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Unofficial answers to the Uniform certified public accountants examination, May 1963 to November 1965

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UNOFFICIAL ANSWERS

.....TO THE UNIFORM CERTIFIED PUBLIC ACCOUNTANTS EXAMINATION

MAY 1963 TO NOVEMBER 1965

UNOFFICIAL ANSWERS

To the Uniform Certified
Public Accountant Examinations of
the American Institute of Certified Public Accountants

MAY 1963 to NOVEMBER 1965

By EDWARD S. LYNN and WILLIAM C. BRUSCHI

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FOREWORD

The text of the Uniform Certified Public Accountant Examinations, prepared by the Board of Examiners of the American Institute of Certified Public Accountants and adopted by the examining boards of 50 states, the District of Columbia, Puerto Rico, and the Virgin Islands, are periodically published in book form. Unofficial answers to these examinations appear twice a year as a supplement to THE JOURNAL OF ACCOUNTANCY. These books have been used in accounting courses in schools throughout the country, and have proved valuable to candidates for the CPA certificate.

Responding to a continuing demand, we now present a book of answers covering the period from May 1963 to November 1965. The problems and questions of this period appear in a separate volume which is being published simultaneously. It cannot be too strongly emphasized that these answers are not in any sense official. They represent merely the opinion of Edward S. Lynn, former Director of Education, and William C. Bruschi, Director of Examinations, who prepared them for publication with the assistance of Rex Cruse and Donald F. Stanhope.

JOHN L. CAREY, *Executive Director*
American Institute of Certified Public Accountants

April 1966

Contents

Unofficial Answers to Complete Examinations

	Page		Page
May, 1963	1	November, 1964	142
November, 1963	47	May, 1965	190
May, 1964	91	November, 1965	245

Individual Subjects

Accounting Practice—Part I

May, 1963	1	November, 1964	142
November, 1963	47	May, 1965	190
May, 1964	91	November, 1965	245

Accounting Practice—Part II

May, 1963	9	November, 1964	151
November, 1963	53	May, 1965	200
May, 1964	102	November, 1965	259

Auditing

May, 1963	22	November, 1964	160
November, 1963	65	May, 1965	214
May, 1964	116	November, 1965	268

Commercial Law

May, 1963	33	November, 1964	171
November, 1963	77	May, 1965	227
May, 1964	126	November, 1965	280

Theory of Accounts

May, 1963	38	November, 1964	176
November, 1963	83	May, 1965	235
May, 1964	131	November, 1965	286

Index 297

Answers to Examinations, May 1963

ACCOUNTING PRACTICE—PART I

May 15, 1963; 1:30 to 6:00 p.m.

Solution 1

a. Computation of Corrected Physical Inventory at November 30, 1962

Inventory per books		$60,570
Understatement per client's computations		3,000
Physical inventory, per client		63,570
Add footing and extension errors		150
Total		63,720
Less: Pricing errors	$2,200	
Obsolete inventory	250	2,450
Corrected physical inventory at November 30, 1962		$61,270

b. Computation of Inventory at December 31, 1962

Corrected physical at November 30			$57,700
Less: Direct labor included		$10,000	
Overhead included (200% of direct labor)		20,000	30,000
Inventory of materials at November 30			27,700
Add purchases			24,700
Total material available			52,400
Deduct: Cost of sales		68,600	
Less: Labor	$13,800		
Overhead (200% of direct labor)	27,600	41,400	
Total		27,200	
Scrap loss on new product		800	
Total		28,000	
Less obsolete items included in cost of sales		250	27,750
Materials inventory at December 31			24,650
Add: Direct labor in inventory		8,300	
Overhead (200% of direct labor)		16,600	24,900
Inventory at December 31, 1962			$49,550

Computation of Direct Labor in Inventory

Direct labor in inventory at November 30	$10,000
Additional direct labor costs incurred in December	12,100
Total	22,100
Less charges to cost of sales in December	13,800
Direct labor in inventory at December 31, 1962	$ 8,300

c. Computation of the Amount of Underabsorbed Overhead

Manufacturing expense incurred in December, per books		$25,200
Less: Excessive scrap loss charged to manufacturing expense	$ 800	
Manufacturing expense absorbed (200% × $12,100)	24,200	25,000
Underabsorbed overhead at December 31, 1962		$ 200

Solution 2

Jones Furniture Company

SCHEDULE OF VARIANCES FROM STANDARD COST
For the Month of December

Favorable variances:		
Material price [110′ × ($.15 − $.12) × 1,200]		$ 3,960
Volume [(5,100 × $2.25) − $10,650]		825
Overhead budget ($10,650 − $10,560)		90
Total favorable variances		4,875
Unfavorable variances:		
Material usage [$.15 × (110′ − 100′) × 1,200]	$1,800	
Labor rate [4¼ × ($2.60 − $2.50) × 1,200]	510	
Labor efficiency [$2.50 × (4¼ − 4) × 1,200]	750	
Overhead efficiency [$2.25 × (4¼ − 4) × 1,200]	675	
Total unfavorable variances		3,735
Total variance		$ 1,140

Proof

Total standard cost of 1,200 units @ $34.00	$40,800
Total actual cost of 1,200 units @ $33.05	39,660
Total variance	$ 1,140

Computation of budget at 5,100 hours

Actual hours worked: 4¼ per unit × 1,200 units =	5,100
Fixed overhead = 30/90 of total at normal capacity (30/90 × $9,000) =	$ 3,000
Variable overhead = 60% of $2.50 or $1.50 per hour. 5,100 hours × $1.50 =	7,650
Budget at 5,100 hours	$10,650

or

Budget at 5,200 hours =	$10,800
Budget at 4,800 hours =	10,200
Difference	$ 600
Budget at 5,100 hours is ¾ of the hour difference between 4,800-hour budget and 5,200-hour budget (¾ × $600)	$ 450
Budget at 4,800 hours	10,200
Budget at 5,100 hours	$10,650

Solution 3

The Kelley-Thomas Company
WORKSHEET
June 30, 1962

	Balance December 31, 1961		1962 Transactions				Statement of Income and Expense		Kelley, Capital	Thomas, Capital	Balance Sheet	
Cash	$10,000		(1)	$ 81,737	(2)	$ 81,800					$ 9,937	
Accounts receivable	8,000		(2)	600	(1)	40,000					18,575	
			(3)	750	(5)	175						
			(4)	49,400								
Account receivable—employee			(2)	300							300	
Allowance for bad debts		$ 600	(5)	175	(5)	494						$ 919
Merchandise inventory	35,000		(8)	2,500							37,500	
Automobiles	7,800		(2)	2,400	(6)	1,800					8,400	
Allowance for depreciation		4,250	(6)	1,800	(7)	1,200						3,650
Furniture and fixtures	2,200										2,200	
Allowance for depreciation		650			(7)	110						760
Prepaid interest			(1)	75							75	
Prepaid insurance	150				(8)	70					80	
Accounts payable		13,800	(2)	45,000	(3)	49,950						18,750
Bank loan payable		8,000	(2)	16,000	(1)	17,000						9,000
Accrued expenses		200	(8)	34								166
Kelley, capital		17,500	(2)	5,000					$12,500			21,836
Thomas, capital		18,150	(2)	5,500						$12,650		21,986
Sales					(1)	25,000		$74,400				
					(4)	49,400						
Cost of sales			(3)	49,200	(8)	2,500	$46,700					
Depreciation—furniture and fixtures			(7)	110			110					
Depreciation—automobiles			(7)	1,200			1,200					
General expenses			(2)	7,000	(8)	34	6,966					
Provision for bad debts			(5)	494			494					
Insurance expense			(8)	70			70					
Gain on retirement of auto					(1)	20		20				
Interest expense			(1)	208			208					
Net income for period							18,672		9,336	9,336		
	$63,150	$63,150		$269,553		$269,553	$74,420	$74,420	$21,836	$21,986	$77,067	$77,067

The Kelley-Thomas Company
TRANSACTIONS FOR SIX MONTHS ENDED JUNE 30, 1962
(Not Required)

(1)

	Debit	Credit
Cash	$81,737	
Prepaid interest	75	
Interest expense	208	
Accounts receivable		$40,000
Bank loan payable		17,000
Sales, cash		25,000
Gain on retirement of old automobile		20
To record cash receipts.		

(2)

	Debit	Credit
Accounts receivable	600	
Accounts receivable—employee	300	
Automobiles	2,400	
Accounts payable	45,000	
Bank loan payable	16,000	
Kelley, capital	5,000	
Thomas, capital	5,500	
General expenses	7,000	
Cash		81,800
To record cash disbursements.		

(3)

	Debit	Credit
Cost of sales	49,200	
Accounts receivable	750	
Accounts payable		49,950
To include purchases and purchase returns in cost of sales.		

(4)

	Debit	Credit
Accounts receivable	49,400	
Sales		49,400
To record sales on account.		

Computation of Sales on Account

Accounts receivable, 6/30/62		$18,000
Accounts receivable, 12/31/61		8,000
Increase in receivables		10,000
Cash payments received	$40,000	
Less redeposited checks	600	39,400
Sales on account		$49,400

(5)

	Debit	Credit
Provision for bad debts	494	
Allowance for bad debts	175	
Accounts receivable		175
Allowance for bad debts		494
To provide for bad debts and to write off an uncollectible account. (1% × $49,400 = $494)		

(6)

	Debit	Credit
Allowance for depreciation—automobiles	1,800	
Automobiles		1,800
To record retirement of old automobile.		

(7)

Depreciation—furniture and fixtures		110	
Depreciation—automobiles		1,200	
Allowance for depreciation—furniture and fixtures			110
Allowance for depreciation—automobiles			1,200

To record depreciation on fixed assets.

Furniture and fixtures	$2,200 × 10% × 1/2 =	$ 110
Automobiles	$6,000 × 33-1/3% × 1/2 =	$1,000
	$2,400 × 33-1/3% × 3/12 =	200
Total automobiles		$1,200

(8)

Merchandise inventory	2,500	
Accrued expenses	34	
Insurance expense	70	
Prepaid insurance		70
Cost of sales		2,500
General expenses		34

To record increase in merchandise inventory and to adjust accruals.

Solution 4

Computation of Taxable Income of Edna and Robert L. Bombast

Wages:		
Bombast Sales Co., Inc.	$ 9,000	
Less travel expenses not reimbursed	230	$ 8,770
Bombast Mfg. Co., Inc.		10,000
Bombast Sales Co., Inc. (Edna Bombast)		7,600
Director's fees	250	
Less travel expenses	130	120
Total		26,490
Less sick pay (3 weeks @ $100)		300
		26,190
Dividend income:		
American Co.	200	
Ceramic Co.	150	
Total dividends	350	
Less exclusion	50	300
Interest income:		
U.S. Savings Bond	310	
First National Trust	140	450
Rent income:		
(Depreciation on cottage held for rent)		(240)
Net capital gain (short-term):		400
Refund of 1961 New York State income tax		130
Total		27,230
Total deductions		5,158
		22,072
Exemptions, 2 @ $600		1,200
Taxable income		$20,868

Deductions

Charitable contributions:		
Fifth Avenue Church	$ 500	
Community Chest	300	
Red Cross	40	$ 840
Interest:		
Interest on mortgage	1,250	
Interest on special assessment	20	1,270
Taxes:		
Real estate	1,300	
Auto license fees	35	
State sales tax	90	
State gasoline taxes	40	
New York State income tax	800	2,265
Medical and dental expense:		
Dr. Reno	750	
Dr. Vine	300	
Dr. Shapiro	50	
Hilltop Hospital	100	
Hospitalization insurance	120	
Total	1,320	
Less 3% of $27,100	817	503
Other deductions:		
Storm damage to house	50	
Expense of entertaining customers at my home	200	
Telephone service at hospital	30	280
Total deductions		$5,158

Computation of Net Capital Gain

	Sales	*Cost*	*Gain*
300 shares American Co.	$3,600	$1,200	$2,400
200 shares Gas Sales Co.	8,000	5,000	3,000
Total			5,400
Loss carryover from prior year			5,000
Net capital gain (short-term)			$ 400

Note: The taxpayers are residents of New York, which is not a community property state. Certain items would be treated differently, however, by taxpayers residing in community property states.

Solution 5

a. 1. Computation of Shares Outstanding

	Preferred	*Common*
Opening balance, 1/1/58	500	1,000
5% stock dividend, 12/31/59		50
Balance, 12/31/59	500	1,050
Additional issue, 3/31/60		400
1-for-5 dividend, 7/1/60	290	
Balance, 12/31/60	790	1,450
2-for-1 stock split, 12/31/61		1,450
Balance, 12/31/61	790	2,900
2-for-1 stock split, 12/31/62		2,900
Balance at date of preparation of annual report	790	5,800

2. Computation of Current Equivalent Number of Shares of Common Stock Outstanding

1958 & 1959 — 1,050 × 2 × 2	=	4,200 shares
1960 — 1,050 × 3 months	=	3,150
1,450 × 9 months	=	13,050
Total	=	16,200
Weighted average (÷ 12)	=	1,350
× 2 × 2	=	5,400
1961 & 1962 —		5,800

3. Computation of Cash Dividends Paid to Holders of Preferred Stock

1958 & 1959 — $50 × 6% × 500	=	$1,500
1960 — $50 × 6% × 500 × ½	=	$ 750
$50 × 6% × 790 × ½	=	1,185
Total for 1960	=	$1,935
1961 & 1962 — $50 × 6% × 790	=	$2,370

Computation of Cash Dividends Paid to Holders of Common Stock

1958 — $1.00 × 1,000		$1,000
1959 —		None
1960 — $1.50 × 1,450		2,175
1961 — $1.00 × 1,450	$1,450	
.50 × 2,900	1,450	2,900
1962 — $1.50 × 2,900		4,350

b.

Sundex Corporation
Five-Year Summary of Financial Statistics

	1958	*1959*	*1960*	*1961*	*1962*
Net income (loss)	$20,000(1)	$(17,000)	$25,000	$38,000	$47,000
Earnings per share of common stock	$4.40(1)	$(4.40)	$4.27	$6.14	$7.69
Dividends per share of common stock	$.24	(2)	$.40(3)	$.50	$.75

(1) Includes extraordinary gain of $8,000 or $1.90 per share.
(2) A stock dividend of one share of common for every twenty shares of common held was distributed.
(3) Plus dividend of one share of 6% cumulative preferred stock for every five shares of common stock held.

Dividends and earnings per share have been adjusted for a stock dividend of 5% in 1959 and stock splits of two-for-one in 1961 and 1962.

Computation of Cash Dividends and Earnings Per Share

	1958	*1959*	*1960*	*1961*	*1962*
Income per statements	$20,000	$(17,000)	$30,000	$38,000	$42,000
Income tax adjustment			(5,000)		5,000
Adjusted income	20,000	(17,000)	25,000	38,000	47,000
Preferred stock dividends	1,500	1,500	1,935	2,370	2,370
(A) Income applicable to common stock	$18,500	$(18,500)	$23,065	$35,630	$44,630
(B) Total cash dividends paid on common stock	$ 1,000	None	$ 2,175	$ 2,900	$ 4,350
(C) Equivalent number of common shares outstanding	4,200	4,200	5,400	5,800	5,800

Earnings per share of common stock = A ÷ C
Dividends per share of common stock = B ÷ C

ACCOUNTING PRACTICE—PART II

May 15, 1963; 1:30 to 6:00 p.m.

Solution 1

1.	D	13.	D	25.	C
2.	A	14.	A	26.	C
3.	B	15.	B	27.	E
4.	C	16.	D	28.	B
5.	A	17.	E	29.	B
6.	A	18.	C	30.	C
7.	A	19.	C	31.	A
8.	C	20.	C	32.	C
9.	B	21.	A	33.	B
10.	C	22.	D	34.	B
11.	B	23.	B	35.	C
12.	D	24.	B		

Solution 2

a.

Adams, Baker and Crane
CASH DISTRIBUTION SCHEDULE

	Adams	*Baker*	*Crane*
Capital balances	$67,000	$45,000	$31,500
Loan balances	12,000		7,500
Net equity	55,000	45,000	24,000
Profit and loss ratio	5.0	3.0	2.0
Equity per unit of profit	$11,000	$15,000	$12,000

Cash receipts		*Distributees*			
Order of Receipt	*Amount*	*Creditors*	*Adams*	*Baker*	*Crane*
First	$ 11,000	$11,000(100%)			
Next [3($15,000 minus $12,000)]	9,000			$ 9,000(100%)	
Next [(3+2) ($12,000 minus $11,000)]	5,000			3,000(60%)	$ 2,000(40%)
Balance	75,000		$37,500(50%)	22,500(30%)	15,000(20%)
Total	$100,000	$11,000	$37,500	$34,500	$17,000

b.

Adams, Baker and Crane

SCHEDULE OF CASH PAYMENTS

July - September 1962

	Total	*Creditors*	*Adams*	*Baker*	*Crane*
July					
100% × $17,000 = $17,000		$17,000			
100% × 6,500 = 6,500				$ 6,500	
Total for July	$ 23,500	17,000		6,500	
August					
100% × $2,500 = $2,500				2,500	
*100% × $1,500 = $1,500				1,500	
Total for August	4,000			4,000	
September					
100% × $ 1,500 = $ 1,500				1,500	
⅝ × 32,000 = 20,000			$20,000		
⅜ × 32,000 = 12,000				12,000	
50% × 43,000 = 21,500			21,500		
30% × 43,000 = 12,900				12,900	
20% × 43,000 = 8,600					$8,600
Total for September	76,500		41,500	26,400	8,600
Total for period	$104,000	$17,000	$41,500	$36,900	$8,600

*Since the next $5,000 of cash was to be divided between Baker and Crane in a 60% to 40% ratio, Baker received $3,000 in cash for $2,000 of the interest in the equipment which Crane received.

60% × $5,000 =	$3,000	cash to Baker
40% × 5,000 =	2,000	interest in equipment to Crane
Total	$5,000	

Crane's remaining $8,000 interest in the equipment was equivalent to a total cash distribution of ($8,000 ÷ 20%)	$40,000
Equipment to Crane in lieu of cash	8,000
Cash to be distributed to Adams and Baker	$32,000

Ratio of distribution between Adams and Baker was 50 : 30 or ⅝ to ⅜.

Solution 3

a.

1. Computation of Number of Shares of Groth Corporation to Be Distributed

Value of Carry-Forward Loss

1958	$15,000
1959	6,000
1960	7,000
1961	11,100
1962 (to June 30)	6,100
Total carry-forward loss	$45,200
Value of carry-forward loss (50% × $45,200)	$22,600

Total Value of Corporations for Merger Purposes

Groth Corporation (book value)	$130,000
Dekline Corporation (book value)	8,600
Dekline Corporation (capitalized carry-forward loss)	22,600
Total	$161,200
Groth Corporation book value per share before merger ($130,000 ÷ 5,000)	$26.00
Shares to be outstanding after merger ($161,200 ÷ $26.00)	6,200
Shares outstanding before merger	5,000
Shares to be distributed	1,200

2. Computation of Ratio of Distribution

1200/250 = 4.8 shares of Groth Corporation stock for each share of Dekline Corporation stock

b. **Journal Entry on Books of Groth Corporation**

	Debit	Credit
Cash	$ 1,500	
Receivables	7,500	
Inventories	8,800	
Fixed assets	35,800	
Other assets	200	
Deferred income tax benefits arising from merger with Dekline Corporation	22,600	
Retained earnings	25,800	
Accounts and notes payable		$35,400
Due from Dekline Corporation		7,600
Accrued expenses		2,200
Capital stock		12,000
Capital contributed in excess of par value		45,000

To record the asset, liability and equity accounts pursuant to the merger with Dekline Corporation and to record issuance of additional capital stock.

c. **Journal Entries on Books of Dekline Corporation**

(1)

	Debit	Credit
Value of carry-forward loss	$22,600	
Retained earnings		$22,600

To record on the books the value of the carry-forward loss.

(2)

	Debit	Credit
Accounts and notes payable	35,400	
Due to Groth Corporation	7,600	
Accrued expenses	2,200	
Capital stock of Groth Corporation	31,200	
Cash		1,500
Receivables		7,500
Inventories		8,800
Fixed assets		35,800
Other assets		200
Value of carry-forward loss		22,600

To record receipt of capital stock of Groth Corporation and to remove assets and liabilities from books after their assignment to Groth Corporation pursuant to the terms of the merger.

(3)

	Debit	Credit
Capital stock	25,000	
Capital contributed in excess of par value	32,000	
Capital stock of Groth Corporation		31,200
Retained earnings		25,800

To record distribution of capital stock of Groth Corporation and to close equity accounts.

Solution 4

a.

The Scoopa Company
COMPARISON OF TOTAL COSTS OF THE PRECISION MACHINERY DEPARTMENT

	Faktrons Made by Department	*Faktrons Purchased from Supplier*
Materials	$ 67,500	$ 50,000
Direct labor	50,000	22,000
Indirect labor	20,000	14,000
Light and heat	5,500	5,500
Power	3,000	2,700
Depreciation	10,000	8,000
Property taxes and insurance	8,000	7,000
Payroll taxes and other benefits (14% of labor cost)	9,800	5,040
Other	5,000	4,500
Additional costs:		
Faktrons (5,000 × $8.00)		40,000
Freight (5,000 × $.50)		2,500
Indirect labor		5,000
Payroll taxes and other benefits (14% of labor cost)		700
Total costs	$178,800	$166,940

For purposes of this comparison the implicit interest on the investment in the machinery now used for Faktrons, and on the change in investment, should also be considered.

b. In addition to the cost factors, other considerations would be brought to the attention of management to assist them in arriving at a decision. These considerations concern the impact of the change upon the Company and the evaluation of the source of supply.

Considerations of the effect upon the Company include the following:

1. Working capital requirements probably would be altered. There might be a reduction in working capital requirements if the investment in inventory can be reduced by the establishment of a close delivery schedule. The reduction in working capital requirements would result from eliminating stocks of raw materials and manufacturing lead time. If the supplier's investment in raw materials is substantial, however, he might ask for an advance payment which would lessen the reduction in working capital requirements.

