partner may not transfer his interest in the partnership.

5. The creation of a corporation requires the sanction of the state while a partnership does not.

6. In control and management:

(a) A shareholder has no direct control while a partner has direct control.

(b) A shareholder is not a manager while a partner may manage.

(c) A corporation vests its management control in a board of directors while each partner has a right to share in the management of the partnership.

7. A corporation or a shareholder may sue one another at law while in a partnership the firm and its members may not. In a partnership a partner must sue for an accounting in equity.

8. A shareholder has no ownership of the corporate property which is vested in the corporation while a partner is a tenant in partnership property.

9. A shareholder is not an agent of the corporation while a partner is an agent of its partnership.

10. Generally a corporation may not engage in the practice of a profession while a partnership may be organized for the practice of a profession.

11. Under the U. S. Internal Revenue Code, a corporation is taxed as an entity on its income while the income of a partnership is taxed to the individual partners. (1 Fletcher §20; 18 C.J.S. Corporations §8; U.S.I.R.C. §181)

b. A corporation is not bound by the contracts of the promoter nor has it any rights thereon except where a statute or the charter declares that the corporation assumes liability under such a contract or where the corporation has accepted and adopted those contracts of the promoter. (1 Fletcher §205 et seq.; 13 Am. Jur., Corporations §100; 18 C.J.S., Corporations §122)

No. 4 (10 points)

a. 1. The general rule is that an undisclosed principal is bound by contracts and conveyances made on his account by an agent acting within his authority. (R.-Agency §186)

2. Exceptions to this rule are that an undisclosed principal is not liable:

(a) As a party to a negotiable instrument. (R. Agency §192)

(b) As a party to a sealed instrument. (R. Agency §191)

(c) Upon a contract which provides that he or any undisclosed principal shall not be a party to it. (R. Agency §189)

(d) Where exclusive credit is given to the agent. (R. Agency §189)

(e) Where the principal has, in good faith, settled with the agent, relying on the conduct of the third party. (R. Agency §183 & §208)

(f) Where the third party has elected to hold the agent alone. (R. Agency §209 & §211)

b. Upon the receipt of the knowledge by Z that X was an agent for the undisclosed principal Y, then Z may make an election as to which person he desires to hold to the contract. The third party, Z, may hold either the principal or the agent but not both. If with full knowledge of the facts material to his rights he elects to hold the agent, he thereby discharges the liability of the principal and conversely if he elects to hold the principal, he thereby discharges the liability of the agent. Once the election is made, he is bound by his election and may not subsequently change his position (3 C.J.S. #248; 3 C.J.S., Agency #248; R. Agency #209–#211)

No. 5 (10 points)

1. Yes. The pledgee (creditor) does not have to sell the security before the debt is due, even if requested to do so by the pledgor (debtor). (R. Security #52; 49 C.J., Pledges #99)

2. Yes. After the maturity of a debt the pledgee has no duty to sell pledged security if the pledgor does not produce a buyer. (R. Security #52; 49 C.J., Pledges #247)

3. Yes. When security is sold for less than the amount of the debt, the creditor may recover the deficiency. This is true, even though the collateral had depreciated in value. (R. Security #48; 49 C.J., Pledges #285)

GROUP II

No. 6 (10 points)

a. Yes. One who wrongfully interferes with the property of another is guilty of conversion and is liable for damages to the person so injured. The fact that the agent acted in good faith and in obedience to his principal's instructions is no defense to the agent. (R. Agency #349; 65 C.J., Conversion, #7–#10)

b. Yes. A principal is liable for the torts of his agents committed within the scope of the agent's work whether commanded by the principal or not. In this instance the tort was the result of following the principal's instructions and there can be no question as to the principal's liability. (R. Agency #215)

c. Yes. The Uniform Conditional Sales Act #22 provides that if, upon resale, the goods bring less than the contract price, the seller may recover the deficiency from the buyer. In the absence of the uniform act and in the event of default in payment, a conditional seller may pursue one of two courses of action. He may allow the buyer to keep the goods and sue the buyer for the unpaid balance, or he may rescind the contract and repossess the goods. He cannot do both; therefore, if he rescinds, he is deemed to have elected his remedy and has no action against the buyer for a deficiency. (55 C.J., Sales #1288)

No. 7 (10 points)

a. No. An insurance contract is not enforceable unless the insured has an insurable interest in the affected property. An unsecured creditor has no legal or equitable interest in the property of his debtor; hence he is deemed to have no insurable interest in such property. (44 C.J.S., Insurance #185)

b. Yes. The policy is enforceable to the extent of $50,000. A creditor has an insurable interest in the life of his debtor—the continued life of the latter may enable him to pay the debt. Because an insurable interest is required only at the time the insurance is procured, the fact that the interest has since declined in value does not void the policy. Therefore, the company will be liable for $50,000. However, most courts would hold that the creditor may retain only $40,000, the amount of indebtedness, and that the excess of $10,000 would go to the estate of the insured. (44 C.J.S., Insurance #208)

c. Yes. A judgment on record normally creates a lien on any real property of the debtor located in the county. A lien which has been on record for more than four months prior to bankruptcy is a good lien and is enforceable as a secured claim. Since secured claims are paid first, to the extent the security is adequate, C should be paid before general creditors. (8 C.J.S., Bankruptcy #244, #453)