On the other hand, to assure uninterrupted production the Company might have to carry larger inventories with not only greater investment in inventory but greater storage space requirements as well. The larger inventories might be required because the Company, which no longer has complete control over its manufacturing schedules, has lost some flexibility in meeting surges of demand for its products.

The Company would be freed of the necessity of maintaining its investment in the machinery necessary to make Faktrons.

Returns from alternative uses of working capital freed by the change or additional amounts required by the change would have to be considered.

2. The impact upon the morale of the personnel should be evaluated. Should the use of a supplier result in a reduction of the labor force, as seems to be the case, there would be worker dissatisfaction and protest from their union if one

exists. On the other hand, the possibility of relying upon a supplier and reducing the labor force might place the Company in a stronger position for bargaining with the union.

3. Disruption of the scheduling of production might occur if a supplier is used. If The Scoopa Company has a peak production period for finished products, the manufacture of Faktrons and other parts may be scheduled for slack periods to retain a skilled labor force.

4. Should circumstances necessitate discontinuing the use of Faktrons, if a supplier is utilized the discontinuance should have no effect upon The Scoopa Company's labor force which has adjusted, physically and mentally, to the purchase of Faktrons from an outside contractor.

In the event of a sudden discontinuance in the use of Faktrons, the existence of uncompleted purchase orders for Faktrons might result in delivery of unneeded units or in the expense of a costly financial settlement with the supplier. On the other hand, if The Scoopa Company decides not to employ a supplier, the sudden discontinuance in the use of Faktrons might result in a similar expense resulting from unusable raw material and work in process.

5. Contracting out the manufacture of Faktrons might reveal confidential information or techniques that would be beneficial to competition.

6. Should the employment of outside suppliers be the start of a general policy to increase the reliance upon them, the capabilities of administrative and supervisory personnel would have to be reviewed. A supervisor, skilled in the management of a production department that is being reduced, might lack the talents necessary to assume responsibility for negotiations with suppliers. Moreover, the administrative staff might be deficient in this respect, and additional qualified personnel would have to be recruited.

Considerations in the evaluation of the source of supply would include:

1. It should be determined that the supplier has the technical competence to furnish Faktrons of the required specifications and that the quality would be maintained for the complete order.

2. Retaining the goodwill of supplier would be important if the supplier might be a customer of The Scoopa Company.

3. Assurance might be sought through financial reports, etc., that the supplier is of sufficient financial strength to complete the order.

4. Consideration should be given to the supplier's reputation for research and awareness of technological developments. The supplier might be able to improve the Faktrons and share any cost reductions with The Scoopa Company so that the completed products could be reduced in price and remain competitive.

5. The reliability of the supplier as a source of supply should be weighed. Not only should the supplier have the production capacity to meet delivery schedules but also the reputation of efficiently managing the productive capacity to meet the schedules. The likelihood of interruption of the supplier's production because of strikes or other casualty might be important. Attention should be given to possible transportation delays of both the raw materials to the supplier and the manufactured parts to The Scoopa Company.

Because the part, Faktron, is a component used in some of The Scoopa Company's finished products, a shortage of Faktrons for any reason could stop the assembly of several different items. To protect against this possibility, it may be necessary to utilize more than one source of supply for Faktrons. The effect upon the unit price of Faktrons is a major consideration in deciding whether to split the annual requirements among several suppliers. Probably having more than one supplier would result in increased costs per unit, with a corresponding decrease in expected savings.

Solution 5

a.

City of Druid
SPECIAL ASSESSMENT FUND WORKSHEET
For the Year Ended June 30, 1962

	Transactions 1961-62				Closing Entries June 30, 1962		Account Balances June 30, 1962	
		Debit		*Credit*	*Debit*	*Credit*	*Debit*	*Credit*
Cash for construction	(3)	$ 300,000	(6)	$ 185,000				
	(4)	50,000	(8)	167,000				
	(5)	100,000						
	(7)	50,000					$148,000	
Cash for payment of bonds	(4)	30,000					30,000	
Cash for payment of interest	(3)	1,000	(9)	4,500				
	(7)	500						$ 3,000
Improvements authorized	(1)	500,000	(2)	500,000				
Assessments receivable—current	(2)	80,000	(4)	80,000				
Assessments receivable—deferred	(2)	320,000					320,000	
Governmental unit's share of cost	(2)	100,000	(5)	100,000				
Interest receivable	(11)	15,000					15,000	
Bonds payable, 3%			(3)	300,000				
			(7)	50,000				350,000
Interest payable			(10)	4,375				4,375
Unappropriated surplus—interest						$ 7,625		7,625
Premium on bonds			(3)	1,000	$ 1,000			
Interest income			(11)	15,000	15,000			
Appropriations			(1)	500,000				500,000
Appropriation expenditures	(6)	185,000						
	(8)	167,000					352,000	
Interest expense	(9)	4,500	(7)	500				
	(10)	4,375				8,375		
		$1,907,375		$1,907,375	$16,000	$16,000	$865,000	$865,000

Notes: 1. The Appropriation and Appropriation Expenditure accounts may properly be closed.

2. Though the Premium account is usually closed, the National Committee on Governmental Accounting has recommended that it be amortized over the life of the bonds.

3. The money to make interest disbursements that exceed interest collections would have to be borrowed from one of the special assessment cash accounts or from another fund.

Special Assessment Fund
(Not Required)

(1)

Improvements authorized	$500,000	
Appropriations		$500,000
To record authorization of Main Street Sewer Project.		

(2)

Assessments receivable—current	80,000	
Assessments receivable—deferred	320,000	
Governmental unit's share of cost	100,000	
Improvements authorized		500,000
To record levy of assessments.		

(3)

Cash for construction	300,000	
Cash for payment of interest	1,000	
Bonds payable		300,000
Premium on bonds		1,000
To record sale of bonds on August 1, 1961.		

(4)

Cash for construction	50,000	
Cash for payment of bonds	30,000	
Assessments receivable—current		80,000
To record collection of first installment of the assessments.		

Allocated as follows:

Cash required for construction provided by City	$100,000
Bonds	350,000
Part of first assessment	50,000
Total	$500,000

(5)

Cash for construction	100,000	
Governmental unit's share of cost		100,000
To record City's contribution.		

(6)

Appropriation expenditures	185,000	
Cash for construction		185,000
To record expenditures of December 1, 1961.		

(7)

Cash for construction	50,000	
Cash for payment of interest	500	
Bonds payable		50,000
Interest expense		500
To record sale of bonds on June 1, 1962.		

(8)

Appropriation expenditures	167,000	
Cash for construction		167,000
To record expenditures of June 30, 1962.		

(9)		
Interest expense	4,500	
Cash for payment of interest		4,500
To record bond interest paid on February 1, 1962.		

(10)		
Interest expense	4,375	
Interest payable		4,375
To record interest accrued on bonds. ($350,000 × 3% × 5/12 = $4,375)		

(11)		
Interest receivable	15,000	
Interest income		15,000
To record interest accrued on deferred assessments. ($320,000 × 5⅝% × 5/6 = $15,000)		

Closing entry		
Interest income	15,000	
Premium on bonds	1,000	
Interest expense		8,375
Unappropriated surplus—interest		7,625
To close interest accounts.		

b. **General Fund**

(1)		
Bonds payable	$350,000	
Assessment income	80,000	
Premium on bonds	1,000	
Construction in progress—Main Street Sewer		$352,000
Interest expense		4,000
Cash special		75,000
To cancel entries made in General Fund.		

(2)		
Appropriation expenditures	100,000	
Due to Special Assessment Fund		100,000
To record City's share of cost.		

(3)		
Due to Special Assessment Fund	100,000	
Cash		100,000
To record payment of City's share of cost.		

General Fixed Assets

Construction work in progress	352,000	
Investment in fixed assets from special assessments		352,000
To record work in progress financed from special assessments.		

Company P and Subsidiaries
CONSOLIDATED WORKING PAPER
For the Year Ended December 31, 1962

	Trial Balance December 31, 1962			*Adjustments and Eliminations*		*Consolidated Income Statement*		*Minority Interest*		*Consolidated Balance Sheet*	
Debits	*Company P*	*Company X*	*Company Y*	*Debit*	*Credit*	*Debit*	*Credit*	*Company X*	*Company Y*	*Debit*	*Credit*
Cash	$ 33,000	$ 41,500	$ 175,200							$ 249,700	
Accounts receivable	85,000	97,500	105,000		(11) $ 52,000					235,500	
Inventories	137,500	163,000	150,000		(10) 15,000					435,500	
Investment in Company X	350,000				(1) 350,000						
Investment in Company Y	650,000				(2) 650,000						
Bonds of Company Y		147,000		(3) $ 3,000						150,000*	
Plant and equipment	700,000	525,000	834,000		(8) 2,000					2,057,000	
Unamortized bond discount			800		(3) 600					200	
Cost of sales	2,500,000	1,200,000	1,400,000	(10) 15,000	(9) 385,000	$4,730,000					
Operating expenses	405,000	280,000	290,500		(8) 100	975,400					
Interest expense	16,200	2,500	9,500		(3) 300	21,900					
	$4,876,700	$2,456,500	$2,965,000		(4) 6,000						
Credits											
Accounts payable	$ 202,000	$ 150,500	$ 90,000	(11) 52,000							$ 390,500
Dividends payable	12,000	5,000		(6) 4,500							12,500
Bonds payable	400,000		200,000								600,000
Accumulated depreciation	402,000	325,000	240,000	(8) 100							966,900
Sales	2,950,000	1,550,000	1,750,000	(9) 385,000			$5,865,000				
Interest income on bonds		6,000		(4) 6,000							
Dividend income	30,500			(7) 35,000	(5) 4,500						
Capital stock, Par $50	600,000										600,000
Capital stock, Par $50		250,000		(1) 225,000				$25,000			
Capital stock, Par $50			500,000	(2) 400,000					$100,000		

*Treasury bonds

(Continued)

Company P and Subsidiaries
CONSOLIDATED WORKING PAPER
For the Year Ended December 31, 1962

Credits	*Trial Balance December 31, 1962* Company P	Company X	Company Y	*Adjustments and Eliminations* Debit	Credit	*Consolidated Income Statement* Debit	Credit	*Minority Interest* Company X	Company Y	*Consolidated Balance Sheet* Debit	Credit
Capital in excess of par			70,000	(2) 56,000					14,000		
Retained earnings, Company P	280,200			(2) 44,000 (8) 2,000	(1) 40,000						274,200
Retained earnings, Company X		170,000		(1) 180,000	(7) 27,000			17,000			
Retained earnings, Company Y			115,000	(2) 100,000	(7) 8,000				23,000		
	$4,876,700	$2,456,500	$2,965,000								
Excess of cost over book value—Goodwill				(2) 50,000	(1) 15,000					35,000	
Gain on acquisition of bonds					(3) 2,100		2,100				
Dividends receivable				(5) 4,500	(6) 4,500						
				$1,562,100	$1,562,100	5,727,300	5,867,100				
Consolidated net income						139,800					
Minority interest of X = 10% [($1,550,000 + $6,000) — ($1,200,000 + $280,000 + $2,500)]								7,350			
Minority interest of Y = 20% [$1,750,000 — ($1,400,000 + $290,500 + $9,500)]									10,000		
Balance to controlling interest											$ 122,450
Minority interest of X to balance sheet								(49,350)			49,350
Minority interest of Y to balance sheet									(147,000)		147,000
						$5,867,100	$5,867,100	—0—	—0—	$3,162,900	$3,162,900

Journal Entries
(Not Required)

(1)

		Debit	Credit
Capital stock—Company X		$225,000	
Retained earnings—Company X		180,000	
Investment in Company X			$350,000
Retained earnings—Company P			40,000
Excess of cost over book value—Goodwill			15,000

To eliminate 90% of net worth of Company X at beginning of year and the investment account; to increase consolidated retained earnings by 80% of the 1961-62 increase in X's retained earnings.

Computation of excess credit:

Cost of investment		$350,000
80% of book value of X stock at 1/1/61	$320,000	
10% of book value of X stock at 1/1/62	45,000	365,000
Excess credit		$ 15,000

(2)

		Debit	Credit
Capital stock—Company Y		400,000	
Retained earnings—Company Y		100,000	
Retained earnings—Company P		100,000	
Excess of cost over book value—Goodwill		50,000	
Investment in Company Y			650,000

To eliminate 80% of net worth of Company Y at beginning of year and the investment account (after giving effect to issuance of 2000 shares to the public).

Computation of consolidated earnings debit:

100% of decrease in Y's retained earnings.	$75,000
25% of Y's retained earnings at 1/1/62 to minority interest. (20% × $125,000)	25,000
Net decrease	$100,000

Computation of excess debit:

Cost of investment	$650,000
Book value of Y stock at 1/1/61	600,000
Excess debit	$ 50,000

(3)

		Debit	Credit
Bonds of Company Y		3,000	
Unamortized bond discount			600
Gain on acquisition of bonds			2,100
Interest expense			300

To eliminate unamortized discount applicable to intercompany bonds, adjust the amortization of discount, and record the gain on the acquisition.

(4)

	Debit	Credit
Interest income on bonds	6,000	
Interest expense		6,000
To eliminate intercompany interest.		

(5)

	Debit	Credit
Dividends receivable	4,500	
Dividend income		4,500
To record dividends receivable from Company X by Company P.		

(6)

	Debit	Credit
Dividends payable	4,500	
Dividends receivable		4,500
To eliminate intercompany dividends receivable and payable.		

(7)

	Debit	Credit
Dividend income	35,000	
Retained earnings—Company X		27,000
Retained earnings—Company Y		8,000
To eliminate intercompany dividends.		

(8)

	Debit	Credit
Retained earnings—Company P	2,000	
Accumulated depreciation	100	
Plant and equipment		2,000
Operating expenses		100
To eliminate intercompany profit in fixed assets and the 6 months' depreciation on this profit.		

(9)

	Debit	Credit
Sales	385,000	
Cost of sales		385,000
To eliminate intercompany sales.		

(10)

	Debit	Credit
Cost of sales	15,000	
Inventories		15,000
To eliminate intercompany profit (25%) in inventories.		

Company X purchased from P $20,000	$ 5,000
Company Y purchased from P $40,000	10,000
	$15,000

(11)

	Debit	Credit
Accounts payable	52,000	
Accounts receivable		52,000
To eliminate intercompany receivables and payables.		

AUDITING

May 16, 1963; 8:30 a.m. to 12:00 m.

Answer 1

The audit work at year-end would be determined by the amount of work done in the interim audit. The following audit program should be followed for the year-end examination of the trade accounts receivable of the Heft Company:

1. Request the client to prepare a summary analysis by months of the accounts receivable general ledger control account for the period from September through December inclusive. The analysis should summarize the entries by months from each source of original entry.
2. Foot and crossfoot the summary analysis and compare it with the accounts receivable general ledger control account.
3. Trace the principal monthly entries shown on the analysis to the record of original entry. For example, the credits for cash receipts should be traced to the cash receipts journal.
4. Compare the amounts of the principal monthly entries for the four months with similar entries for preceding and subsequent periods and with corresponding periods in the preceding year. Determine if major variations, or lack thereof, correspond to known business conditions such as seasonal fluctuations, sales trends, price changes, etc. Trace all unusual entries in the control account to the supporting data.
5. On the basis of the review in procedure 4 above, from the interim period select one month in which unusual changes have occurred for further investigation. In the absence of unusual variations, select the month of December. The following work should be done on the selected month:
    a. Trace the remainder of the monthly entries, not traced in procedure 3 above, to the records of original entry.
    b. Trace the write-off of bad accounts to the Allowance for Bad Debts account.
    c. On a test basis examine for propriety, approval of proper official, etc., the underlying document supporting the write-off of bad accounts. Trace the items tested to the entry on the customers' account cards and determine that the accounts have been excluded from the December 31 trial balance. Mail confirmation requests for large or unusual accounts written off.
    d. On a test basis trace a selection of large and small entries appearing in the detail of sales returns and allowances to the supporting approved credit memo and the receiving ticket, where applicable, and to the corresponding entry in the customer's account.

6. Obtain the December 31 subledger aged trial balances and see that the totals agree with the general ledger control account.

7. Foot and crossfoot two of the subledger aged trial balances.

8. For each of the two trial balances in 7 above, trace 75 to 100 accounts of larger amounts to the customer account cards. Conversely, trace 75 to 100 customer account cards of larger amounts to the trial balances. Some accounts with small balances should also be tested under this procedure.

9. Compare the trial balances at December 31 with the trial balances at August 31.

   a. Confirm any relatively large accounts appearing in the December 31 trial balance that are new or that are delinquent.
   b. For any large past due balances in the August 31 trial balance that changed materially, trace the credits to the underlying source documents such as remittance advices, approved authorizations for write-offs, etc.
   c. The replies to the August 31 confirmation requests should be reviewed. For those active accounts not responding to the confirmation requests, consideration should be given to sending confirmation requests as at December 31. For other accounts not responding, or replying that their accounting systems preclude confirming balances, alternative auditing procedures (examination of remittance advices, shipping documents, etc.) should be applied. Replies stating that there were matters in dispute should be followed up to determine if the matters have been settled.
   d. For accounts in the December 31 trial balance with new credit balances, trace the entries giving rise to the credit balances to the supporting documents. Select the larger accounts for confirmation. Consider the materiality of the total amount of the credit balances and decide whether or not to set it out separately on the balance sheet as a liability.

10. The subledger aged trial balances should be summarized and the results interpreted to evaluate the adequacy of the Allowance for Bad Debts account. Past due accounts should be reviewed with a responsible official as to their collectibility and as an additional test of the adequacy of the valuation account.

11. The sales cut-off should be tested by selecting representative sales transactions for the last few days of the current fiscal period and for the first few days of the next period and tracing these transactions to the related shipping documents. Conversely, for the same days selected shipments should be traced from the shipping documents to the related entries in the records.

12. Any deviation from the client's standard procedures should be noted. If an important variation is found, the audit program should be re-evaluated and appropriate changes considered.

Answer 2

a. The CPA is required to state whether, in his opinion, the principles of accounting used in the financial statements have been observed consistently in the

current period in relation to the preceding period. His opinion implies that the principles have been consistently observed within each period. Not only is he concerned with the observance of accounting principles but also with the methods of applying them.

The objective of requiring the CPA to include in his opinion a statement regarding consistency is to assure the readers of financial statements that their comparability with prior periods has not been materially impaired by the adoption of different accounting principles or by a change in the method of the application of the principles. If the comparability of the financial statements has been materially affected by such changes, the CPA is required to disclose the nature of the changes and their effects upon the statements.

b. 1. When a CPA completes his first audit of the financial statements of a newly organized company ending its first accounting period, he would make no reference to consistency in his opinion because there is no prior period to which a comparison can be made.

2. When the CPA is conducting his first examination of an established company, his audit program should include procedures that would enable him to give an opinion on consistency.

If the financial records for prior years are adequate but the client imposes a limitation on the extent of his auditing procedures, the CPA's opinion would require appropriate qualifications.

On the other hand, if the prior years' records are so inadequate that the CPA is unable to satisfy himself as to the consistent application of accounting principles and the reasonable accuracy of account balances of material amount at the beginning of the current year, he would be unable to give his opinion on the income statement.

c. 1. If the company disposed of one of its three subsidiaries that had been included in its consolidated statements for prior years, no comment as to consistency need be made in the CPA's opinion. The comparability of the financial statements has been affected by a business transaction, but there has been no change in any accounting principle employed or in the method of its application. (The transaction would probably require informative disclosure by a footnote to the financial statements; in unusual circumstances a comment in the CPA's report might be necessary.)

2. If the company converted its method of computing depreciation from the straight-line method to the declining-balance method, the comparability of the financial statements has been affected by a change in the method of applying the accounting principles employed. The change would require comment in the CPA's opinion as to consistency.

3. If the company reduced the estimated remaining useful life of plant property because of obsolescence, the comparability of the financial statements has been affected. The change is not a matter of consistency; it is an accounting change required by altered conditions and involves no change in accounting principles employed or in their method of application. The change would probably be disclosed by footnote; if commented upon in the CPA's report, it would be as a matter of disclosure rather than consistency.

Answer 3

Part a. 1. The reasons supporting the rule of professional conduct prohibiting CPAs from advertising their professional attainments or services include the following:

(a) The CPA's independence and quality of his examination would be impaired if he were engaged as the result of his advertising for additional clients. By advertising the CPA would place himself in a position subservient to the client's whims and demands with consequent detrimental effect upon the quality of his professional services.

(b) Advertising detracts from the status of public accounting as a profession by placing it on a level with commercial activities. The social and financial values inherent in the recognition of professional standing would be lost if CPAs advertised their professional capabilities as though they were selling mechanic services or manufactured products. The impression is created that money-making, rather than service, is the primary motive of CPAs.

(c) The CPA's financial capacity to conduct advertising campaigns, rather than his professional competence, might determine whether he would be selected as a company's CPA. Accordingly, the larger CPA firms with greater financial means for advertising could overwhelm the smaller firms and could make the establishment of a new practice a hazardous venture.

(d) Advertising would result in an undesirable turnover of clients. The professional services received from the CPA would deteriorate because he would be forced to devote considerable time to the solicitation of new clients to replace those lost through another firm's advertising.

(e) The personal nature of the services rendered by the CPA cannot be appropriately advertised by himself. In effect he would be extolling his own personal attributes of intelligence, professional skill, integrity, etc. It is unlikely that such self-praise would have a beneficial effect upon potential clients.

(f) Advertising would probably be uneconomical because of the intimate and personal nature of the relationship between the CPA and his client. In view of this confidential relationship, the client's selection of a CPA is determined from personal acquaintance or personal recommendation of a mutual acquaintance rather than by the impersonal appeals of advertising.

2. The newly established CPA can obtain new clients by the following means that are generally considered to be ethical:

(a) An announcement may be made to his circle of friends and professional acquaintances that he has undertaken public practice.

(b) His name may be placed in directories under the listings of certified public accountants.

(c) A primary source of new clients will be the recommendations of his present clients who are satisfied with his professional work and will suggest him to their acquaintances who are in need of services of a CPA.