No. 8 (10 points)

a. B. When unascertained goods are appropriated to a contract by one of the parties to the contract and the other assents, the title passes. However, the appropriation without assent is not enough. There is no evidence in this problem that A had assented to B's appropriation. (U.S.A. #19, Rule 4(1))

b. A. When goods are to be sent F.O.B. from the point of origin, the seller is deemed to have completed his part of the contract by delivering the goods to the carrier. Moreover, when such delivery takes place, the carrier is acting as the buyer's agent. Accordingly, acceptance by the carrier constitutes assent by the buyer to the appropriation, and title passes to the buyer. (U.S.A. #19, Rule 4(2))

c. Yes. When title is reserved to the seller for security purposes only, the risk of loss passes to the buyer. The title reserved to the seller is only a lien. (U.S.A. #19, Rule 4(2), #22a)

No. 9 (10 points)

a. A bailee's lien is the bailee's right to retain possession of the bailed property until some charge or obligation in connection with it is discharged or satisfied. The lien is possessory; that is, it arises out of and depends on possession. When possession of the bailed property is parted with, the bailee's lien is lost. (8 C.J.S., Bailments #35 a)

b. A bailee will have a right to a lien:

1. When he has lawful possession of the bailed property and compensation is contemplated. When the bailment is gratuitous the bailee has no lien.

2. Where services have been performed in connection with the bailment, such as custody (warehouseman's lien), transportation (carrier's lien), or labor and skill bestowed on the chattel (artisan's lien).

3. Where there is a special contract creating a bailment for security purposes in connection with some collateral obligation. (8 C.J.S. Bailments #35 (a), #36 (a), #38 (b).

c. No. A bailee has the possession of but not the title to a bailed article. Since he cannot give away something which he does not have, he cannot transfer title by a sale of the bailed article. In some instances, however, a statute or agreement will grant the bailee such power. (8 C.J.S., Bailments #32 a)

No. 10 (10 points)

a. Mastercraft cannot recover. The Statute of Frauds requires contracts for the sale of personal property worth $500 or more to be in writing signed by the party to be charged. The "Purchase Memorandum" was not signed by Black the party to be charged. (U.S A. #4)

b. Mastercraft can recover. Since the purchase price was less than $500, no writing was required by the Statute of Frauds. NOTE: It is not believed that Questions 10(b), 10(c), or 10(d) were designed to elicit information as to the measure of damages. If title had passed, as it probably had, the seller could recover the unpaid purchase price. If title had not passed, it probably would be necessary to know the market price—not given in the question—in order to determine the measure of damages.

c. Mastercraft recovers. The Statute of Frauds applies because the purchase price is over $500. However, Green's letter satisfies the statute—its purported cancellation of the contract and its reference to "Purchase Memorandum No. 1208" (which in turn contained the terms of the order) comprise a sufficient memorandum.

d. Mastercraft recovers. The Statute of Frauds applies to sales of personalty worth $700, but the part payment of $100 satisfied the Statute.

Note: The amount set in the Statute of Frauds is $500 under the Uniform Sales Act. In states not following the Uniform Act the amount may vary from $50 to $2,500.

No. 11 (10 points)

a. No. A mortgagee has no interest in the proceeds of insurance carried by the mortgagor unless the insurance policy so provides or the mortgage contract requires the owner to carry insurance for the benefit of the mortgagee. The mortgage creates no equity in the proceeds of an insurance policy held by the mortgagor unless the mortgage or policy so provides. Generally, however, the mortgage agreement, the insurance policy, or both, give the mortgagee a prior interest in the proceeds of the insurance. (59 C.J.S., Mortgages #328(d) (2))

b. The balance of T's lease is cancelled by foreclosure. A lease, inferior in point of time to a mortgage of record, may be cut off by foreclosure of the mortgage. The mortgagor has no right to impair the interest of the mortgagee by subjecting it to a long-term lease. (59 C.J.S., Mortgages #319)

c. I should prefer to buy subject to the mortgage because in that event I have no personal liability for the mortgage. In case the land falls in value below the face of the mortgage, one who buys "subject to" the mortgage has no personal liability for the deficit, whereas one who assumes the debt is primarily liable for it (59 C.J.S., Mortgages #399 and #406)

d. Yes. A may so insist. Under the doctrine of marshalling assets the court will insist that M foreclose, if possible, in such a manner as to protect the inferior lien of A. If M can realize the full $60,000 out of the business building, lot X will be made available as security for A. If both properties are sold at M's foreclosure sale, any surplus over and above what is needed to pay M, will be used to pay A, provided the sale of lot X realized that much of the proceeds. (59 C.J.S., Mortgages #694)

No. 12 (10 points)

a. X would receive $1,000 of his $4,000 debt and $1,500 of his $6,000 debt. Y would receive $1,500 of his $6,000 debt. Under the U.P.A. creditors of the old firm and creditors of the new firm share alike in the new firm assets. No distinction is drawn between creditors. Each receives a proportionate share. (U.P.A. #41(1))

b. 1. Yes. The withdrawing partner remains liable for debts incurred before he withdraws. Unless released by the creditor, he remains personally liable. (U.P.A. #36(1), (2))

2. Yes. Creditors of the old firm, who are also creditors of the new firm, can hold the withdrawing partner for debts of the new firm as well as debts of the old firm, unless they know he had withdrawn. (U.P.A. #41 (3)) (40 Am. Jur., Partnership #260)

3. No. A newspaper notice of withdrawal, whether seen or not, protects a withdrawing partner against personal liability for debts of the new firm if the creditor had not done business on credit with the old firm. (40 Am. Jur., Partnership, #261)

c. D is personally liable as a partner to Y and to X on the credit extended the new firm. D has no personal liability for the $4,000 debt to X, an obligation of the old firm, since he did not assume it. (U.P.A. #17, #41(7))

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NOTE: The first figure in parentheses, e.g. (Q 4), indicates that this subject appears in Question 4 on the page shown at the right. The letters in parentheses indicate which of the four examinations this subject appears in. (L) is Law; (T), theory; (P), practice; (A), auditing.