(d) New clients will seek his services when they are aware of his presence in the community. The CPA can keep the community aware of his presence by a number of means, such as by joining social or civic organizations, delivering speeches before civic clubs or other groups, preparing newspaper or magazine articles on topics of current interest, etc. If circumstances permit he

might teach at a local educational institution and benefit from the recommendations of his students. He might extend his acquaintance among bankers.

(e) He may offer his professional services to public accounting firms by letter or personal call.

(f) Should he intend to specialize in tax work, he may write to lawyers of his acquaintance and to accountants in public practice announcing his availability as a tax consultant.

(g) The purchase of public accounting practices or accounts from other practitioners or their estates is a generally accepted method of acquiring clients.

Part b. 1. The arguments for the belief that competitive bidding by CPAs for auditing engagements is unethical include the following:

(a) Since competitive bidding involves the establishment of specifications of the commodity to be supplied or the services to be performed, it is not an effective procedure in arranging for an independent audit because the details of the audit cannot be rigidly specified. To render a professional service as an auditor, the CPA must be unrestricted in the exercise of his professional skill and judgment. The extent of his auditing work is not subject to the dictation of the client.

(b) Acceptance of an engagement awarded on a bid basis results in a loss of professional stature by the CPA. Competitive bidding is analogous to advertising or solicitation of clients because it places the CPA in the position of contending for the engagement. The effect of such competition is the loss of independence on the part of the CPA and his assumption of a position subordinate to the client's.

(c) By basing the selection of the auditor on the amount of his fee, competitive bidding ignores the personal relationship between the CPA and his client. The CPA is usually selected for his competence, good judgment and integrity; competitive bidding would disregard these professional attributes.

(d) Competitive bidding is detrimental to the interests of the public and the accounting profession. A comparison of fees is not a sound basis for evaluating the relative worth of the services to be performed because, in an effort to match his expenses with his lowered fee, the CPA might be tempted to reduce the quality and scope of his examination below the proper level. The accounting profession is harmed by competitive bidding because it tends to drive down the fees of all CPAs to a level that might make the profession unattractive to desirable young men of superior intelligence who are selecting their careers and because it might require practicing CPAs to devote more of their time to directly productive work and less time to self-education and advancement of the accountancy profession.

2. (a) If a governmental body is seeking an estimate of the cost of a CPA's services before he is appointed and the CPA is aware that his estimate will be compared with estimates of other auditors, then he is confronted with disguised competitive bidding. In this situation the CPA should decline to submit an estimate and should explain to the governmental body the reasons for his inability to quote a fee for the over-all auditing engagement. If the governmental body is merely

seeking information on how the CPA computes his fee, then the CPA can reveal his method of computing his fee.

(b) Once a governmental body has decided to engage a CPA, it is entirely proper to discuss the matter of the fee. After reviewing the accounts and accounting system to identify any auditing problems and after arriving at an understanding on the scope of his examination, the CPA should be able to estimate the size and difficulty of the audit. Then he would be in a position to give the client an estimate of the amount of his fee which is not likely to be exceeded unless unforeseen problems are encountered.

Answer 4

a. There seems to be poor control over the requisitioning of materials. Each bill of materials from the engineering department, along with a schedule of the planned production of the item called for by the bill of materials, should be forwarded to a stores supervisor. The stores supervisor should be responsible for preparing the necessary purchase requisitions to maintain a supply of materials to meet the scheduled production. The foremen would draw the necessary materials from stores on a material requisition and should have no part in the purchase requisition process.

b. The copy of the purchase order that is sent to the receiving department and used as a receiving report should not show the quantities so that receiving department personnel would be required to count incoming material. Receiving department personnel would also be prevented from converting overshipments to their own use.

Additional copies of the purchase order and the receiving report might prove desirable. The accounting department should receive a copy of the purchase order for vouching purposes. A copy of the purchase order routed to the stores manager might prove helpful to him in planning storage space. A copy of the receiving report would be necessary if stock record cards are maintained. Routing a copy of each to the foreman who will use the material might help him in scheduling his work.

c. In the purchasing department there is no safeguard against issuance of unauthorized purchase orders. The purchasing department supervisor should assign purchase order numbers to the requisitions prior to distribution to the employees who place the orders. He should also account for the sequence of purchase order numbers.

There is no evidence that the purchase orders are approved. They should be approved by the purchasing department supervisor to insure that purchases are made from approved vendors at the best price for the quantity and quality requested.

d. The mail department should send the vendors' invoices to the purchasing department when they are received. The purchasing department should compare the terms, etc., of the invoices and purchase orders and send one invoice copy to the accounting department for vouchering. The other copy should be retained in the files of the purchasing department.

The accounting department, rather than the purchasing department, should approve the vouchers for payment. The voucher section should receive a copy of each purchase order and receiving report and the original invoice. This section should then reconcile the purchase orders, receiving reports, and invoices; check discounts, footings, and extensions; prepare a voucher; and approve the voucher for payment. This will insure that payment is made only for authorized material received.

The voucher section should not prepare the checks. After approval for payment the vouchers should be forwarded to the cash disbursements section for preparation of prenumbered checks in duplicate and insertion of checks in the check signing machine. The check signing machine should be arranged so that signed checks would flow into a locked box to which those responsible for the cash disbursements function would have no access. Or, perhaps it would be sufficient if the check writing machine had a locked-in numbering device. A person independent of the cash disbursements function and the voucher section should remove the checks from the locked box or reconcile the number of checks with the number written by the machine. In either event this independent person should compare the checks with the vouchers for payee's names and addresses and amounts and then mail the checks direct to the vendors. He should date stamp the invoices and vouchers "paid," send the duplicate copies of the checks to the cash disbursements bookkeeper, and return the "paid" vouchers to the voucher section. This procedure would prevent a voucher section employee from approving or the cashier from preparing a check for an improper disbursement.

A listing of unpaid accounts payable (rather than an adding machine tape) should be prepared monthly by one of the voucher clerks. A responsible person, other than a voucher clerk, should review the listing.

Answer 5

Part a. The opinion prepared by Doe & Doe is deficient in the following respects:

1. The term "certificate" should not be used because it implies an inappropriate degree of certitude and precision. If a title is used, it should be auditors' "opinion" or "report."

2. The opinion should be dated to indicate the end of the auditor's responsibility for disclosing events occurring subsequent to the balance sheet date. The date of completion of the work in the client's office is normally used.

3. The report should be addressed to the client and not to the public at large. The report is prepared for the information and purposes of the client who engaged the auditor and should usually be directed to him. If the officers of a company make the selection, the report should be addressed to the company; if the report is to be included in the annual report to the stockholders, it may be addressed to the stockholders even though the auditor was not appointed by stockholder action.

4. The dates of the statements should be given. Such information is a part of that necessary to reveal the responsibility assumed by the auditor.

5. No reference is made to the question of whether the statements have been prepared in conformity with generally accepted accounting principles.

A primary objective of the engagement of an auditor is to determine that generally accepted accounting principles have been followed in the accumulation and presentation of accounting data.

6. Since no mention is made of principles of accounting, none is made of the consistency with which they were applied. Knowledge of the consistent application of these principles is needed to ascertain that the statements are comparable to prior year's statements in this important respect.

7. The exception with respect to verification of accounts receivable is inconclusive. The auditor should state whether he was able to satisfy himself with respect to the stated amount of receivables by the application of alternative auditing procedures.

8. In like manner the statement regarding the physical inventory quantities is deficient. If he is to say that the statements "present fairly," he must state that alternative procedures were applied with respect to the physical inventory quantities and that he was satisfied by the procedures.

9. The opinion on the financial statements may be intended to be qualified as to the inventory figure and probably the receivables figure as well. However, in view of the significance of these figures to the over-all financial position and results of operations of a department store, even a qualified opinion is out-of-order and there should be a disclaimer of any over-all opinion.

10. The opinion should have been manually signed to substantiate the statement as being a personal attestation.

Part b. The three generally accepted standards of field work and their relation to the illustration are as follows:

1. The first standard is that the work is to be adequately planned and assistants, if any, are to be properly supervised. Fulfilling this standard would include the preparation of an audit program for the accounts receivable and reviewing it with the assistant prior to his beginning the examination. There is no indication in the illustration that an audit program existed; reliance upon the prior year working papers is an indication that no program has been prepared. Another aspect of the standard is a review of the completed working papers to determine whether an adequate examination was performed. The illustration states that this procedure was followed.

2. The second standard is that there is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted. The case presented makes no mention of a study of the internal control system. If such study had been made, the results, as they pertained to receivables, should be considered by the supervisor in determining that the testing has been extended to the point that he is satisfied as to the validity of the receivables. Reliance upon prior year working papers in lieu of an appraisal of the existing system of internal control is improper because changes may have been made in the system.

3. The third standard is that sufficient competent evidential matter is to be obtained through inspection, observation, inquiries and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination. The junior's preparation of working papers, confirmation requests and

other procedures would fulfill the requirements of this standard if the audit work is properly performed and is of sufficient depth.

Answer 6

a. While statistical sampling techniques do not relieve the CPA of his professional responsibilities but are only one tool that he may use in fulfilling these responsibilities, the application of statistical sampling techniques to audit testing might result in the following advantages:

1. The CPA might place greater confidence in his audit findings because the use of statistical sampling techniques provides him with an objective basis for determining the size of his samples and interpreting the sample results.

2. The extent of the CPA's work might be reduced because, without the use of statistical sampling techniques, he might choose a larger sample to attain the same degree of assurance.

3. Statistical sampling contributes objectively to the CPA's evaluation of the preliminary appraisal of the internal control system through establishing standards whereby the quality of the work under audit can be measured.

4. Should the CPA be placed in the position of defending his auditing procedures in a court proceeding, he would be able to demonstrate mathematically that his sampling procedures or conclusions were statistically justifiable. Similarly, the CPA would be able statistically to justify his work to a client who was critical of the extent of his testing.

5. A statistical sampling plan might permit better advance planning of the audit since the accounts to be audited or the numbers of documents or transactions to be examined may be determinable in advance and worksheet formats prepared before regular field work begins. Furthermore, if the application of statistical sampling discloses the need for a substantial increase in the amount of audit testing, the CPA will promptly have grounds for estimating the additional audit costs involved and for related discussions with the client.

6. Clients' employees might feel that more thorough examinations were being made. Statistical sampling requires the selection of sample items on a random basis; under conventional testing the selection need not be random. Statistical sampling would result in selection of items from a greater number of files and might, therefore, give an impression of greater thoroughness.

b. The following decisions involving professional judgment would be made by the CPA in applying statistical sampling techniques to audit testing:

1. The areas susceptible to statistical sampling would have to be determined. The areas should be comprised of numerous items or transactions that are similar in nature and that are to be subjected to a test having essentially a single objective. If the auditor's conclusion is not to be based mainly on a single test, substantial difficulty arises in determining the appropriate ranges of precision and levels of reliability for the several tests.

2. The CPA's preliminary evaluation of the system of internal control for an area would determine the reliability or confidence level he believes is appropriate. The existence of a strong internal control system would minimize testing

that the CPA believes necessary for verification and might, therefore, cause him to use a lower confidence level for statistical sampling than he would use in the absence of strong internal control.

3. The information derived from prior audits of the client's records would be evaluated. Judgment based upon prior experience would be exercised in decisions regarding the desirability and design of statistical sampling applications.

4. The maximum rate of error that the auditor will consider acceptable must be decided. Decisions regarding the definition of an error are included in making this evaluation.

5. The level of confidence must be determined. This is the probability that an estimate made from a sample will fall within a stated range about the true value for the population as a whole. The auditor may think of it as the percentage of times that a correct decision (within the specified precision limits) will result from using an estimate based on a sample.

6. Conclusions about the universe must be drawn from the results of the sampling. In arriving at these conclusions the CPA must judge the significance of the errors discovered.

c. When the CPA has applied probability sampling techniques and discovered that the error rate exceeded his acceptable error rate at the predetermined confidence level, the following courses of action are available to him:

1. His sample of the material under audit might be extended to determine whether his first sample fell in the range of extreme probability and is not actually representative.

2. The client might be advised of the number of errors and requested to check and correct the entire material.

3. The CPA might reconsider his selection of the maximum rate of error that can be tolerated. Sample results that are unacceptable if his standard is 2% error may be entirely acceptable if he is willing to increase his tolerance.

4. The CPA might reconsider the level of confidence that he would consider acceptable. Again, a reduction in his standard would render acceptable sample results that had been unsatisfactory when measured by the higher standard. There is an obvious danger in procedures 3 and 4: a reduction in standards the CPA considers acceptable may make him vulnerable to a charge of negligence or lack of independence. He should be prepared to defend his decision.

5. If sample results, even after the sample is extended, are unsatisfactory, and if the client is unwilling or unable to correct his work, the auditor must consider whether to examine the entire population. If he is unable to satisfy himself as to the validity of the population, he must consider what effect his lack of satisfaction will have on his report and opinion.

Answer 7

The Soo Company

WORKSHEET TO DETERMINE SALARY EXPENSES AND PAYROLL TAXES

December 31, 1962

a.	Salary Expense	Payroll Taxes Withheld			Wages Subject to		Payroll Taxes Expense				Employer Payroll Taxes Payable
		FICA	Income	Total	FICA	SUI	FICA @ 3⅛%	SUI @ 2.7%	FUT @ .8%	Total	
First quarter	$13,600	$ 425	$ 2,600	$ 3,025	$13,600	$13,000	$ 425	$ 351	$104	$ 880	$ 880
Second quarter	12,000	375	2,280	2,655	12,000	11,000	375	297	88	760	760
Third quarter	12,800	325	2,400	2,725	10,400	10,000	325	270	80	675	675
Fourth quarter	18,700	225	4,000	4,225	7,200	6,000	225	162	48	435	435
Total for the year	57,100	$1,350	$11,280	12,630	$43,200	$40,000	$1,350	$1,080	$320	2,750	2,750
Payments on liability											
First quarter ($3,801)				(3,025)							(776)
Second quarter ($3,327)				(2,655)							(672)
Third quarter ($3,320)				(2,725)							(595)
Correct balances	57,100			4,225						2,750	707
Balances per general ledger	44,470			3,200						14,548	900
Adjustment = Debit (Credit)	$12,630			($1,025)						($11,798)	$193

b.

Salary expense	$12,630	
Payroll taxes payable	193	
Payroll taxes withheld		$ 1,025
Payroll tax expense		11,798

To adjust salary and payroll tax expense accounts and to correct accruals.

Note: It is assumed that the state unemployment tax is applied to the first $3,000 of wages paid to each employee.

COMMERCIAL LAW

May 17, 1963; 8:30 a.m. to 12 m.

Answer 1

1. False
2. False
3. True
4. True
5. False
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Answer 2

76. True
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81. True
82. True
83. False
84. True
85. True
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87. True
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Answer 3

151. True
152. False
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223. True
224. True
225. False

Answer 4

Part a. No. If the principal debtor and the creditor, without the consent of the surety, make a binding agreement to extend the time of payment, the noncompensated surety is discharged. As an exception to this rule the creditor may nevertheless hold the surety on his promise if the creditor reserved his rights against the surety in the extension agreement. Here there was neither consent nor a reservation of rights and thus the surety's obligation is discharged. The extension agreement was clearly binding on the parties (the principal debtor and the creditor). The element of consideration, which is often lacking in such extensions, was present since the creditor received a promissory note that he was not previously entitled to in exchange for the extension of time.

Part b. The term "compensated surety" refers to a person or corporation that engages in the business of executing surety contracts for a premium or a fee.

The distinction is important because the law of suretyship, notably those rules relating to the defenses of the surety, are not in all respects the same for the two types of sureties. To illustrate, the noncompensated surety is completely released as a result of a binding extension of time, but the compensated surety is released only to the extent that he is harmed by the extension. In general, the compensated surety is not treated as favorably as the noncompensated surety.

Part c. Unlike the unconditional or absolute guarantee of payment where the guarantor becomes liable without notice on default, the guaranty of collectibility requires the creditor to take two steps before he can resort to the guarantor's promise. These are

1. To give timely notice to the guarantor of the principal debtor's default, and

2. To exhaust his remedies against the debtor (e.g., have a judgment returned uncollected).

A guarantor of collectibility, whose undertaking relates to the principal debtor's inability to pay, is not chargeable with knowledge of the principal's default and is therefore entitled to timely notice thereof by the creditor. Because such a guarantor obligates himself to pay if the principal debtor cannot, the creditor must therefore show that the principal cannot pay; that is, he must first exhaust his legal remedies against the principal.

Answer 5

Part a. 1. The Statute of Frauds is designed to prevent the use of the courts for the purpose of enforcing certain oral agreements or alleged oral agreements. The various Statutes of Frauds adopted in this country have been closely patterned after a statute adopted in England in 1677 that was intended to reduce the evil of perjured testimony by providing that certain contracts could not be enforced if they depended upon the oral testimony of witnesses alone and were not evidenced by a writing.

2. (a) An agreement that cannot be performed within one year after the contract is made.

(b) An agreement to sell or a sale of any interest in real property.

(c) A promise to answer for the debt or default of another.

(d) A promise by the executor or administrator of a decedent's estate to pay a claim against the estate from his personal funds.

(e) A promise (other than ordinary mutual promises to marry) made in consideration of marriage.

(f) Contracts with respect to the sale of personal property above a specified minimum dollar amount.

3. No. The requirement that a promise to answer for the debt of another be in writing does not apply when the promisor makes the promise primarily for his own benefit. In this case Casey made the promise to make good Whatt's debt to the supplier for his own benefit since it prevented the interruption of the subcontractor's work and thus enabled Casey to complete the work as required by his contract.

Part b. No. The validity of an agreement which restrains employment, as part of the sale of business including the goodwill, depends upon whether the restrictive provisions are necessary to protect the goodwill. In this case the five-year period for such restraint does not appear unreasonable but the prohibition to practice "anywhere within the United States" is unreasonable in view of the fact that the practice is a one-man operation limited to a small part of the United States.

Part c. Substantial performance, as it relates to the construction contracts, is performance that is essentially, though not technically, complete. In order that recovery be had under this doctrine the following are necessary:

1. A bona fide (good faith) effort toward full compliance with the contract.

2. Lack of major deviations or omissions from the contract.

3. Lack of major defects in the structure of the building.

Answer 6

Part a. 1. No. This is an agency coupled with an interest. Unless otherwise agreed, such authority is irrevocable by act of the principal (Able). Hence, Able is without power to revoke this agency and has no remedy against Baker for the latter's action in selling the painting in accordance with the authority given.

2. No. Notice of termination of an agency by act of the principal must be given to third persons who rely on written authority possessed by special agents. Here the notice of termination was given by Able to the curator by implication when Able informed the curator that the painting was not for sale. However, since the principal (Able) was without the power to revoke the agency, the notice had no legal effect.

Part b. Ways in which an agency relation may be created as to third parties include:

1. Ratification.
2. Estoppel.
3. Necessity.
4. Apparent or ostensible.
5. Operation of law.

Part c. 1. No. If a person gratuitously promises to act as agent of another and then does not act, there is no liability imposed because the promise is lacking in consideration.

2. Yes. If the agent does embark upon the agency (performance of promised act), the principal is entitled to assume that he will discharge his duties as agent with reasonable care. Failure to do so will impose upon the agent liability for consequent loss. The fact that his services were gratuitous will furnish no defense.

Answer 7

a. This is a mutual benefit bailment in which goods are delivered by the bailor (Peters) to the bailee (David) under a contract or agreement whereby the latter is to perform the agreed-upon work on the goods, for compensation, and to return the identical property to the former or to deliver or dispose of it as directed by the agreement.

b. The bailment transaction depends for its validity upon the fact that there has been an actual or constructive transfer of possession of the property to the bailee. The agreement preceding this transfer of possession, or delivery and acceptance of the goods, is merely an agreement to make a bailment rather than the actual bailment.

c. David. He was bound under his contract to use the particular cotton delivered to him by Peters for the latter's exclusive use and to return it in the form of specified sport trousers. In a mutual benefit bailment the bailee is required to use ordinary care and is liable for ordinary negligence. Ordinary care is generally defined as that care which a person of ordinary prudence customarily takes of his own goods of a similar kind and under similar circumstances. In this case there

was negligence on David's part in leaving the place unlocked and therefore he has failed to exercise the required (reasonable) degree of care.

d. In a bailment only possession of the goods is transferred by the bailor to the bailee; title to the goods does not pass to the bailee and his right to the use of the property is limited or restricted to that dictated by the purpose of the bailment. In a sale title to the goods is transferred by the seller to the buyer and generally no restrictions are imposed upon the buyer as to the use of the property.

Answer 8

Part a. 1. No. James had no insurable interest in the life of the janitor. The courts have sustained "key man" insurance so that an employer may insure a valuable employee's life. However, in this case the man was a janitor and not so essential to the business as to sustain the validity of the policy. The contract of insurance in this case was a mere wager and consequently against public policy. The incontestable clause has no effect upon the requirement of an insurable interest. Nor is the requirement of an insurable interest waived because the janitor had given his consent to the issuance of the policy. The insured's consent is, in most cases, an added requisite to a valid life insurance policy.

2. Yes. The law recognizes an employer's insurable interest in the lives of key employees. Such insurance has been appropriately labeled "key man" insurance and is based upon the substantial economic interest that the employer has in the life of such employees.

Part b. The three principal purposes of requiring an insurable interest in insured property are:

1. To prevent gambling.

2. To prevent destruction of property by one who would suffer no loss as a result of the destruction and who would be tempted to do this in order to obtain the insurance proceeds.

3. To measure the actual loss that has been suffered in order to ascertain the amount payable (other than in a valued policy).

Part c. 1. The right of subrogation is available to the S Surety Company. If the S Surety Company fully satisfies the obligation to the Able Corporation, it succeeds to all the rights that Able might assert in such a case.

2. No. While an insurer is liable regardless of fault and is, therefore, strictly liable, a CPA performing an ordinary examination undertakes only to exercise average professional competence and reasonable care. Being responsible solely for negligence, bad faith or dishonesty, he would be liable for failure to discover an irregularity only if it should have been uncovered in applying the procedures required by generally accepted auditing standards. Certainty of discovery would require an unrealistically detailed examination of all transactions and records, plus professional infallibility. Such unlimited responsibility is not imposed either by law or professional standards.

3. The standard of care required of a CPA is to exercise reasonable care or the ordinary degree of care that a reasonably prudent CPA would exercise in a given undertaking.

THEORY OF ACCOUNTS

May 17, 1963; 1:30 p.m. to 5 p.m.

Answer 1

1. C
2. A
3. E
4. B
5. B
6. C
7. A
8. D
9. B
10. A
11. False
12. True
13. False
14. True
15. False
16. True
17. False
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31. False
32. False
33. True
34. False
35. False

Answer 2

a. Cost depletion is the procedure by which the capitalized costs, less residual land values, of a natural resource are systematically charged to operations. The purpose of this procedure is to match the cost of the resource with the revenue which it generates. The usual method is to divide the total cost less residual value by the estimated number of recoverable units to arrive at a depletion charge for each unit removed. A change in the estimate of recoverable units will necessitate a revision of the unit charge.

Percentage depletion is the procedure, authorized by the Internal Revenue Code, by which a certain percentage of gross income is charged to operations in arriving at taxable income. Percentage depletion is considered not to be a generally accepted principle of accounting because it is not related to the cost of the asset and is allowed even though the property is fully depleted under cost depletion accounting. Applicable rates, ranging from 5% to 27½% of gross income, are specified for nearly all natural resources. The total amount deductible in a given year may not be less than the amount computed under cost depletion procedures, and it may not exceed 50% of taxable income from the property before the depletion deduction. Cost depletion differs from percentage depletion in that cost depletion is a function of production whereas percentage depletion is a function of income.

Percentage depletion has arisen, in part, from the difficulty of valuing the natural resource or determining the discovery value of the asset and of determining the recoverable units. Although other arguments have been advanced for maintaining percentage depletion, a primary argument is its value in encouraging the search

for additional resources. It is deemed to be in the national interest to provide an incentive to the continuing search, and percentage depletion provides this incentive.

b. (1) Depreciation and cost depletion are similar in the accounting sense in that

1. The cost of the asset is the starting point from which computation of the amount of the periodic charge to operations is made.

2. The estimated life is based on economic or productive life.

3. The accumulated total of past charges to operations is deducted from the original cost of the asset on the balance sheet.

4. When output methods of computing depreciation charges are used, the formulas are essentially the same as those used in computing depletion charges.

5. Both represent an apportionment of cost under the process of matching costs with revenue.

6. Assets subject to either are reported in the same classification on the balance sheet.

7. Appraisal values are sometimes used for depreciation while discovery values are sometimes used for depletion.

8. Residual value is properly recognized in computing the charge to operations.

9. They may be included in inventory if the related asset contributed to the production of the inventory.

10. The rates may be changed upon revision of the estimated productive life used in the original rate computations.

(2) Depreciation and cost depletion are dissimilar in the accounting sense in that:

1. Depletion is almost always based on output whereas depreciation is usually based on time.

2. Many formulas are used in computing depreciation but only one is used to any extent in computing depletion.

3. Depletion applies to natural resources while depreciation applies to man-made assets.

4. Depletion refers to the physical exhaustion or consumption of the asset while depreciation refers to the wear, tear, and obsolescence of the asset.

5. Under statutes which base the legality of dividends on accumulated earnings, depreciation is usually a required deduction but depletion is usually not a required deduction.

6. The computation of the depletion rate is usually must less precise than the computation of depreciation rates because of the greater uncertainty in estimating the productive life.

7. A difference that is temporary in nature arises from the timing of the recognition of depreciation under conventional accounting and under the Internal Revenue Code and results in the recording of deferred income taxes. On the other hand, the difference between cost depletion under conventional accounting and its counterpart, percentage depletion, under the Internal Revenue Code is permanent and does not require the recording of deferred income taxes.

c. (1) Fixed assets received as a gift are recorded on the books on the grounds that a purpose of accounting is to establish accountability for or control over the

assets of the company. In acknowledgment of its responsibility for the assets, management reports a value for all assets entrusted to it. While the usual measure of accountability is the accounting entity's cost of the fixed assets, the measure of accountability is the fair value of the property acquired if the fixed assets have been acquired at no cost.

(2) The accountability for fixed assets does not stop with the balance sheet. If the donated fixed assets are deemed to be properly includable within the family of fixed assets, then the income statement should report the utilization of these assets by matching a portion of the attributed cost of the assets, in the form of depreciation or depletion, with the related revenues produced. To record on the balance sheet a value for an asset usually subject to depreciation or depletion and then to disregard its related effect upon the income statement would be illogical. Omission of depreciation or depletion on donated assets would cause the income statement to indicate a higher operating efficiency in the utilization of assets than actually existed because the reported net income would include an element of gift.

Answer 3

a. Book value is the amount recorded in or computable from the books of account as the carrying value of an asset or equity at the date of determination, after adjustments for corrections of errors and inconsistencies in the application of accounting principles and procedures. If a company were liquidated without accounting gains or losses, its stockholders would receive an amount equal to the book values of their respective equities. Because it is based on going concern values, which are not expressions of realizable value either for individual assets or the whole business, book value is not logically suitable, except as a possible starting point, for determining actual liquidating value or the selling price of a business that is expected to continue in operation indefinitely.

b. The procedure for computing book values of ownership equities involves a consideration of the respective rights of each class of outstanding capital stock. To ascertain these rights, reference must be made to the governing state laws and articles of incorporation and to the specific features of each class of preferred stock. The portion of total owners' equity applicable to preferred stock is then assigned. If a liquidating value is given for the preferred stock, it should be used instead of par value. Dividends in arrears on cumulative preferred stock and the applicable portion of retained earnings on participating preferred stock should be included in the portion of total owners' equity assigned to preferred stockholders. The book value of common stock is computed by subtracting the amount assigned to preferred stocks from total owners' equity. Per share book values for each class of stock are computed by dividing the amounts assigned to each class by their respective numbers of shares outstanding.

c. Where equally acceptable alternatives are available, the policies and methods used to account for the underlying assets can materially affect the book value of owners' equity. Thus, a consideration of these policies and methods is necessary to evaluate the reported book value of the P.K. Leash Company's common stock. A determination of the policies and methods pertaining to the following should be made:

1. Asset valuation methods for inventories, receivables, investments, and fixed assets.
2. Depreciation methods for plant and equipment.
3. Amortization policies for intangible assets.
4. Capitalization policies for plant and equipment charges.
5. Contingency provision policy.
6. Policies for recognizing accruals and deferrals.

d. The following factors should be considered by your client in valuing the common stock of the P. K. Leash Company.

1. Earning power. This would include a study of past earnings and estimated future earnings as to rate, stability and trend.
2. The amount and estimated duration of differential earnings resulting from various goodwill factors.
3. Trend of profit margin.
4. Trend of gross sales.
5. Competitive position of the Company in the industry.
6. Extent of the market for the Company's products.
7. Appraised value of the underlying assets, both tangible and intangible.
8. Suitability of assets for alternative uses.
9. Qualities of executive personnel.

Answer 4

a. In support of its decision to report the unearned portion of the 10% finance charges as a current liability, Whitewall might argue that the amount is a liability in the sense that an obligation has been incurred to render a service, namely, to forego the collection of the amount due. Furthermore, inasmuch as current assets will have to be expended (cash will have to be paid to the bank for the interest on the short-term loans), the unearned portion of the finance charges represents a claim on the current assets and, in strict conformity with accounting theory, must be classified as a current liability.

b. It can be argued that the unearned portion of the finance charges should be reported as deferred income because the amount actually measures future interest revenue or income. The amount deferred will eventually be recorded as income. Moreover, the revenue is properly deferred because the furnishing of the service, i.e., use of the funds, is yet to be provided. Likewise the cost of providing the service (interest on the short-term loans) will be incurred in a subsequent period, therefore for a proper matching of costs with revenues, the revenue should be deferred to the period in which the interest cost arises.

c. Recording the unearned portion of the finance charges as a deduction from the installment contracts receivable is proper accounting, it can be reasoned, because the face value of the contracts is thereby reduced to its "present" or "discounted" value, that is, the amount of the receivable earned to date. This is the more conservative balance sheet treatment because maintaining the contracts at full market value would result in an overstatement of assets. In addition, the amount of the unearned finance charges should not appear on the liability side of the

balance sheet because no funds have been advanced to Whitewall nor has Whitewal incurred any liability.

d. Although accounts termed "deferred income" are often shown on the credit side of the balance sheet in practice, the third method of presentation—designating the unearned portion of the finance charges as a valuation reserve and deducting it from the receivables—is the theoretically correct method. The transaction is analogous to the case in which the purchaser signs a contract in which he agrees to pay the sales price of the merchandise with interest accrued to the date of payment; the contract would appear as a receivable at face value and the accrued interest would be shown as a receivable. In reality Whitewall has no liability for the unearned portion of the finance charges, and the portion of the contract that represents the unearned finance charges is not part of the present value of the asset. The deferred income classification is not theoretically correct because all elements of the credit side of the balance sheet should be classified as liabilities or owners' equity. The unearned portion of the finance charges is a true valuation account rather than either a liability or net worth item.

e. The principal accounting methods of recognizing revenue on installment sales are the following:

1. The sales basis method. Since this method provides that the full amount of revenue be recognized in the period of sale and that provisions be made for losses on bad debts, collection expenses, expenses of reconditioning repossessed property, etc., it is in accord with strict accounting theory. However, in some cases it is very difficult to estimate the provisions. Moreover, provisions for collection expense and reconditioning expense are not deductible for tax purposes and may differ from actual expenditures for these purposes. Finally, if this method is used for tax purposes, the revenue is taxable before a large part of the related cash is collected. Hence there is great pressure on a taxpayer to adopt the installment method described below.

2. The cost recovery method. The first collections are considered a return of cost and no gross profit is recognized until the collections exceed the cost. This method is extremely conservative; it understates the income until the final collections have been made. The use of this method would probably be confined to circumstances where there are substantial losses on the accounts and the merchandise cannot be recovered or has little resale value upon recovery. The method is rarely used and is not recognized for income tax purposes.

3. The profit recovery method. The first collections are considered to be profit. After the entire gross profit is taken up, subsequent collections are treated as recoveries of cost. This method is not conservative because it tends to overstate income—future losses on collections and on returned merchandise would adversely affect the original profit margin. It would result in a gross mismatching of costs with revenues. The method, which is rarely used and is unacceptable for income tax purposes, might be used in connection with the installment sales of property whose value does not deteriorate, such as jewelry, land, or art paintings.

4. The installment method. Under this method each cash collection is considered to be both a realization of gross profit and a return of cost in the same ratio that these factors had in the original sales price. The method, which is acceptable from the standpoint of both accounting theory and income taxes, has a

number of advantages. It apportions revenue over the full installment payment period and thus provides for possible loss on defaulted payments. Spreading the recognition of profits results in a better matching with revenues of the collection expenses that are generally difficult to estimate when the original sale is made. The recognition of income is contingent upon the collection of cash and is therefore related directly to the inflow of the cash.

Answer 5

a. Direct labor is that portion of the total labor cost that can be traced to the product. In some cases the relationship between labor and product may be quite direct, as in the job order system in which labor costs of an operation are identified by means of time tickets with the order on which the costs were incurred. In other cases, as in a process system, direct labor may be that which can be traced to a cost center, department, production line or like unit that can be identified as contributing directly to the production process. The ability to associate the labor costs directly with the product, rather than the nature of the labor, is usually held to be the distinguishing characteristic of direct labor. Both skilled and unskilled labor can be classified as direct labor.

Indirect labor is labor that can not be expediently traced to a product on other than an averaging or allocation basis. Certain indirect labor costs might be construed as direct labor costs of a particular costing unit but, in relation to the final product, are still considered to be indirect. For example, wages paid to a power plant worker would be direct in relation to the power plant as a costing unit; but, since the power plant costs are distributed by some averaging or allocation method, the wages would be indirect when related to the end product.

b. The segregation of labor costs into direct labor and indirect labor is important for a number of reasons:

(1) More accurate costs for individual products result from the segregation because the labor necessary to produce a product is directly identified with the product to the extent that it is possible to do so. Knowledge of accurate costs facilitates managerial decisions regarding pricing, product mix, sales emphasis, and the like.

(2) Separation of labor costs into direct and indirect provides a means of measuring the efficiency of the labor. The association of direct labor costs with units produced enables management to arrive at decisions regarding the productive effectiveness of individuals, groups, or departments. Since indirect labor has little relationship to total units produced, production is not a good measure of indirect labor's efficiency.

(3) Direct labor costs or hours provide a reliable method of applying manufacturing overhead because it measures the amount of productive effort expended on a product.

(4) The separation of labor costs into direct and indirect furnishes a means for the negotiation of the "cost-plus" type of contract.

c. One costing method of accounting for the premium costs of overtime direct labor is to charge the premium directly to the products as an integral part of the

base wage. This method would be preferable when a particular job or product can be identified as requiring the overtime work to meet a completion date. The method would also be applicable to long-term projects in which overtime is a continuing condition.

Another costing method is to treat the premium as an overhead item to be charged to all products through the allocation of overhead. When the overtime is a recurring condition arising from the business's level of operations, its allocation to all products or jobs is proper. It would be unreasonable to charge the premium to the job which, by chance, was selected for the overtime work.

A third costing method is to charge the premium as a period cost directly to income. This method has application when the overtime premium costs are caused by inefficient operations.

d. Changing from the cash basis to the accrual basis of expensing vacation pay would affect both the income statement and the balance sheet. The change would result in dual charges—for 1963 and 1964—in the single year 1964 and would cause the 1964 income statement to be not consistent with the statements of prior years. The cost of 1963 vacation pay should be charged to retained earnings in cases where the dual charges, alone or in company with other adjustments to prior year earnings, are sufficient to make the income statement misleading. If the dual charges appear in the income statement, the 1963 charge may appear as an adjustment of prior year earnings or may be shown with the 1964 charge.

The effect of the change in basis on the balance sheet would be the addition of a liability for the accrual of vacation pay at the end of 1964. If the amount of the accrual is material, it should be shown separately, or the change in basis should be described in a footnote, or both means of disclosure should be used.

Answer 6

a. The retail inventory method can be employed to estimate retail, wholesale, and manufacturing finished goods inventories.

The valuation of inventory under this method is arrived at by reducing the ending inventory at retail to an estimate of the lower of cost or market. The retail value of ending inventory can be computed by (1) taking a physical inventory, or by (2) subtracting net sales plus net markdowns from the total retail value of merchandise available for sale (i.e., the sum of beginning inventory at retail, net purchases at retail, and net markups.) The reduction of ending inventory at retail to an estimate of the lower of cost or market is accomplished by applying to it an estimated cost ratio arrived at by dividing the retail value of merchandise available for sale as computed in (2) above into the cost of merchandise available for sale (i.e., the sum of beginning inventory, net purchases, and other inventoriable costs.)

b. Since the retail method is based on an estimated cost ratio involving total merchandise available during the period, its validity depends on the underlying assumption that the merchandise in ending inventory is a representative mixture of all merchandise handled. If this condition does not exist, the cost ratio may not be appropriate for the merchandise in ending inventory and can result in significant error.

Where there are a number of inventory subdivisions for which differing rates of markon are maintained, there is no assurance that the ending inventory mix will be representative of the total merchandise handled during the period. In such cases accurate results can be obtained by subclassifications by rate of markon.

Seasonal variations in the rate of markon will nullify the ending inventory "representative mix" assumption. Since the estimated cost ratio is based on total merchandise handled during the period, the same rate of markon should prevail throughout the period. Because of seasonal variations it may be necessary to use data for the last six months, quarter, or month to compute a cost ratio that is appropriate for ending inventory.

Material quantities of special sale merchandise handled during the period may also bias the result of this method because merchandise data included in arriving at the estimated cost ratio may not be proportionately represented in ending inventory. This condition may be avoided by accumulating special sale merchandise data in separate accounts.

Distortion of the ending inventory approximation under this method is often caused by an inadequate system of inventory control. Adequate accounting controls are necessary for the accurate accumulation of the data needed to arrive at a valid cost ratio. Physical controls are equally important because, for interim purposes, this method is usually applied without taking a physical inventory.

c. The advantages of using the retail method as compared to cost methods include the following:

1. Approximate inventory values can be determined without maintaining perpetual inventory records.
2. The preparation of interim financial statements is facilitated.
3. Losses due to fire or other casualty are readily determined.
4. Clerical work in pricing the physical inventory is reduced.
5. The cost of merchandise can be kept confidential in intracompany transfers.

d. The treatments to be accorded net markups and net markdowns must be considered in light of their effects on the estimated cost ratio. If both net markups and net markdowns are used in arriving at the cost ratio, ending inventory will be converted to an estimated average cost figure. Excluding net markdowns will result in the inventory being stated at an estimate of the lower of cost or market.

The lower cost ratio arrived at by excluding net markdowns permits the pricing of inventory at an amount that reflects its current utility. The assumption is that net markdowns represent a loss of utility that should be recognized in the period of markdown. Ending inventory is therefore valued on the basis of its revenue producing potential and may be expected to produce a normal gross profit if sold at prevailing retail prices in the next period.

Answer 7

a. (1) The purpose of developing basic postulates and principles of accounting is to provide an expression of what constitutes generally accepted accounting principles for the guidance of CPAs and other accountants in their development of accounting information. When the basic postulates and principles have been estab-

lished, the foundation has been laid for the logical development of rules and other guides for the application of principles in specific situations—a frame of reference has been provided for the solution of accounting problems.

(2) The benefits to be derived from the development of basic postulates and principles are the determination of appropriate accounting practice and a narrowing of the areas of difference and inconsistency in reporting on similar events. As a result of these benefits the comparability of the financial statements between companies and between industries will be improved to the advantage of management, investors and the general public. In addition, unsettled and controversial issues will be identified for subsequent research and study. These benefits, as well as others such as the guidance of accounting educators and textbook authors, will be obtained from the determination of basic accounting postulates and principles.

b. Although they need not all be present in a situation, financial information would in general be considered objective in nature under the following conditions:

1. It is expressed free from personal opinion or distortion from personal bias. The facts are given impersonally, unprejudicially, and not subjectively.

2. It results from the exchange of something for something. Both things being exchanged should have value.

3. It arises from a transaction made at arm's length or the equivalent.

4. It arises from a transaction between parties who are competent to contract and perform.

5. It is based on the accounting for the transaction for the purposes of one of the parties to the transaction.

6. It arises from a transaction that is capable of being measured in well-defined units such as dollars.

7. It is substantiated or is capable of being substantiated or verified by an independent investigator.

c. The conflict between the acknowledgment of the tentativeness of the financial statements and the requirement for objectivity in accounting arises from the accountant's problem of timing the recognition of events and of allocating their effects. The preparation of financial statements cannot be deferred indefinitely or until the consummation of certain events (such as determining the useful life of a depreciable asset and its salvage value at the end of its period of usefulness) because such statements on a completed basis would hardly be meaningful and would serve little purpose as guides or measures of progress to their readers. Therefore the accountant, recognizing that certain events extend over a number of accounting periods, is confronted with the task of determining the appropriate means of allocating the effect of these events over the periods.

The conflict can be resolved by recognizing that, in satisfying the need for financial statements for short periods of time, the accountant can measure the interim effect of a long-term event through the use of unbiased estimates. These estimates or forecasts would be determined from decisions arrived at by the application of the accountant's judgment, observation and experience. Since the postulate of objectivity implies that the financial information is subject to verification by another competent investigator, an estimate or forecast that can be substantiated by another accountant can be considered to be objective in context.

Answers to Examinations, November 1963

ACCOUNTING PRACTICE—PART I

November 6, 1963; 1:30 to 6:00 p.m.

Solution 1

1. E	6. A	11. C	16. D
2. E	7. A	12. A	17. B
3. B	8. D	13. B	18. C
4. B	9. C	14. C	19. C
5. A	10. B	15. A	20. B

Solution 2

Hillcrest Blood Bank

a. **STATEMENT OF TOTAL EXPENSE OF TAKING AND PROCESSING BLOOD**
For the Year Ended June 30, 1962

Laboratory expense:			
Serum			$ 3,098
Salaries			3,392
Supplies		$3,533	
Less: Increase in inventory	$65		
Decrease in payables	50	115	3,418
Laundry and miscellaneous			277
Total			10,185
Less sales of serum and supplies			2,260
Net laboratory expense			7,925
Other expenses and disbursements:			
Salaries			5,774
Dues and subscriptions			204
Rent and utilities			1,404
Blood testing			2,378
Payments to professional blood donors			2,410
Other expenses			1,805
Depreciation			350
Total expense of taking and processing blood			$22,250

b. 1. **COMPUTATION OF PINTS OF BLOOD SOLD**

		No. of Pints
Receipts from hospitals	$11,520	
Less opening accounts receivable	1,302	
	10,218	
Add ending accounts receivable	1,448	
Total sales on accrual basis	11,666	
Less handling charges for returned blood	402	
Sales of blood to hospitals during year	$11,264	
Pints of blood sold to hospitals ($11,264 ÷ 8)		1,408
Receipts from individuals	$ 6,675	
Add increase in accounts receivable	125	
Total sales to individuals on accrual basis	$ 6,800	
Pints of blood sold to individuals ($6,800 ÷ 25)		272
Pints of blood sold to other blood banks ($602 ÷ 14)		43
Total number of pints sold		1,723

2. **COMPUTATION OF PINTS OF BLOOD WITHDRAWN BY MEMBERS**

Pints of blood taken from donors		2,568
Less:		
Pints of blood sold	1,723	
Pints of blood discarded	343	2,066
Pints of blood withdrawn by members		502

c. **COMPUTATION OF THE EXPENSE PER PINT OF TAKING AND PROCESSING BLOOD THAT WAS USED**

$$\frac{\text{Total expense}}{\text{Total pints taken less outdated blood}} = \frac{\$22{,}250}{2{,}568 - 343} = \$10.00$$

Solution 3 **The Zuba Mfg. Company**

a. **COMPUTATION OF INSURED GROSS EARNINGS**
Based on the Year Ended December 31, 1962

Gross sales			$600,000
Less finished goods inventory, 1/1/62, at sales value ($10,000 ÷ 80%)			12,500
			587,500
Add finished goods inventory, 12/31/62, at sales value ($10,000 ÷ 80%)			12,500
Sales value of production			600,000
Less:			
Sales returns and allowances		$ 4,900	
Manufacturer sales representatives' commissions		28,600	
Bad debts		6,000	39,500
Net sales value of production			560,500
Less:			
Raw material inventory, 1/1/62		44,000	
Purchases		340,000	
Freight in		5,000	
Manufacturing supplies		8,000	
Total		397,000	
Raw material inventory, 12/31/62	$ 30,000		
Purchase discounts	6,500	36,500	360,500
Insured gross earnings			$200,000
Insurance in force	$125,000		
Insurance required (70% × $200,000)	$140,000		

Under operation of the 70% coinsurance clause, the insurance company's liability is limited to 125,000/140,000 of the loss.

The Zuba Mfg. Company

b. **COMPUTATION OF FIRE LOSS DUE TO LOST GROSS EARNINGS**
For the Three Months Ended March 31, 1963

Lost gross sales ($600,000 × 3/12)		$150,000
Reduction in gross earnings (200,000/600,000 × $150,000)		$ 50,000
Less noncontinuing expenses:*		
Rent ($12,000 × 3/12)	$3,000	
Depreciation ($24,000 × 80% × 3/12)	4,800	7,800
Fire loss due to lost gross earnings		$ 42,200

COMPUTATION OF FIRE LOSS TO BE ABSORBED BY THE ZUBA MFG. COMPANY

15,000/140,000 × $42,200 = $4,521.43

*Some of the factory heat, light and power will undoubtedly be reduced during a business operation. If it is assumed that the entire amount will be eliminated, then the fire loss due to lost gross earnings will be reduced to $36,175 and the fire loss to be absorbed by the Zuba Mfg. Company will be $3,875.89.

Solution 4 **The General Medical Institute**

STATEMENT ACCOUNTING FOR THE INCREASE IN CASH

For the Year Ended October 31, 1963

Cash provided by:			
Investment income			$16,500
Contributions			10,300
Sale of investments			50,000
Gain on sale of investments			18,600
Miscellaneous income			2,700
Cash provided			98,100
Cash applied to:			
Operations (patient revenues and related expenses):			
Net revenues from services rendered		$324,000	
Less:			
Increase in patient accounts receivable	$ 24,600		
Accounts written off	800	25,400	
Cash derived from revenues		298,600	
Expenses	323,200		
Add increase in prepaid expenses	600		
	323,800		
Less:			
Increase in accounts payable—current	1,600		
Noncash expenses:			
Loss on sale of equipment	2,000		
Depreciation—building and equipment	9,900		
Provision for uncollectible accounts	5,400		
	18,900		
Cash applied to expenses		304,900	
Cash applied to operations			6,300
Research activities:			
Expenses	23,300		
Less noncash expenses—depreciation	6,600	16,700	
Less research grants		10,000	
Cash applied to research activities			6,700
Construction in progress:			
Building		793,800	
Less accounts payable—construction	110,800		
Less accounts receivable applicable thereto	80,000		
Net accounts payable	30,800		
Grant from government	335,000		
Mortgage funds drawn down	365,000	730,800	
Cash applied to construction in progress			63,000
Equipment:			
Therapy equipment purchased		15,000	
Less proceeds from sale of replaced equipment		3,000	
Cash applied to purchase of equipment			12,000
Cash applied			88,000
Net increase in cash			$10,100

Solution 5

The Hartrey Contractors Corporation

1. ESTIMATED DIRECT COSTS OF CONTRACTS IN PROCESS

	Original Estimates					
	Material and Labor		*Subcontracts*			
Contract	*Billing Value*	*Cost (4/5 of Billing Value)*	*Billing Value*	*Cost (10/11 of Billing Value)*	*Costs Incurred in Excess of Original Estimate*	*Total Estimated Direct Costs*
A	$16,875	$13,500	$22,000	$20,000	$1,000	$34,500
B	20,000	16,000	33,000	30,000		46,000
C	23,000	18,400	16,500	15,000		33,400

2. PERCENTAGE OF COMPLETION OF CONTRACTS IN PROCESS

Contract	*Actual Costs to Date*	*Total Estimated Direct Costs (Schedule 1)*	*Percentage of Completion*
A	$13,800	$34,500	40%
B	32,200	46,000	70
C	16,700	33,400	50

3. REVENUE FROM CONTRACTS IN PROCESS

Contract	*Contract Price*	*Percentage of Completion (Schedule 2)*	*Billing Value*
A	$43,875	40%	$17,550
B	62,000	70	43,400
C	46,500	50	23,250
Revenue from contracts in process			$84,200

4. COMPUTATION OF FEDERAL INCOME TAX

PROVISION AND LIABILITY

	Completed Contract Basis (Per Books)	*Percentage of Completion Basis (Per adjusted trial balance)*
Construction revenue	$750,000	$834,200
Costs applicable to construction revenue	600,000	662,700
Supervision and other indirect costs	75,000	75,000
Selling and administrative expenses	42,000	42,000
Total	717,000	779,700
Taxable income	$ 33,000	$ 54,500
Federal income taxes @ 50%	$ 16,500	$ 27,250
Current tax liability		16,500
Deferred income taxes		$ 10,750

5. ADJUSTING JOURNAL ENTRIES

(1)

		Debit	Credit
Recognized revenue not yet billed		$13,200	
Progress billings		71,000	
Costs applicable to construction revenues		62,700	
Construction revenue			$84,200
Costs of contracts in process			62,700

To record the revenue and costs applicable to contracts in process at December 31, 1962 as determined by the percentage of completion method of accounting for long-term contracts.

Revenue from contracts in process	$84,200
Less progress billings	71,000
Recognized revenue not yet billed	$13,200

(2)

	Debit	Credit
Provision for income taxes	27,250	
Deferred income taxes		10,750
Income taxes payable		16,500

To record provision and liability for income taxes payable, and deferred income taxes.

ACCOUNTING PRACTICE—PART II

November 7, 1963; 1:30 to 6:00 p.m.

Solution 1

a. COMPUTATION OF THE JARMAN CORPORATION'S CONTRIBUTION TO THE PENSION PLAN

Contribution computed on net income for 1962 (10% of $73,250)		$7,325
Limitation on contribution (15% of $40,000)		$6,000
Salaries paid to eligible participants in 1962		
Bone	$17,900	
Cohan	14,100	
Kolman	8,000	
	$40,000	
The Jarman Corporation's 1962 contribution		$6,000

b. COMPUTATION OF THE VESTED INTERESTS OF PARTICIPANTS TERMINATING THEIR EMPLOYMENT DURING 1962

Dohler was the only participant terminating his employment during the year.

Equity at January 1, 1962	$850
Length of employment (1960 and 1961)	2 years
Percentage of vested interest (10% per year for 2 years)	20%
Amount of vested interest due to Dohler (20% of $850)	$170

c. ALLOCATION OF THE JARMAN CORPORATION'S 1962 CONTRIBUTION

Name	*Years of Employment*	*Employment Points*	*Salary*	*Salary Points*	*Total Points*	*Per Cent*	*Share of Contributions*
Bone	5	10	$17,900	179	189	45%	$2,700
Cohan	3	6	14,100	141	147	35	2,100
Kolman	2	4	8,000	80	84	20	1,200
		20	$40,000	400	420	100%	$6,000

d. ALLOCATION OF PLAN'S 1962 INCOME AND FORFEITURES

Name	*Equity*	*Per Cent*	*1962 Income*	*Forfeiture*	*Total*
Bone	$1,590	60%	$180	$408	$588
Cohan	1,060	40	120	272	392
	$2,650	100%	$300	$680	$980

COMPUTATION OF FORFEITURE

Dohler's equity at January 1, 1962	$850
Vested interest due to Dohler	170
Forfeiture	$680

Solution 2

Big Company and Subsidiary
WORKING PAPERS FOR CONSOLIDATED BALANCE SHEET
December 31, 1962

	Big Company	Little Company	Adjustments and Eliminations Debit	Adjustments and Eliminations Credit	Consolidated Balance Sheet
Cash	$ 36,400	$ 28,200			$ 64,600
Notes receivable	22,000	9,000		(2) $ 8,000	23,000
Accounts receivable	20,900	21,700		(2) 16,000	20,600
				(7) 6,000	
Accruals receivable	13,000	3,300	(4) $ 80	(4) 80	16,300
Inventories	81,200	49,600	(7) 6,000	(5) 2,500	133,100
				(7) 1,200	
Plant and equipment	83,200	43,500		(6) 2,000	124,700
Accumulated depreciation	(12,800)	(9,300)	(6) 100		(22,000)
Investment in Little Company	50,000			(1) 50,000	
Dividends receivable			(8) 4,500	(8) 4,500	
	$293,900	$146,000			$360,300
Notes payable	$ 4,000	$ 12,000	(2) 8,000	(3) 3,000	$ 11,000
Accounts payable	42,000	19,600	(2) 16,000	(7) 6,000	45,600
			(7) 6,000		
Dividends payable		4,500	(8) 4,500		
Accruals payable	2,600	2,100	(4) 80		4,620
Notes receivable discounted	8,100		(3) 3,000		5,100
Capital stock, $10 par value	120,000				120,000
Capital stock, $20 par value		60,000	(1) 60,000		
Capital in excess of par	28,500	20,000		(1) 10,000	58,500
Retained earnings	88,700	27,800	(5) 2,500	(6) 100	115,480
			(6) 2,000	(8) 4,500	
			(7) 1,200	(4) 80	
	$293,900	$146,000	$113,960	$113,960	$360,300

Big Company and Subsidiary
ADJUSTING AND ELIMINATION JOURNAL ENTRIES
(Not Required)

(1)

	Debit	Credit
Capital stock—Little Company	$60,000	
Investment in Little Company		$50,000
Capital in excess of par		10,000

To eliminate reciprocal elements in investment and equity accounts.

(2)

	Debit	Credit
Notes payable—Little Company	8,000	
Accounts payable—Little Company	16,000	
Notes receivable—Big Company		8,000
Accounts receivable—Big Company		16,000

To eliminate intercompany notes and accounts.

(3)

	Debit	Credit
Notes receivable discounted—Big Company	3,000	
Notes payable—Little Company		3,000

To record notes receivable discounted with bank as a primary liability of Little Company.

(4)

	Debit	Credit
Accruals receivable—Big Company	80	
Accruals payable—Little Company	80	
Retained earnings—Big Company		80
Accruals receivable—Big Company		80

To record interest receivable in Big Company's accounts and to eliminate intercompany receivable and payable.

(5)

	Debit	Credit
Retained earnings—Big Company	2,500	
Inventories—Little Company		2,500

To eliminate intercompany profit in Little Company's inventory.

Purchases from Big Company included in Little Company's inventory	$10,000
Big Company's cost computed on basis of gross profit rates ($30,000/$40,000 = 75%)	7,500
Intercompany profit in inventories	$ 2,500

(6)

	Debit	Credit
Retained earnings—Little Company	2,000	
Accumulated depreciation—Big Company	100	
Plant and equipment—Big Company		2,000
Retained earnings—Big Company		100

To eliminate intercompany profit and to adjust accumulated depreciation on equipment purchased by Big Company from Little Company.

	Equipment	*Depreciation*
Sales price	$17,000	$850
Cost	15,000	750
Excess	$ 2,000	$100

(7)

		Debit	Credit
Inventories—Big Company		6,000	
Accounts payable—Big Company		6,000	
Retained earnings—Little Company		1,200	
Accounts payable—Big Company			6,000
Accounts receivable—Little Company			6,000
Inventories—Big Company			1,200
To record shipment in transit in Big Company's accounts, to eliminate intercompany receivable and payable, and to eliminate intercompany profit in inventories.			
Sales price of shipment in transit	$6,000		
Little Company's cost of shipment	4,800		
Intercompany profit in inventory	$1,200		

(8)

	Debit	Credit
Dividends receivable—Big Company	4,500	
Dividends payable—Little Company	4,500	
Retained earnings—Big Company		4,500
Dividends receivable—Big Company		4,500
To record dividend receivable in Big Company's accounts and to eliminate intercompany receivable and payable.		

Solution 3

The Connau Corporation

a. **COMPUTATION OF TAXABLE INCOME**
For the Year Ended December 31, 1962

Net income per books		$79,600
Add unallowable deductions and additional income:		
Premium for insurance on life of Company president	$ 550	
Correction of Miscellaneous Expense:		
Penalty on federal income tax deficiency	800	
Federal excise tax on purchase of new car	400	
Payment to Community Chest (to reclassify; see contra)	750	
Provision for cash discount on accounts receivable	250	
Excess amount of loss recorded on sale of milling machine	2,400	
Total	5,150	
Contributions in excess of 5% limitation	2,105	7,255
Total		86,855
Deduct nontaxable income and additional deductions:		
Interest on State of Iowa bonds	200	
Refund of prior year's federal income taxes	625	
Overallowance on trade-in of car	100	
Payment to Community Chest (see contra)	750	
Depreciation on new car	725	
Dividends-received deduction (85% × $3,000)	2,550	4,950
Taxable income		$81,905

Computation of Excess Amount of Loss Recorded on Sale of Milling Machine

Adjusted basis	$5,600
Sales price	3,700
Loss on sale (Sec. 1231 asset)	1,900
Loss on sale recorded in ledger account	4,300
Excess amount of loss recorded	$2,400

Computation of Depreciation Allowable on New Car

Net price of new car	$3,650
Add adjusted basis of car traded-in	700
Basis for allowable depreciation	$4,350
Depreciation allowable (1/2 × 33-1/3% × $4,350)	$ 725

Computation of Contributions in Excess of Limitation

Net income per books		$79,600
Add:		
Contributions ($5,800 + $750)		6,550
Unallowable deductions and additional income		5,150
Total		91,300
Deduct nontaxable income and additional deductions	$4,950	
Less dividends-received deduction	2,550	2,400
Income basis for determining allowable contributions		$88,900
Contribution limitation (5% × $88,900)		$ 4,445
Contributions		6,550
Contributions in excess of limitation		$ 2,105

The Connau Corporation

b. 1. COMPUTATION OF TAXABLE INCOME SUBJECT TO TAX RATES APPLICABLE TO CAPITAL GAINS AND LOSSES
For the Year Ended December 31, 1962

Gain on sale of Acme Electronic stock ($7,000 − $3,000)	$4,000
Loss on sale of F. M. Motors stock ($19,000 − $16,080)	2,920
Net long-term capital gain reduced by long-term capital loss	$1,080

The Connau Corporation

b. 2. COMPUTATION OF TAXABLE INCOME SUBJECT TO NORMAL TAX AND SURTAX
For the Year Ended December 31, 1962

Taxable income	$81,905
Less net long-term capital gain	1,080
Taxable income subject to normal tax and surtax	$80,825

Solution 4

The Marcia Company

a. **CONTRIBUTION TO PROFIT BY A UNIT OF EACH PRODUCT**

Item	Sales Price	Variable Costs				Contribution to Profit
		Material	Labor	Overhead	Total	
Laurie	$5.20	$1.40	$ .80	$ .40	$2.60	$2.60
Debbie	2.40	.70	.50	.25	1.45	.95
Sarah	8.50	2.69	1.40	.70	4.79	3.71
Kathy	4.00	1.00	1.00	.50	2.50	1.50
Sewing kit						
Regular	3.00	.60	.40	.20	1.20	1.80
Reduced	2.55	.60	.40	.20	1.20	1.35

b. **CONTRIBUTION TO PROFIT PER LABOR DOLLAR EXPENDED ON EACH PRODUCT**

Item	Profit Contribution Per Unit	Labor Cost Per Unit	Profit Contribution Per Labor Dollar
Laurie	$2.60	$ .80	$3.25
Debbie	.95	.50	1.90
Sarah	3.71	1.40	2.65
Kathy	1.50	1.00	1.50
Sewing kit			
Regular	1.80	.40	4.50
Reduced	1.35	.40	3.38

c. **TOTAL HOURS REQUIRED TO PRODUCE ESTIMATED SALES UNITS**

Item	Estimated Unit Sales	Labor Hours Per Unit	Total Labor Hours
Laurie	50,000	80/200	20,000
Debbie	42,000	50/200	10,500
Sarah	35,000	140/200	24,500
Kathy	40,000	100/200	20,000
Sewing kit	325,000	40/200	65,000
Total hours required			140,000
Effective productive capacity			130,000
Hours required in excess of effective productive capacity			10,000

Since the Kathy doll produces the lowest profit contribution per labor hour, it should be recommended that its production be reduced by 20,000 units (10,000 ÷ 100/200).

d.

The possible methods of providing the estimated missing productive capacity of 12,000 labor hours or 24,000 Kathy dolls include the following:

1. The Company may resort to employing its labor on an overtime basis.

During the overtime periods, a premium of 50% of the base labor rate would be paid. Assuming that the variable costs are related directly to the labor costs, the cost of producting a Kathy doll on an overtime basis would be

Material	$1.00
Labor	1.50
Variable Overhead	.75
Total	$3.25

The selling price of $4.00 per doll results in a contribution to profit of $.75. Also to be considered is whether fixed costs and the rate for the application of the variable overhead will change as a result of the extended use of personnel and facilities. In addition, the effect of the overtime on labor efficiency would be determined.

2. The production of the 24,000 Kathy dolls needed to fill the estimated sales figures may be contracted out to another manufacturer. In this case the main factor would be the contract price per doll. If the contract price did not exceed the difference between the $4.00 selling price and the added handling costs, a contribution would be made to total profit.

3. The Company may expand facilities and equipment to attain the increased output of 12,000 hours. Here the factors to be weighed include the cost of the expansion, the expectations as to sales volume in subsequent years, and the cost of training additional personnel.

4. The Company may give thought to installing a second shift. This move does not appear to be a feasible alternative because the needed output represents a minor amount of the total productive capacity.

Solution 5

Town of Ridgedale
WORKING PAPERS
Year Ended June 30, 1963

Debits	*Balance Sheet 6/30/62*		*1963 Transactions Debit*		*1963 Transactions Credit*	*Estimated Revenues*	*Actual Revenues*	*Encumbrances and Expenditures*	*Appropriations and Other Authorizations*	*Balance Sheet 6/30/63*
Cash	$180,000	(4)	$ 955,000	(5)	$ 880,000					$255,000
Taxes receivable	20,000	(2)	809,000	(3)	6,000					48,000
				(4)	775,000					
Estimated revenues		(1)	1,000,000			$1,000,000				
Encumbrances		(10)	47,000					$ 47,000		
Expenditures		(8)	785,000					895,000		
		(9)	110,000							
Expenditures chargeable to the reserve for encumbrances		(6)	37,000					37,000		
	$200,000									$303,000
Credits										
Allowance for uncollected taxes	$ 4,000	(3)	6,000	(2)	9,000					$ 7,000
Vouchers payable	44,000	(5)	880,000	(6)	37,000					53,000
				(7)	67,000					
				(8)	785,000					
Due to Working Capital Fund	2,000	(7)	7,000	(9)	10,000					5,000
Due to Sinking Fund	10,000	(7)	60,000	(9)	100,000					50,000
Reserve for encumbrances	40,000			(10)	47,000				$ 40,000	47,000
Unappropriated surplus	100,000			(1)	35,000					135,000
Appropriations				(1)	965,000				965,000	
Revenues—taxes				(2)	800,000		$ 800,000			
Revenues—other				(4)	180,000		180,000			
Balance to surplus							20,000	26,000		6,000
	$200,000		$4,696,000		$4,696,000	$1,000,000	$1,000,000	$1,005,000	$1,005,000	$303,000

JOURNAL ENTRIES
(Not Required)

(1)		
Estimated revenues	$1,000,000	
Appropriations		$965,000
Unappropriated surplus		35,000
To record the adoption of the budget for the year.		
(2)		
Taxes receivable	809,000	
Revenues—taxes		800,000
Allowance for uncollectible taxes		9,000
To record the tax levy for the year.		
(3)		
Allowance for uncollectible taxes	6,000	
Taxes receivable		6,000
To record write-off of uncollectible taxes.		
(4)		
Cash	955,000	
Taxes receivable		775,000
Revenues—other		180,000
To record cash collections during the year.		
(5)		
Vouchers payable	880,000	
Cash		880,000
To record cash payments during the year.		
(6)		
Expenditures chargeable to the reserve for encumbrances	37,000	
Vouchers payable		37,000
To record expenditure for encumbrance of prior year.		
(7)		
Due to Working Capital Fund	7,000	
Due to Sinking Fund	60,000	
Vouchers payable		67,000
To record vouchers for payment to the respective funds shown.		
(8)		
Expenditures	785,000	
Vouchers payable		785,000
To record vouchers for payment of current operations.		
(9)		
Expenditures	110,000	
Due to Working Capital Fund		10,000
Due to Sinking Fund		100,000
To record liability for amounts due the respective funds.		
(10)		
Encumbrances	47,000	
Reserve for encumbrances		47,000
To record encumbrances at the end of the year.		

Solution 6

McLean Processing Company

COMPARATIVE STATEMENT OF MANUFACTURING COSTS AND GROSS PROFIT

For the Month Ended July 31, 1963

	Actual		*Estimated*	
	Gallons	*Amount*	*Gallons*	*Amount*
Sales ($4.60 per gallon)	10,080	$46,368	8,820	$40,572
Cost of goods processed and sold:				
Raw material	14,000	15,000	14,000	15,000
Tin cans ($.60 each)	10,080	6,048	8,820	5,292
Processing Department costs:				
Mixing ($.40 per gallon)	14,000	5,600	14,000	5,600
Cooking ($.50 per gallon)	14,000	7,000	14,000	7,000
Cooling ($.30 per gallon)	12,600	3,780	12,600	3,780
Packing ($.10 per gallon)	10,080	1,008	8,820	882
Total		38,436		37,554
Deduct net realizable value of by-product at point of separation	2,520	5,040	3,402	7,261
Cost of goods sold		33,396		30,293
Gross profit		$12,972		$10,279

Computation of Raw Material Cost

Material FE — 10,000 gallons @ $.90 per gallon	$ 9,000
Material QT — 4,000 gallons @ $1.50 per gallon	6,000
Total raw material cost	$15,000

Schedule of Net Realizable Values Assigned to By-Product

	Groex		*Fasgro*	
	Gallons	*Amount*	*Gallons*	*Amount*
Sales ($2.00 and $5.00 per gallon)	2,520	$5,040	3,402	$17,010
Less additional costs incurred:				
Material SK ($1.10 per gallon)			1,890	2,079
Processing costs—variable ($1.00 per gallon)			5,670	5,670
Processing costs—fixed				2,000
Total				9,749
Net realizable value at point of separation		$5,040		$ 7,261

Computation of Gallons of Production

	By-Product Produced	
	Groex	*Fasgro*
Principal product, Supergro:		
Placed into production—		
Material FE	10,000	10,000
Material QT	4,000	4,000
Total in mixing and cooking	14,000	14,000
Less 10% loss in Cooking Department	1,400	1,400
Transferred to Cooling Department	12,600	12,600
Less residue retained—20% and 30%	2,520	3,780
Canned and sold	10,080	8,820
By-products:		
Retained residue	2,520	3,780
Material SK added		1,890
Total processed in Boiling Department		5,670
Less 40% loss		2,268
Sold as by-product	2,520	3,402

AUDITING

November 7, 1963; 8:30 a.m. to 12:00 m.

Answer 1

a. In addition to examining the fire insurance policies for the amounts of insurance and premium, for effective and expiration dates, and for verification of the insurance register, the auditor should also examine the policies and endorsements for the following details:

1. Are the original policies on hand? The absence of the original policies is an indication that another party has an insurable interest in the assets as a creditor.
2. Is the client listed as a beneficiary? If the client is not a beneficiary, a question is raised as to who is the legal owner of the assets.
3. Does the policy have a mortgage clause or a loss-payable endorsement? If so, it is an indication of pledging or mortgaging of the assets.
4. Are the insurers stock companies or mutual companies? If the insurance carrier is a mutual company, the premium is a deposit and will probably be adjusted. In rare cases a mutual company operating at a loss may make an additional assessment against its policy holders.
5. Do the terms of the policies and subsequent endorsements indicate the receipt of premium refunds by reason of a good experience rating or changes in the amount of coverage? Such miscellaneous cash receipts should be traced to the cash records to verify their deposit to the company's account.
6. What is the location of the assets or inventories being insured? This examination can be used as a check that all assets are recorded and, conversely, that all assets are covered by insurance.
7. Do policy endorsements indicate changes in the amount of insurance? Such changes might indicate unrecorded acquisitions or retirements of assets.
8. Do the policies have coinsurance clauses and what are the rates of coinsurance? This information is necessary in determining the adequacy of insurance coverage.
9. Do the policies include extended coverage? If extended coverage is not included in the policies or in separate policies, management should be advised of this lack.
10. Were the policies issued by an agent or by a broker? Since a broker is the agent of only the insured, policies he issues must be accepted by the insuring company.

11. Are the policies of the reporting-type? The reasons for examining for reporting provisions are to ascertain their effect on prepaid insurance or accrued expenses and also to ascertain that proper reports have been made on the required dates so that the inventories are appropriately covered pursuant to the terms of the policies.

b. 1. The adequacy of the insurance coverage is generally not mentioned in the CPA's short-form report unless the inadequacy is in default of a contractual agreement relating to a capitalization, loan, or credit arrangement. Indeed, many firms have adopted so-called self-insurance and thus have little or no coverage by insurance companies. The CPA's review of insurance coverage is performed as an advisory service and is not intended to relieve management of its direct responsibility for safeguarding the company's assets. Such coverage review is a corollary arising from the verification of expenditures for insurance, and gross underinsurance would probably be brought to management's attention by a letter.

   The possibility of fire loss does not require disclosure in the CPA's report. The contingent fire loss is in the nature of a general risk contingency which might arise in the future from natural or human events over which there is little control and which is generally protected against by insurance. On the other hand, contingent liabilities, which do require disclosure if the amount is material, arise from past circumstances, actions or transactions resulting in an unalterable position that might impose a future liability contingent upon the occurrence of a related future event or action at law. Therefore, inasmuch as a contingent fire loss falls into the classification of a contingent loss from a catastrophe that is ordinarily (but not necessarily) insured against, disclosure of inadequate insurance coverage is not required in the financial statements.

   2. Management's refusal to increase the fire insurance coverage to an amount that the auditor considers necessary, in the absence of a contractual violation, should have no effect upon the auditor's opinion on the financial statements. Such refusal is a managerial decision based upon consideration of the general risks of doing business and is not subject to the auditor's opinion.

Answer 2

a. A CPA may express an unqualified opinion that his client's financial statements present fairly the client's financial position and results of operations when he is satisfied, on the basis of an examination made in accordance with generally accepted auditing standards, that the statements are in conformity with generally accepted accounting principles applied on a consistent basis and include all informative disclosures necessary to make the statements not misleading.

b. 1. The CPA expresses a qualified opinion when he must take exception to the presentation of one or more components of the financial statements but the exception or exceptions are not serious enough to negative his expression of opinion.

The reasons for exceptions and the resulting qualified opinion include limitation in the scope of the examination and the CPA's inability to satisfy himself by alternative procedures, lack of sufficient information to satisfy the CPA, failure of the financial statements to conform with generally accepted accounting principles, inadequate disclosures in the statements, and inconsistency in the application of accounting principles.

Proper presentation of a qualified report requires that the opinion paragraph clearly state the nature of the qualification, the reasons for the qualification, and, if ascertainable, its effect upon the financial statements.

2. An adverse opinion is defined as an opinion that the financial statements do not present fairly the financial position or the results of operations in conformity with generally accepted accounting principles.

   The CPA is required to render such an adverse opinion in his report when, in his judgment, a qualified opinion is not justified because of the materiality of the exceptions as to fair presentation. It is not proper to disclaim an opinion under these circumstances because the auditor has information that led him to arrive at an adverse opinion.

   The CPA should disclose all his reasons for rendering an adverse opinion. Such disclosure should be made by referring to a middle paragraph in the short-form report setting forth the circumstances.

3. A disclaimer of opinion is made by a CPA when he states in his report that he cannot express an opinion on the financial statements because he has insufficient competent information to form an over-all opinion on the fairness of the presentation of the financial statements. The CPA may be forced to disclaim an opinion because of a serious limitation of the scope of his examination or because of unusual uncertainties concerning the amount, or outcome, of an item or matter having a material effect upon the financial statements.

   In rendering a disclaimer of opinion the CPA should state all his reasons for doing so. If the CPA issues a disclaimer of opinion because of the inadequacy of the scope of his examination, it is also incumbent upon him to disclose any reservations or exceptions he may have regarding fair presentation. Furthermore, where the scope of his examination has been limited significantly, he may want to set forth the procedures he applied (or omitted) for the information of the reader of the report.

c. A piecemeal opinion may be issued by a CPA when, in his judgment, the scope of his examination and his findings justify it. The CPA may find from his examination that he must either express an adverse opinion or disclaim an opinion on the over-all financial statements, yet he may be satisfied that certain items in the financial statements are fairly presented. Under these circumstances he may decide to issue a piecemeal opinion. The CPA is aware that if he is to render a piecemeal opinion on individual items he may be required to extend his procedures beyond those required if he were expressing an opinion on the over-all financial statements. Such extension of procedures may be necessary because he cannot rely upon the interrelationship of the accounts and because the factors leading to his adverse opinion or disclaimer of opinion may arouse

unusual uncertainty about the reliability of the records supporting other items in the financial statements.

The piecemeal opinion may name the accounts with which the CPA is satisfied, or conversely, may name those accounts with which he is dissatisfied. The CPA must keep in mind the interrelationship of the accounts and avoid an opinion on an account that bears upon another account on which no opinion is rendered. For example, the CPA cannot give a piecemeal opinion on the cost of sales if he is unable to give a piecemeal opinion on the ending inventory.

Inasmuch as the piecemeal opinion arises in instances where the CPA has satisfied himself with regard to individual items but not as to the over-all financial statements, piecemeal opinions cannot be issued in conjunction with unqualified or qualified opinions which indicate that the CPA is generally satisfied with the over-all fairness of the financial statements' presentation. Piecemeal opinions are properly issued in connection with adverse opinions or disclaimers of opinions because the CPA may be able to attest to certain items but not to the over-all financial statements. In the latter case the piecemeal opinion should be carefully worded so that it will not appear to contradict or overshadow the over-all adverse opinion or disclaimer of opinion or create other misleading inferences on the financial statements as a whole.

Answer 3

Solicitations of funds are difficult to control and it is probable that the possibility will always exist for solicitors to misappropriate contributions. The following procedures will improve the controls of contributions collected by solicitors:

1. The receipts and stubs should be prenumbered and filled out in ink by the solicitors. Consideration may be given to adopting prenumbered receipts with provision for carbon copies. A complete accounting should be made for all stubs (or carbon copies) and the cash turned in by the solicitors should be reconciled with the amounts on the stubs (or carbon copies). The use of checks, made payable to United Charities, should be encouraged.
2. An official receipt should be prepared in the organization's office for each stub turned in by the workers, and it should be mailed to the donor. The receipt left with the donor by the worker would be an acknowledgment of the amount of the donation. Because it brings the donor into the control system, this procedure would probably disclose the cases of the worker issuing a receipt for the correct amount and writing a lesser amount on the stub.
3. Workers should be assigned specific geographic areas or professional groups, such as lawyers, doctors, etc., for their solicitation work. Lists of donors and their contributions should be compiled by areas or groups; the lists would be useful for campaigns in subsequent years. In addition, shifting the workers so that a worker does not solicit the same area in successive years would permit a comparison of listings for successive years that would disclose any missing donors or deviations in the amounts of their gifts.

4. Follow-up letters or requests for donations should be sent to persons who did not contribute. These letters, in effect, would serve as confirmation that no contribution had been made.
5. At the end of the campaign period the organization might publish a complete list of all donors. If there is objection to showing the amount of each donor's contribution by his name, perhaps the donors could be grouped by the size of their contribution, for example, a grouping of donors giving from $25 to $50. Omission of a name from the list or a difference in grouping could be investigated.
6. Before they are appointed to the staff the workers should be investigated to determine that there is nothing in their background that would raise a question about their character. Consideration should be given to covering the workers by a fidelity bond and to issuing identification badges to them.

Answer 4

a. The following general elements or basic characteristics would be included in a satisfactory system of internal control:
   1. A plan of organization should exist to establish proper functional divisions of the company's activities. The organization of the activities into independent departments prevents operational and custodial departments from controlling the accounting records relating to their operations. It follows that the accounting department should not have operational or custodial functions. Such separation makes difficult the manipulation of accounting records to cover abstractions of assets and avoids misrepresentations of the results of activities. Included in the establishment of independent departments might be an internal audit staff reporting directly to management that would serve as a check on the accuracy of the accounting data, the safeguarding of assets, and adherence to policies prescribed by management.

      When independent departments are created, they must be assigned responsibility for their efficient operation in accordance with prescribed policies. If this responsibility is to be effective, appropriate authority must also be delegated. Both responsibility and authority should be clearly defined and set forth in organizational charts and operating manuals.
   2. A system of authorization and record procedures should be devised to provide accounting control over assets, liabilities, revenues and expenses. The system usually includes a chart of accounts and an accounting manual to facilitate the classification of data within a formal structure of accounts. The proper records control of operations and transactions is obtained by designing forms and records and arranging the flow of record-keeping and approval procedures among departments. These matters might be set forth in a procedures manual.

      The procedures may include material and production controls, cost systems, budgets, and periodic summaries or reports.
   3. To a considerable extent the effectiveness of the system of internal control will be determined by the soundness of the practices followed in the per-

formance of the duties and functions of each department. An important practice is the division of duties or responsibilities so that no single individual or group has exclusive control over any one transaction or group of transactions. Such division of duties would afford an internal check on the accuracy of the work.

Other sound practices would be determined by the circumstances existing in the department. For example, sound practices would include such procedures as checking the amount and quality of incoming materials and obtaining competitive quotations of prices of items to be purchased.

The maintenance of a smoothly functioning organization and of interdepartmental co-operation is important. Management should be alert for and eliminate interdepartmental frictions arising from interpretations of authority and clashes of personalities.

4. The personnel of the company should be of adequate capacity to carry out efficiently and economically the prescribed procedures of the positions they occupy. The positions should be carefully analyzed and the qualifications required of the occupants established.

   Before an individual is employed he should be carefully interviewed; his personality, character, and ability appraised; and his references investigated. A program of employee training is helpful in indoctrinating the new employee in the company's organization and for preparing employees for advancement.

   The work of the employee should be subjected to review to insure good performance. The form of the review depends upon the position. For minor positions the work may be examined by supervisors, or the review may be obtained by the separation of duties so that the work of two or more employees is complementary. For responsible or supervisory positions the review might be in the form of reports accounting for the results of the operations for which the supervisor is responsible.

b. The CPA reviews his client's system of internal control for the following purposes:
   1. To inform himself of the client's policies and their relationship to his examination.
   2. To evaluate the over-all reliability of the financial statements and accounting records.
   3. To determine the degree of reliance that can be placed upon the accounting evidence insofar as genuineness is concerned and, on the basis of these findings, to determine the qualitative scope of his examination. A greater variety of accounting evidence or evidence from a source external to the company would be required under a poor system of internal control than if the control is good.
   4. To ascertain the accuracy of accounting evidence and, on the basis of these findings, to determine the quantitative scope of his examination.
   5. To decide which accounts or other matters are questionable and will require more intensive examination.
   6. To identify areas or circumstances affording opportunities for fraudulent acts.

7. To obtain additional accounting evidence leading to the formulation of his opinion.
8. To decide whether certain auditing procedures might be applied at an interim date or at year end.
9. To develop a knowledge of the company's procedures that will enable him to render a report to management on the adequacy of the internal control system. This knowledge would be the basis for rendering additional services to management such as the installation or revision of accounting procedures and systems.

Answer 5

a. An inventory certificate is obtained by the CPA for the following reasons:
   1. The inventory certificate emphasizes that the client has the primary responsibility for the accuracy of the financial statements.
   2. It is part of the evidence that the CPA has complied with the auditing standard of field work that sufficient competent evidential matter be obtained through inspection, observation, inquiries and confirmation.
   3. It serves as evidence substantiating the accuracy of the inventory.
   4. The inventory certificate aids in preventing misunderstandings between the client and the auditor by reducing to writing the nature and meaning of the information exchanged. The client is also reminded again that all appropriate information should be disclosed to the auditor.
   5. It may provide information that might not otherwise come to the attention of the auditor, for example, obsolete merchandise, consigned goods, pledged goods, and loss in market values.

b. The following information or statements may be included in an inventory certificate:
   1. A summary of the dollar amount of inventories by classes (work-in-process, etc.) and the related statement that all inventories owned are included in the summary and that inventories not owned are excluded.
   2. A statement that none or a specified part of the inventories has been hypothecated.
   3. A statement that the inventories were physically counted or, for those items not counted, a description of the method used in determining the quantities. If the inventories were not counted at year end, the date of the physical inventory taking and the method of computing the amounts at year end would be given.
   4. Statements that there were proper cut-offs of purchases and sales.
   5. Statements as to the basis of valuing the inventory (lower of cost or market, etc.), the method of determining cost (FIFO, etc.), and that the basis of pricing was consistent with prior years.
   6. A statement that the inventories are in good and salable condition.
   7. Statements that there are no purchase commitments in excess of current market price, no sales commitments below inventory prices, and no pur-

chase or sales commitments in excess of normal operations. Included would be a comment regarding the effect of any post-balance-sheet-date events, such as market declines, on the inventory valuation.

c. The following individuals should sign the inventory certificate:
   1. The person supervising the taking of the physical inventory should sign the certificate to affirm the correctness of the inventory quantities.
   2. The chief accounting officer (controller, chief accountant, etc.) should sign to attest to the trustworthiness of the inventory valuation, pricing, and related accounting records.
   3. The president or other principal executive should sign for over-all representation and for other matters about which he would be expected to be knowledgeable, such as pledged inventories, company policies or external matters affecting the inventory, and other significant matters.

d. If the client refuses to sign an inventory certificate, the matter should be discussed with him to determine the reason for his refusal. Should the CPA be successful subsequently in his effort to obtain an inventory certificate, the information obtained in his discussion with the client may be reason for a more intensive investigation into the matters that were troubling the client.

   If the client persists in his refusal to sign an inventory certificate and if inventories are a sufficiently material item in the financial statements, the CPA would be compelled to issue a disclaimer on the over-all financial statements. Since the representation includes commitments and other items which normal auditing procedures might fail to disclose, it is difficult for the auditor to conclude that there are not any material amounts involved. In some instances the CPA may be able, on the basis of his examination, to attest to the fairness of the presentation of certain other items in the financial statements.

Answer 6

Part a. 1. Before accepting an engagement from a new client, the CPA should make discreet inquiries to determine that the engagement will not result in criticism of his ethical conduct. He should ascertain that the prospective client is reputable, responsible and engaged in a legitimate business so that the association will not impair the CPA's professional reputation.

The CPA should attempt to find out how the prospective client learned of him so that he can appraise the reasons for his being selected. He is also interested in ascertaining whether the prospective client is "shopping" for CPA services at lowest price.

The CPA would also want to know if the new client has been served by other CPAs and the reasons for the change. Permission of the client would be requested to discuss the situation with the former CPAs. If the permission is refused, it may be suspected that the prospective client expected the former CPAs to do something ethically improper or that the client is not financially responsible.

2. Even though the prospective client has been the client of another CPA it

is ethically proper to discuss the possibility of becoming the client's CPA on the grounds that service may be rendered to those who request it. The prospective CPA would want to ask for the client's permission to communicate with the former CPA. In any event, the discussion of the possibility of rendering service should not be initiated by the CPA because he would be subject to the criticism that he was soliciting business.

Part b. 1. Before undertaking any revision of the report the CPA should, with the client's approval, discuss the matter with the bank president. Credit grantors are usually concerned more with the debtor's reputation, past earnings, and future earning power, and with eliminating the possibility of watered capital, than they are in encouraging the recording of fixed asset appraisal values in excess of cost. A discussion with the bank president along these lines may result in a change of his attitude.

If the CPA is unable to persuade the bank president to change his mind, the discussion should be directed towards a method of revising the report so that the appraisal values are disclosed without a substantive change in the financial statements. The report may be acceptable (and the CPA's opinion would be unchanged) if the appraisal values were disclosed by a supplementary method that would not distort the financial statements, such as by footnote or parenthetically in the balance sheet. If the appraisal values are disclosed in any form in his report, the CPA would have to satisfy himself as to their reasonableness. If neither of these methods of supplemental disclosure fills the bank president's needs, the client may take it upon himself to submit the required information in a letter or by supplementary financial statements that include the assets at appraisal values, as well as the appraisal capital, and are prepared on the Company's letterhead or on plain paper. If the appraisal values are disclosed in any form in his report, the CPA would have to satisfy himself as to their reasonableness.

If supplemental disclosure of the appraisal values fails to satisfy the bank president and he continues to insist upon financial statements prepared on the same basis as the prior years' unaudited statements, then the CPA may consider it desirable to revise his report so that the fixed assets under question are stated at appraisal values and the appraisal capital account presented. In this situation, however, the CPA would render either a qualified opinion or an adverse opinion.

If the upward departure from cost can be measured and disclosed, as seems likely in this case, the CPA would describe the departure from generally accepted principles of accounting in a paragraph immediately preceding his opinion. In his opinion he would refer to the preceding paragraph for a full description of the reasons for his rendering a qualified opinion or an adverse opinion. The CPA's opinion would be adverse if he judged that the exception to the fairness of presentation was so material that a qualified opinion was not justified.

2. As mentioned above, it may be proper for the client to submit additional financial statements that report the fixed assets at appraisal values to supplement the CPA's report with the expectation that these statements would be informative and that the report would remain unchanged. Such statements should be on the client's letterhead or on plain paper and should not be bound with the CPA's report. Preferably they should be accompanied by an explanatory letter from the client's president.

3. It would be improper, in this case, for the CPA to prepare and to label these statements "prepared without audit" because an audit had been performed. The CPA cannot deny having performed an audit nor can he overlook his audit findings.

Answer 7

(1)

Buildings	$2,000	
Machinery and equipment		$2,000
To correct the recording of the cost of constructing the small storage building.		

(2)

Due from officers	600	
Machinery and equipment		600
To correct the recording of the cost of the power lawnmower purchased for the personal use of the president.		

(3)

Allowance for depreciation	180	
Gain or loss on retirement of machinery and equipment	420	
Machinery and equipment		600
To record retirement of damaged lift truck battery.		

(4)

Prepaid equipment rental expense	150	
Equipment rental expense	210	
Gain or loss on retirement of machinery and equipment		40
Machinery and equipment		320
To remove equipment rental expense and prepayment from machinery and equipment account.		

(5)

Machinery and equipment	150	
Allowance for depreciation	1,500	
Gain or loss on retirement of machinery and equipment		150
Machinery and equipment		1,500
To record retirement of Rockwood saw and gain on sale.		

(6)

Machinery and equipment held for sale	1,800	
Allowance for depreciation	2,500	
Gain or loss on retirement of machinery and equipment	700	
Machinery and equipment		5,000
To record retirement of casting machine and writedown to its market value.		

(7)

Machinery and equipment	900	
Equipment rental		900
To reclassify monthly payments on lease-purchase agreement on electric spot welder.		

(8)

Machinery and equipment	6,964	
Interest expense	36	
Notes payable		7,000

To record full cost of baking oven purchased on installment payment plan and interest charges paid in December.

(9)

Allowance for depreciation—machinery and equipment	195	
Depreciation expense—machinery and equipment		195

To correct recording of depreciation.

Recorded by Company	$2,800
Correct depreciation	2,605
Correction	$ 195

(10)

Federal income tax payable	1,337	
Deferred income—investment credit		1,337

To record the investment credit on machinery and equipment acquisitions.

Calculation of Investment Credit

Burnham grinder	$ 1,200
Air compressor	2,500
Electric spot welder	5,400
Baking oven	10,000
Total	$19,100
Investment credit @ 7%	$ 1,337

(11)

Deferred income—investment credit	67	
Income from investment credit		67

To record amortization of deferred income for the first six months of the life of 1962 machinery and equipment acquisitions (½ × 10% × $1,337).

The Smoky Mountain Mfg. Co.

MACHINERY AND EQUIPMENT ACQUISITIONS
December 31, 1962

(Schedule not required)

Burnham grinder	$ 1,200
Air compressor	2,500
Electric spot welder	5,400
Baking oven	10,000
Total	$19,100

MACHINERY AND EQUIPMENT

(Schedule not required)

	Balance 12/31/61	*1962 Retirements*	*1962 Additions*	*Balance 12/31/62*
1948-51	$ 5,900	$1,500 (5)	—	$ 4,400
1952	400	—	—	400
1953	—	—	—	—
1954	—	—	—	—
1955	3,900	—	—	3,900
1956	—	—	—	—
1957	5,300	5,000 (6)	—	300
1958	—	—	—	—
1959	4,200	600 (3)	—	3,600
1960	—	—	—	—
1961	5,700	—	—	5,700
1962	—	—	$19,100	19,100
	$25,400	$7,100	$19,100	$37,400

ACCUMULATED DEPRECIATION

(Schedule not required)

	Balance 12/31/61	*1962 Retirements*	*1962 Provision*	*Balance 12/31/62*
1948-51	$ 5,900	$1,500 (5)	—	$ 4,400
1952	380	—	$ 20	400
1953	—	—	—	—
1954	—	—	—	—
1955	2,535	—	390	2,925
1956	—	—	—	—
1957	2,385	2,500 (6)	280	165
1958	—	—	—	—
1959	1,050	180 (3)	390	1,260
1960	—	—	—	—
1961	285	—	570	855
1962	—	—	955	955
	$12,535	$4,180	$2,605	$10,960

COMMERCIAL LAW

November 8, 1963; 8:30 a.m. to 12 m.

Answer 1

1. True	9. True	17. True	25. True	33. True
2. False	10. False	18. False	26. True	34. False
3. False	11. True	19. True	27. False	35. True
4. True	12. False	20. False	28. False	36. False
5. True	13. True	21. True	29. True	37. False
6. True	14. True	22. False	30. True	38. False
7. False	15. True	23. True	31. False	39. True
8. True	16. True	24. True	32. True	40. True

Answer 2

41. True	56. True	71. True	86. True	101. True
42. True	57. False	72. True	87. False	102. False
43. False	58. False	73. False	88. False	103. False
44. False	59. True	74. False	89. True	104. False
45. False	60. True	75. False	90. False	105. True
46. True	61. True	76. True	91. True	106. True
47. False	62. False	77. False	92. False	107. False
48. True	63. False	78. True	93. True	108. True
49. False	64. True	79. False	94. True	109. True
50. False	65. True	80. True	95. True	110. True
51. True	66. False	81. False	96. True	111. False
52. True	67. True	82. False	97. False	112. False
53. False	68. True	83. False	98. True	113. True
54. True	69. True	84. True	99. True	114. True
55. True	70. False	85. False	100. False	115. True

Answer 3

116. True	131. True	146. True	161. True	176. False
117. True	132. True	147. True	162. False	177. True
118. False	133. False	148. True	163. True	178. True
119. True	134. True	149. True	164. False	179. True
120. False	135. True	150. True	165. True	180. True
121. True	136. False	151. True	166. True	181. False
122. False	137. True	152. True	167. False	182. True
123. False	138. True	153. True	168. False	183. False
124. True	139. True	154. True	169. True	184. False
125. False	140. True	155. True	170. False	185. True
126. True	141. True	156. True	171. True	186. False
127. True	142. True	157. True	172. False	187. False
128. True	143. True	158. True	173. True	188. True
129. True	144. True	159. True	174. True	189. True
130. True	145. True	160. True	175. False	190. True

Answer 4

Part a. No. The arrangement in this case constitutes an illegal partnership which in turn is an illegal contract, and the courts will leave the parties where it finds them, i.e., grant no relief and not lend the aid of its process to either party.

Part b. The Uniform Partnership Act defines dissolution as "the change in relation of the partners caused by any partner ceasing tc be associated in the carrying on, as distinguished from the winding up, of the business."

Other than by acts of the parties, dissolution occurs

1. Upon death of a partner.
2. Upon bankruptcy of a partner or of the partnership.
3. When the partnership enterprise becomes illegal or participation by a partner becomes illegal.
4. When, upon outbreak of war, partners are enemy aliens.
5. Upon the granting of a judicial decree of dissolution. The decree is based on an application by one or more partners and may be granted when
   (a) A partner is of unsound mind.
   (b) A partner is incapacitated.
   (c) There is serious misconduct on the part of a partner.
   (d) The business is a failure.
   (e) Equity among the partners requires it.

Part c. 1. The vested rights of the partners are not extinguished by dissolving the firm. Moreover, the existing firm liabilities remain and the individual partners may be held personally responsible for any firm liabilities not satisfied by firm assets.

2. The dissolution affects the authority of the partners. From the moment of dissolution the partners are shorn of all authority to act on behalf of

the firm, except so far as may be necessary to wind up partnership affairs or to complete transactions begun but not finished.

3. When dissolution is caused by the agreement of the partners, notice must be given to third persons. Actual notice must be given to persons who have dealt with the firm. A publication of the fact of dissolution is sufficient for persons who know of the partnership but have had no dealing with the firm. Notice is not necessary to persons who had no knowledge of the firm or dealings with it prior to its dissolution.

Answer 5

a. Yes. The facts indicate that there has been a unilateral mistake on the part of M Corporation. A mistake by only one party that forms the basis on which he enters into a transaction does not render the transaction voidable. This rule is not applicable if the mistake is the fault of the other party, if the mistake is known or the other party is deemed to know there is a mistake, or if there is fraud by the other party. None of these exceptions is applicable here.

b. No. The contract in question contained a clause which guaranteed personal satisfaction. If the property in question involves personal taste and preference, the test to be applied in such a case is a subjective one, i.e., was the particular party satisfied? If the answer is no, and provided further that the party's dissatisfaction is real or urged in good faith rather than being spurious, then despite the fact that the property would satisfy a reasonable man, there can be no recovery.

c. 1. In order to establish promissory estoppel the following elements or requirements must be met:

1. There must be promise by the promisor,
2. Which should reasonably be expected to induce action or forbearance of a definite and substantial character on the part of the promisee,
3. Which does induce said action or forbearance, and
4. Injustice can be avoided only by enforcement of the promise.

2. Promissory estoppel is important as a mitigating factor in the consideration area of contracts law. It permits some types of promises, e.g., charitable subscriptions, to be enforced despite lack of consideration.

Answer 6

Part a. 1. No. The negotiable note was signed by an agent in behalf of an undisclosed principal. An undisclosed principal is not liable on a negotiable instrument since his name does not appear thereon. The rule that an undisclosed principal may be held liable on the contract upon discovery of his identity has no application in the field of negotiable instruments according to the Negotiable Instruments Law.

2. No. Anson's authority to purchase a site was a power which involved Anson's exercise of judgment and discretion, and it could not properly be delegated to Stuart without the assent of the Acme Company. However, the Company's letter to Stuart approving the purchase of Davis' lot amounts to a

ratification of Anson's unauthorized delegation of authority to Stuart. But the purchase of Davis' lot was beyond the actual authority of Anson. Necessarily it was also beyond the authority of Stuart. Acme's letter approving the purchase of Davis' lot cannot be considered a ratification of the unauthorized purchase, since at the time of writing the letter Acme did not know that the purchase was made in violation of his authority. Acme was notified that the lots were purchased but had no knowledge that one was not within the proposed site. A principal will not be deemed to have ratified an unauthorized transaction unless he had full knowledge of all material facts.

3. Yes. The purchase of the Davis lot was made by Stuart in behalf of an undisclosed principal. In such a case the third person may elect to hold the agent liable on the contract since he was dealt with as a principal and his personal credit relied upon. The fact that Acme Company (principal) cannot be held to the contract by Davis because Stuart acted in excess of his authority in no manner affects the liability of Stuart to Davis. Davis is entitled to specific performance of the contract by Stuart.

Part b. 1. Yes. An employee is liable for wrongs he commits while acting within the scope of his employment. He is not absolved of liability to the person harmed because the wrongful acts were specifically directed by the employer and he (employee) was unaware of their wrongful nature.

2. Yes. The repossession of the machine by Arthur was a conversion, and since it was done at the express direction of Robert, he is liable for the wrongful act. Neither Arthur nor Robert is absolved of liability merely because Robert directed that Arthur repossess the machine.

3. Yes. The employer has the duty to indemnify the employee for any losses suffered without his fault but occurring on account of the employment. Here, Arthur committed the wrong against Brian at Robert's direction unaware that he (Arthur) was doing wrong. Upon payment of damages to Brian, Arthur can seek indemnification from Robert.

Answer 7

Part a. 1. Blair has a life interest estate in Greenacre. A life estate is a possessory interest in land and Blair's will last for the duration of his life.

Curt has a vested remainder in fee. It is a remainder in fee because upon Blair's death Curt will get complete ownership of Greenacre; it is a vested remainder because Curt is alive at the time of transfer and therefore acquires his interest at that time, subject to use by Blair during his life.

2. Blair is under a duty to

(a) Maintain the conditions of the estate against waste, voluntary or passive.

(b) Pay the general taxes.

(c) Pay special assessments for temporary improvements.

(d) Pay the interest on the mortgage.

Part b. 1. A copyright is a grant to authors giving them the exclusive right to possess, make, publish, and sell copies of their intellectual productions, or to

authorize others to do so, for a period of 28 years, with the privilege of a renewal and an extension for an additional term of 28 years.

A patent is a grant to one who has given physical, i.e., tangible, expression to an idea regarding the creation of a product giving him the exclusive right to make, use, and sell, and to authorize others to do so, for a 17-year period. A patent is not renewable.

2. Yes. A copyright may be secured for any work which is an original expression of an idea so long as it is not seditious, immoral, or blasphemous. The report prepared by Andy meets these requirements and a copyright can be secured for them.

Answer 8

a. 1. Actual fraud, as used in this connection, means that the element of scienter, i.e., the actual intent to deceive, is present. That element is fulfilled if the representation was known to be false by the person making it. The CPA, obviously, must scrupulously avoid making any such statements. An example of actual fraud would be a case in which a CPA, being fully aware of the fact that a certain building was fictitious, i.e., nonexistent, nevertheless gives his opinion that a balance sheet in which the building appears as a material asset is a fair presentation of the client's assets.

On the other hand, the actual knowledge of falsity and, therefore, intent to deceive is not essential to a finding of constructive fraud. Instead, the intent is inferred from the fact that the representation was made with a reckless disregard for the truth. Once again, the CPA will normally be liable for fraud if he makes this type of representation. To illustrate, if a CPA fails to observe the physical inventory of stock in trade which he honestly believes to be in existence (although he has no basis for such belief), he commits a constructive fraud if he gives his opinion that the statements in which the stock in trade appears as a material item are fair presentations of the client's financial position and results of operations.

2. With the exception of third party beneficiaries, the accountant's legal responsibility for ordinary negligence is based upon the direct contractual relationship between the parties and therefore, does not extend beyond the obligation owed to his client or clients. As to third party beneficiaries, the accountant's responsibility for ordinary negligence extends only to those third parties who are primarily intended to be benefited by the accountant's services. However, liability for fraud, including constructive fraud, extends to third parties who are only incidentally or collaterally intended to be benefited, even though they are not clients or not primarily intended to be the beneficiaries of the accountant's engagement. They are usually third parties to whom a financial statement has been shown by the CPA's client and who have extended credit in reliance upon the financial statement.

b. 1. The working papers belong to the CPA, and he has the right to retain possession thereof because the CPA is not a mere employee but instead an independent contractor and the working papers are vital to the CPA if the performance or accuracy of his work is questioned by his client or third parties.

2. Although the CPA owns the working papers, his ownership is limited inasmuch as he may not assert unrestricted rights as to their use or disposition. For example, he may not sell them, even to another CPA firm, unless he has obtained the client's consent. This restriction against the transfer of working papers arises from the confidential relationship existing between the CPA and his client and would be equally applicable in connection with the sale by a CPA of his entire firm. In addition, the client's consent must also be obtained to effectively pass ownership of the working papers to the beneficiaries of a deceased CPA under his will or to his heirs at law pursuant to the intestate succession laws. Finally, despite his ownership of the working papers, the CPA may be compelled by court order, which overrides the confidential relationship between the CPA and his client, to disclose their contents. Subject to the aforesaid qualified right to transfer his limited ownership, the CPA's rights as to working papers are deemed to be primarily custodial in nature.

THEORY OF ACCOUNTS

November 8, 1963; 1:30 p.m. to 5 p.m.

Answer 1

1.	D	11.	A
2.	D	12.	B
3.	B	13.	C
4.	A	14.	C
5.	B	15.	B
6.	D	16.	C
7.	C	17.	B
8.	C	18.	D
9.	C	19.	D
10.	C	20.	A

Answer 2

a. The combined effects of some or all of the following lease provisions would indicate that the arrangement, in substance, is a purchase of property:

1. The term of the lease is approximately equal to the useful life of the leased property.
2. The lessee is required to pay insurance, taxes, maintenance, and other costs usually associated with ownership.
3. The lessee has the option of acquiring ownership for a nominal amount at the termination of the lease.
4. The terms of the lease include a provision for noncancellation.
5. The rental payments are not competitive with conventional lease rentals on comparable property; that is, the lessee agrees to pay fixed rents at a level which permits the lessor to recover his investment in the leased property plus a normal return.
6. The lease involves property to be constructed by the lessor to the specifications of the lessee.
7. At the termination of the lease the lessee has the option of renewing the lease at a nominal amount for the remainder of the asset's estimated life.
8. The lessee has guaranteed the obligations of the lessor.
9. The lessee has obtained a ruling from the Treasury Department that for tax purposes the transaction is a purchase.
10. The lessor's business is limited to leasing property to the lessee and the leases are pledged to secure the lessor's obligations.

b. Recording the property and related liabilities under a lease will remove the charge for rent from the income statement accounts. Instead, the annual rent payment will be treated as a partial discharge of the liability recorded under the lease and interest thereon. The rent charge to income will be superseded by (1) a financial expense for interest, and (2) an amortization expense for the assets recorded under the lease.

The annual total of these two expenses may or may not equal the annual rental payment, depending on the method of amortizing the cost of the property. If the method of amortization that is used maintains the equality of the assets and liabilities recorded under the lease, the total annual charge to income will equal the annual rental payment. However, if the cost of the property is amortized on either a straight-line or accelerated basis, the total annual charge to income will be greater than the annual rental payments during the early years of the lease and lower during the later years. If tax deductions exceed the charges to income for accounting purposes, it will be necessary to recognize a liability for deferred income taxes during the early years of the lease. The total charges for interest plus amortization will, in either case, equal the total rental payments over the life of the lease.

Although net income will not be affected if the cost of the property is amortized on a basis that maintains the equality of the assets and liabilities, it should be noted that operating income will be higher because the interest portion of the annual charge is treated as a financial expense. In manufacturing firms the effect of lease capitalizations on operating margins is further reflected in manufacturing overhead and in work-in-process and finished goods inventory valuations.

Lease capitalization will, of course, increase total assets and liabilities by an equal amount in the year of capitalization. Whether this equality will be maintained in subsequent years depends on the method of amortizing the cost of the leased assets. The balance sheet may further be affected by classifying as a current liability an amount equal to that portion of the capitalized rental obligations due within one year.

The above changes in the composition of the balance sheet will affect various ratios associated with a firm's financial position. Included among these would be the current ratio, the debt/equity ratio, the profit/asset ratio, and the profit/net worth ratio.

In a statement of sources and applications of funds the effect of lease capitalizations will also be significant. In the year of capitalization the property acquired under leasing agreements should be shown as an application of funds, while the obligations incurred under such agreements will be disclosed as a source of funds. In subsequent years, that portion of the annual rental applied as a reduction to the capitalized rental obligation will be treated as an application of funds, while the portion treated as interest expense will have the effect of reducing funds provided by operations. Amortization charges on the property recorded under lease arrangements will be treated in a manner consistent with other noncash charges to operations.

Answer 3

a. A stock dividend is the issuance by a corporation of its own stock to its stockholders on a pro rata basis without receiving payment therefor. The stock dividend

results in an increase in the amount of the legal or stated capital of the enterprise. The dividend may be charged to retained earnings or to any other capital account that is not a part of legal capital.

1. From the legal standpoint a stock split-up is distinguished from a stock dividend in that a split-up results in an increase in the number of shares outstanding and a corresponding decrease in the par or stated value per share whereas a stock dividend, though it results in an increase in the number of shares outstanding, does not result in a decrease in the par value of the shares.
2. From the accounting standpoint the distinction between a stock dividend and a stock split-up is dependent upon the intent of the board of directors in making the declaration. If the intent is to give to stockholders some separate evidence of a part of their pro rata interests in accumulated corporate earnings, the action results in a stock dividend. If the intent is to issue enough shares to reduce the market price per share of the stock, the action results in a stock split-up, regardless of the form it may take. In other words, if the action takes the form of a stock dividend but reduces the market price markedly, it should be considered a stock split-up. Such reduction will seldom occur unless the number of shares issued is at least 20% or 25% of the number previously outstanding.

b. The usual reason for issuing a stock dividend is to give the stockholders something on a dividend date and yet conserve working capital.

A stock dividend that is charged to retained earnings reduces the total accumulated earnings, and all stock dividends reduce the per share earnings. Issuing a stock dividend to achieve these ends would be a public relations gesture in that the public would be less likely to criticize the corporation for high profits or undue retention of earnings.

A stock dividend also may be issued for the purpose of obtaining a wider distribution of the stock. Although this is the main consideration in a stock split-up, it may be a secondary consideration in the issuance of a stock dividend. The issuance of a series of stock dividends will accomplish the same objective as a stock split-up.

A stock split-up is intended to obtain wider distribution and improved marketability of shares by means of a reduction in the market value of the company's shares.

c. The amount of retained earnings to be capitalized in connection with a stock dividend (in the accounting sense) might be (1) the legal minimum (usually par or stated value), (2) the average paid-in capital per outstanding share, or (3) the market value of the shares. The third basis is generally recommended on the grounds that recipients tend to regard the market value of the stock received as a dividend as the amount of earnings distributed to them. If the corporation in such cases does not capitalize an amount equal to the fair value of the shares distributed as a dividend, there is left in the corporation's retained earnings account an amount of earnings that the stockholders believe has been distributed to them. This amount would be subject to further stock dividends or to cash dividends. The recipients might thus be misled into believing that the company's distributions—and earnings—are greater than they actually are.

If the per share market value of the stock is materially reduced as a result of a distribution, no matter what form the distribution takes, the action is a stock split-up and should be so designated and treated to the extent permitted by legal requirements.

Answer 4

a. Income is the increase in the resources of a business (or other) entity which results from the operations of the enterprise. It should be distinguished from the capital contributed to the entity and from the results of transactions by the entity in its own stock.

Income is a net concept; it consists of the revenue generated by the business, less losses and less expired costs that contribute to the production of revenue.

b. Income as defined above applies to the entire life of an entity. Because of the need for periodic reporting, arbitrary periods of time, usually a year, are used to measure an entity's efficiency in terms of its ability to maintain a satisfactory level of income. Since the process of business activity is usually continuous, at any given point in time an entity's activity will be at various stages of completion as regards the flow of income being generated. Attempts to measure income for short time periods within the life of an entity must, therefore, have an objective and consistent frame of reference for the timing of revenue recognition from which all expired costs and losses can be deducted. Expired costs include those which can be matched by direct association with the revenue which is recognized as well as those which by their very nature expire with the passage of time. The realization convention provides this frame of reference.

The realization convention provides for a distinction between realized and unrealized elements of revenue by requiring that revenue be objectively and reliably measured before it is reported as realized. (Except under special circumstances the sale of goods or services satisfies this requirement.) There is no implication that revenue is earned only at the time of recognition; on the contrary, revenue is earned throughout the operating process.

If no attempt was made to measure income until the end of the life span of an accounting entity the distinction between realized and unrealized revenue would be unnecessary. The realization convention is therefore the controlling element in the process of periodic income determination.

c. Accounting is frequently described as being primarily a process of periodic income determination, not one of asset valuation. Because of the significance attached to the process of periodic income determination the valuation of assets for balance sheet purposes is in many cases relegated to a position of secondary importance. As a result of the attention which is focused on revenue realization and cost matching, unrealized assets are viewed as cost residues chargeable to the future revenue which it is anticipated they will produce. When the applicable realization test has been met, appropriate costs are transferred from the balance sheet to the income statement. Prior to this point assets are in essence deferred costs. Thus, it is the realization convention which also controls the valuation of these assets because of the distinction it makes between realized and unrealized

elements of revenue. In other words, the valuation of unrealized assets is not an independent process; rather, it is inextricably tied to the process of periodic income determination. The fact that the balance sheet is referred to as a connecting link between successive income statements further amplifies the extent to which the valuation of assets is dependent on the process of periodic income determination and, therefore, on the realization convention.

Answer 5

1. The amount of the claim should be described in the accompanying notes to the financial statements or shown as an appropriation of retained earnings. It would also be acceptable to report the amount "short" below current liabilities on the balance sheet. If shown as an appropriation of retained earnings, the amount involved should be restored to retained earnings when the claim is settled. Any losses sustained should be charged to a special loss account or, if such treatment would distort income for the period in which the loss occurred, directly to retained earnings with appropriate disclosure.

The patent infringement claim gives rise to a contingent liability, which, although not sufficiently predictable to permit recording in the accounts, must be disclosed because of its potential effect on the company's financial position.

2. An appropriate portion of the total estimated reconditioning and restoration costs should appear as a charge to operations during each of the ten years covered by the lease with an offsetting credit to an accrued liability account. Accompanying footnotes should be used if the account title does not clearly identify the nature and purpose of the liability and its total estimated amount. The liability should be reclassified to a current status in financial statements prepared during the year preceding the expiration of the lease.

Expenditures for reconditioning and restoration at the termination of the lease should be charged against the accrued liability. Any remaining debit or credit balance in the liability account should then be transferred to retained earnings through a nominal account or, if material, directly.

If the annual accrual results in a material difference between income per books and taxable income, the excess of the actual tax liability over the recorded liability should be charged to a deferred income tax account in each of the first nine years. In the last year, when the actual reconditioning and restoration expenditures are deducted for tax purposes, the excess of the tax expense in the income statement over the tax liability will be credited to the deferred income tax account.

Although the amount involved is not presently determinable, there can be no question that there exists an actual liability which can be reasonably estimated. Failure to accrue annually a proportionate share of the contractual obligation to recondition and restore the property at the termination of the lease would result in a misstatement of the results of operations during each of the first nine years of the lease and a much larger misstatement in the last year.

3. The amount of the estimated refund claim for a prior year's taxes should be disclosed in the accompanying footnotes to the financial statements or reported "short" below current assets on the balance sheet. If it is not feasible to estimate the amount of the refund claim, the accompanying footnote should state this

together with a general description of the claim. If the refund claim is settled in the company's favor, a receivable should be recorded with an offsetting credit to retained earnings or an appropriately designated nominal account. An asset could be recognized and included in the accounts of the current period, even though the refund claim had not yet been approved by the taxing authority, if the claim was not being contested and there was no reason to expect it to be contested.

As in the case of contingent liabilities, contingent assets which may materially affect a company's financial position must be disclosed when the surrounding circumstances indicate that, in all likelihood, a valid asset will materialize.

4. The increased likelihood that the company will suffer a costly strike requires no disclosure in the financial statements.

The possibility of a strike is an inherent risk of many businesses. It, along with the risks of war, recession, etc. is in the category of general risk contingencies and requires no accounting recognition.

Answer 6

a. The basic objective of profit and loss sharing arrangements should be to distribute to each partner his proper share of partnership profits and losses. This is achieved by measuring each partner's contribution to the success of the firm and recognizing it in the arrangements that are included in the partnership agreement. Factors influencing a partner's contribution include capital investment, time devoted to the firm, experience, and ability.

Allowing interest on invested capital recognizes the relative capital risks of investing partners. Salary and bonus allowances, on the other hand, compensate working partners for their time, experience, and ability.

b. A basic accounting assumption is that a business is an entity in its own right, separate and distinct from its owners, without regard to its legal form. A firm's financial statements are therefore those of the entity, not those of its owners. Working and managing parners, from this point of view, occupy a position of dual relationship to the partnership. They are employees of the entity and, at the same time, owners. The value of the services rendered by working partners is logically an operating cost of the entity and should therefore be reported in its statement of operations. This treatment recognizes that the costs of managing a business are justifiably matched against its revenue stream to produce a realistic measure of periodic business income of the entity. If salary allowances are in excess of the value of a partner's services, the excess should not be treated as a charge to operations.

It is also argued that this treatment results in a more meaningful income statement for purposes of departmental analysis, comparisons with corporate competitors, and obtaining credit. Deduction of salaries in arriving at net income helps to produce a meaningful statement of the earning power of the partners' capital investment.

c. Contrary to the view that working partners can be treated as occupying positions of dual relationship to a partnership is the view that, as an association of individuals, they have only a proprietary interest in the firm. Thus, it is contended

that salary and bonus allowances can only be recognized as distributions of proprietary income. A partner is not an employee of the firm, and to treat him as an employee is a distortion of legal realities. Salary and bonus allowances are merely provisions permitting equitable profit distributions where there are disproportionate contributions of partners' time, ability and experience.

It is also contended that the amount of salary and bonus allowances is frequently unrelated to the value of the services rendered. To report these amounts on the statement of income would not, therefore, improve income measurement or comparability with corporate competitors. Any attempt to estimate an amount equal to the value of the services rendered for purposes of treating it as a charge to operations may be too subjective to warrant consideration.

d. An agreement providing that "interest is to be allowed on invested capital" should also specify the following:

1. An interest rate acceptable to all partners.
2. The capital base on which the agreed rate of interest is to be allowed. The amount of the interest allowance can vary considerably depending on whether beginning, average, or ending capital is used as the base. If average capital is used, the agreement should also state how the average is to be computed.
3. The procedure to be used when a loss occurs or when the interest allowance is in excess of net income.
4. The restrictions on withdrawals and additional investment. In the absence of such restrictions partners may make large additional investments that are in excess of the firm's capital needs, thereby increasing their interest allowances to the disadvantage of the other partners.

Answer 7

a. 1. The acquisition costs of land may include the purchase or contract price, the broker's commission, title search and recording fees, assumed tax or other liabilities, and surveying, demolition (less salvage), and landscaping costs.

2. If a building is purchased, all repair charges, alterations, and improvements necessary to ready the building for its intended use should be included as a part of the acquisition cost. Building costs in addition to the amount paid a contractor may include excavation, permits and licenses, architect's fees, interest accrued on funds obtained for construction purposes (during construction period only), insurance premiums applicable to the construction period, temporary buildings and structures, and property taxes levied on the building during the construction period.

3. Machinery and equipment costs may properly include freight and drayage, taxes on purchase, insurance in transit, installation, and expenses of testing and breaking in.

b. 1 *Additions.* Additions represent entirely new units or extensions and enlargements of old units. Expenditures for additions are capitalized by charging either old or new asset accounts depending on the nature of the addition.

2. *Betterments.* A betterment does not add to existing plant. Expenditures for betterments represent increases in the quality of existing plant by rearrangements

in plant layout or the substitution of improved components for old components so that the facilities are better in some way than they were when acquired. Such increases in the quality of the improved facilities are measured by their increased productivity, greater capacity, or longer life. The cost of betterments is accounted for by charges to the appropriate property accounts and the elimination of the cost and accumulated depreciation associated with the replaced components, if any.

3. *Extraordinary repairs.* Expenditures to replace parts or otherwise to restore assets to their previously efficient operating condition are regarded as repairs. To be classified as an extraordinary repair an expenditure must benefit future periods by increasing the useful life of an existing asset. Expenditures for extraordinary repairs are capitalized by charges to the appropriate accumulated depreciation account or by eliminating from the accounts the cost and accumulated depreciation on the replaced parts and charging the asset account for the cost of the repairs. The latter treatment is preferred because it maintains the integrity of the accounts in that the actual cost of the asset in use is recorded.

4. *Deferred maintenance.* Deferred maintenance is an amount equal to the expenditure necessary to restore a plant or item of equipment to normal operating efficiency. Accounting for deferred maintenance involves the establishment of an allowance account by a charge to operations in the period during which it occurs. Actual repairs and other deferred maintenance expenditures are then charged to the allowance account when they occur.

5. *Replacements.* Replacements involve an "in kind" substitution of a new asset or part for an old asset or part. Accounting for major replacements requires entries to retire the old asset or part and to record the cost of the new asset or part. Minor replacements are treated as period costs.

c. 1. The position that no overhead should be capitalized assumes that the construction of fixed assets will be timed so as not to interfere with normal operations. If this were not the case, the savings anticipated by constructing instead of purchasing fixed assets would be nullified by reduced profits on the product that could have been manufactured and sold. Thus, construction of fixed assets during periods of low activity will have a minimal effect on the total amount of overhead costs. To capitalize a portion of overhead as an element of the cost of constructed assets would, under these circumstances, reduce the amount assignable to operations and therefore overstate net income in the construction period and understate net income in subsequent periods because of increased depreciation charges.

2. The inclusion of overhead only to the extent that it is directly attributable to the assets being constructed is based on the fact that a decision to construct instead of purchase takes into consideration only the differential overhead cost, and it should therefore be capitalized. To capitalize less or more overhead than is actually incurred by fixed asset construction activities would distort both the results of normal operations and the actual cost of the assets involved.

3. Capitalizing overhead at the same rate as is charged to normal operations is defended by those who feel that all manufacturing overhead serves a dual purpose during fixed asset construction periods. Any attempt to assign to construction activities less overhead than the normal rate implies costing favors and results in the misstatement of the cost of both fixed assets and finished goods.

Answers to Examinations, May 1964

ACCOUNTING PRACTICE—PART I

May 13, 1964; 1:30 to 6:00 p.m.

Solution 1

1. D	11. D
2. B	12. D
3. C	13. C
4. C	14. C
5. D	15. A
6. D	16. C
7. A	17. A
8. D	18. B
9. C	19. D
10. A	20. B

Solution 2

Bard Corporation

COMPUTATION OF NET WORTH AND OUTSTANDING STOCK OPTIONS
December 31, 1963

Date	Description	Common Stock Issued		Capital Contributed	Retained	Treasury Stock		Options Outstanding	
		Shares	Amount	In Excess of Par Value	Earnings	Shares	Cost	Shares	Price Per Share
12/31/62	Balances	75,000	$ 750,000	$375,000	$725,000	4,700	$11,500	1,000	$22
1/16/63	Declaration of cash dividend of 20¢ per share on 70,300 shares outstanding				(14,060)				
2/1/63	Options exercised on 500 shares at $22 per share	500	5,000	6,000				(500)	$22
2/1/63	Adjustment of 1/16/63 declaration of cash dividend of 20¢ per share for additional 500 shares issued				(100)				
3/1/63	Stock split 2-for-1	75,500				4,700		500	$11
4/1/63	Exchange of 25,000 shares of unissued common stock for all of the stock of the Herbert Corporation	25,000	125,000	325,000					
6/30/63	Options exercised on 400 shares at $11 per share	400	2,000	2,400				(400)	$11
11/1/63	Ten percent stock dividend	16,700	83,500	317,300	(400,800)			60	$10
11/15/63	Merger with Albert Corporation	100,000	500,000	(40,000)	270,000				
12/1/63	Options exercised on 100 shares at $10 per share	100	500	500				(100)	$10
12/31/63	Net income for 1963				400,000				
	Totals	293,200	$1,466,000	$986,200	$980,040	9,400	$11,500	560	$10

Computation of Amount of Capital in Excess of Par Value to Be Recorded Under 10 Per Cent Stock Dividend

Market value of stock issued to stockholders [.10 (176,400 − 9,400) × $24]	$400,800
Less par value of additional stock issued (16,700 × $5)	83,500
Capital in excess of par value to be recorded	$317,300

Computation of Price Per Share for Options Outstanding After 10 Per Cent Stock Dividend

Total price of outstanding options (600 × $11):	$6,600
Price per share after 10% stock dividend [$6,600 ÷ (600 + 60)] =	$10

Solution 3

a.

Blank Corporation

INCOME STATEMENT

For the Year Ended May 31, 1963

Sales		$3,100,000
Operating expenses:		
Inventories, June 1, 1962	$ 532,000	
Purchases	2,600,300	
Goods available for sale	3,132,300	
Less inventories, May 31, 1963	426,300	
Total	2,706,000	
Depreciation and amortization	24,200	
Other expenses	336,100	
Total operating expenses		3,066,300
Income from operations		33,700
Provision for income taxes		13,300
Net income for the year		$ 20,400

Computation of Inventories at May 31, 1963

	Retail	*Mark-on*	*Cost*
General merchandise	$330,000	25%	$247,500
Vegetables and meats	84,000	30%	58,800
Warehouse			120,000
Total			$426,300

Computation of Depreciation and Amortization

Depreciation and amortization, as recorded		$23,000
Adjustment for depreciation on self-service units		
As recorded [($16,000 ÷ 10) × 3]	$4,800	
Per leasehold life [($16,000 ÷ 8) × 3]	6,000	1,200
Depreciation and amortization, adjusted		$24,200

Computation of Other Expenses

Other expenses, as recorded	$332,200
Provision for losses on bad checks [60% (5,700 + 800)]	3,900
Total other expenses, adjusted	$336,100

Computation of Provision for Income Taxes

Taxable income before application of carry-over	$40,600
Net operating loss carry-over ($31,000 − 17,000)	14,000
Taxable income	$26,600
Provision for income taxes @ 50%	$13,300

b.

Blank Corporation
COMPUTATION OF TAXABLE INCOME
For the Year Ended May 31, 1963

Income from operations per books as adjusted	$33,700
Add:	
Provision for losses on bad checks	3,900
Deposits received from sublessees	3,000
Taxable income	$40,600

c.

Computation of Purchase Price of Blank Corporation's Common Stock

Contract price before adjustment			$800,000
Adjustment for deficiency in net worth			
Capital stock		$600,000	
Deficit, May 31, 1962	$14,000		
Less income for year ended May 31, 1963	1,000	13,000	
Total net worth		587,000	
Tax effect of net operating loss carry-over		2,500	
Total		589,500	
Contract basis of net worth		600,000	
Deficiency in net worth			10,500
Purchase price			$789,500

Computation of Tax Effect of Net Operating Loss Carry-over

Year Ended	*Income (Loss)*
May 31, 1961	$ 17,000
May 31, 1962	(31,000)
May 31, 1963	9,000
Net operating loss carry-over	$ (5,000)
Tax effect @ 50%	$ 2,500

Solution 4

a.

Conol Sales Company
COMPUTATION OF INVENTORY AT DECEMBER 31, 1963 and 1962

	Number of Units				
	Open Account	*Consignment*	*Total*		*Amount*
Inventory, December 31, 1963	814	23	837	@ $130 =	$108,810
Units sold	3,008	(1) 2,826	5,834		
	3,822	2,849	6,671		
Shipments to consignees in 1963	2,142	(2,142)			
	5,964	707	6,671		
Purchases	(4,454)		(4,454)		
Inventory, December 31, 1962	1,510	707	2,217	@ $130 =	$288,210

(1) $706,500 ÷ $250 = 2,826 units

b.

WORKSHEET JOURNAL ENTRIES TO CORRECT FINANCIAL STATEMENTS AT DECEMBER 31, 1962

(1)

Sales	$176,750	
Accounts receivable		$176,750

To adjust for units in inventory that were shipped on consignment and recorded as sales.
(707 × $250 = $176,750)

(2)

Inventory—on consignment	91,910	
Cost of goods sold		91,910

To record in inventory shipments made on consignment and recorded as sales.
(707 × $130 = $91,910)

(3)

Liability for federal income taxes	42,420	
Provision for federal income taxes		42,420

To adjust provision for federal income taxes.

Reduction in sales	$176,750
Reduction in cost of goods sold	91,910
Reduction in income	$ 84,840
Reduction in income taxes @ 50%	$ 42,420

c. **JOURNAL ENTRIES TO CORRECT THE ACCOUNTS AT DECEMBER 31, 1963**

(1)		
Prior year adjustments (Retained earnings)	$176,750	
Sales		$176,750
To record sales of merchandise shipped on consignment in 1962 and recorded as sales in that year in error.		
(2)		
Cost of goods sold	91,910	
Prior year adjustments (Retained earnings)		91,910
To charge current year with cost of goods shipped on consignment in 1962 and recorded as sales in that year in error.		
(3)		
Claim for refund of federal income taxes	42,420	
Prior year adjustments (Retained earnings)		42,420
To record claim for excess income taxes paid for 1962.		
(4)		
Sales	5,750	
Accounts receivable		5,750
To adjust for units in inventory that were shipped on consignment and recorded as sales in error. (23 × $250 = $5,750)		
(5)		
Inventory on consignment	2,990	
Cost of goods sold		2,990
To record in inventory shipments made on consignment and recorded as sales in error. (23 × $130 = $2,990)		
(6)		
Provision for federal income taxes	41,040	
Liability for federal income taxes		41,040
To adjust provision for federal income taxes.		

Increase in sales ($176,750 − $5,750)	$171,000
Increase in cost of goods sold ($91,910 − $2,990)	88,920
Increase in income	$ 82,080
Increase in income taxes @ 50%	$ 41,040

Solution 5

a. **COMPUTATION OF UNITS LOST DURING JANUARY**

	Extruding Department	*Finishing-Packing Department*
Units in process, January 1	10,000	29,000
Units started or received from preceding department during January	20,000	22,000
Total units to be accounted for	30,000	51,000
Units completed and transferred or shipped	22,000	44,000
Units in process, January 31	8,000	6,000
Total units accounted for	30,000	50,000
Units lost during January	None	1,000

b. **COMPUTATION OF OUTPUT DIVISOR FOR UNIT COSTS**

Extruding Department

	Production Units	Output Divisor: Material	Output Divisor: Labor and Overhead
Transferred to next department during January	22,000	22,000	22,000
In process, January 31 (material, 50% complete; labor and overhead, 40% complete)	8,000	4,000	3,200
Total		26,000	25,200

Finishing-Packing Department

	Production Units	Output Divisor: Material	Output Divisor: Labor and Overhead
Shipped during January	44,000	44,000	44,000
In process, January 31 (material, 0% complete; labor and overhead, 35% complete)	6,000	—0—	2,100
Total		44,000	46,100

c. **Mantis Manufacturing Company**
COST OF PRODUCTION REPORT
For the Month of January

	Extruding Department: Total cost	Extruding Department: Unit cost	Finishing-Packing Department: Total cost	Finishing-Packing Department: Unit cost
Costs charged to department:				
Costs from preceding department:				
Work in process, January 1			$ 60,200	$2.08
Received during January			41,800	1.90
Total			102,000	2.00
Costs added in department:				
Work in process, January 1				
Material	$ 5,900		—0—	
Labor	1,900		1,500	
Overhead	1,400		2,000	
Costs added during January:				
Material	20,100	$1.00	4,400	.10
Labor	10,700	.50	7,720	.20
Overhead	8,680	.40	11,830	.30
Total	48,680	1.90	27,450	.60
Adjustment for lost units				.04
Total cost to be accounted for	$48,680	$1.90	$129,450	$2.64
Distribution of costs:				
Transferred or shipped	$41,800		$116,160	
Work in process, January 31				
Adjusted cost from preceding department	—0—		12,240	
Material	4,000		—0—	
Labor	1,600		420	
Overhead	1,280		630	
Total costs distributed	$48,680		$129,450	

SUPPORTING COMPUTATIONS

Costs from preceding department:

$$\frac{\$102{,}000}{29{,}000 + 22{,}000} = \$2.00$$

Material:

$$\frac{\$5{,}900 + \$20{,}100}{26{,}000} = \$1.00$$

$$\$8{,}000 \times 50\% \times \$1.00 = \$4{,}000$$

$$\frac{\$4{,}400}{44{,}000} = \$.10$$

Labor:

$$\frac{\$1{,}900 + \$10{,}700}{25{,}200} = \$.50$$

$$8{,}000 \times 40\% \times \$.50 = \$1{,}600$$

$$\frac{\$1{,}500 + \$7{,}720}{46{,}100} = \$.20$$

$$6{,}000 \times 35\% \times \$.20 = \$420$$

Overhead:

$$\frac{\$1{,}400 + \$8{,}680}{25{,}200} = \$.40$$

$$8{,}000 \times 40\% \times \$.40 = \$1{,}280$$

$$\frac{\$2{,}000 + \$11{,}830}{46{,}100} = \$.30$$

$$6{,}000 \times 35\% \times \$.30 = \$630$$

Transferred or shipped:

$$22{,}000 \times \$1.90 = \$\ 41{,}800$$
$$44{,}000 \times \$2.64 = \$116{,}160$$

Adjusted cost from preceding department:

$$6{,}000 \times \$2.04 = \$12{,}240$$

Adjustment for lost units:

$$1{,}000 \times \$2.00 = \frac{\$2{,}000}{50{,}000} = \$.04$$

Solution 6

The City of Larnaca
City Hall Bond Fund

a.

WORKING TRIAL BALANCE
June 30, 1963

	Preliminary Trial Balance		*Adjustments*				*Adjusted Trial Balance*	
	Debit	*Credit*		*Debit*		*Credit*	*Debit*	*Credit*
Cash	$ 893,000						$ 893,000	
Appropriation expenditures	140,500				(2)	$ 40,000	100,500	
Encumbrances	715,500						715,500	
Accounts payable		$ 11,000	(4)	$ 11,000				
Reserve for encumbrances		723,000	(5)	7,500				$ 715,500
Appropriations		1,015,000	(3)	15,000	(1)	1,000,000		2,000,000
	$1,749,000	$1,749,000						
Bonds authorized—unissued			(1)	1,000,000			1,000,000	
Due to General Fund					(3)	15,000		26,000
					(4)	11,000		
Due from General Fund			(2)	40,000			40,000	
Contract payable—retained percentage					(5)	7,500		7,500
				$1,073,500		$1,073,500	$2,749,000	$2,749,000

CITY HALL BOND FUND

Adjusting Entries
(Not required)

(1)

Bonds authorized—unissued	$1,000,000	
Appropriations		$1,000,000
To record bonds authorized but not issued.		

(2)

Due from General Fund	40,000	
Appropriation expenditures		40,000
To record amount due from General Fund for interest paid by City Hall Bond Fund. (Since the bonds issued are "general obligation" bonds, the interest would ordinarily be paid from the General Fund.)		

(3)

Appropriations	15,000	
Due to General Fund		15,000
To record the premium realized on the sale of bonds as payable to the fund that will pay the interest.		

(4)

Accounts payable	11,000	
Due to General Fund		11,000
To correct recording of charge by General Fund.		

(5)

Reserve for encumbrances	7,500	
Contract payable—retained percentage		7,500
To record liability for amount of retained percentage.		

b.

GENERAL FIXED ASSETS FUND

Adjusting Entries

(1)

Construction work in progress	$100,500	
Investment in fixed assets from bonds		$100,500
To record construction work in progress.		

GENERAL FUND

Adjusting Entries

(1)

Due from City Hall Bond Fund	$ 15,000	
Appropriation expenditures—interest		$ 15,000
To record receivable from City Hall Bond Fund for premium realized on sale of bonds. (Alternative treatments would credit Revenues or Unappropriated Surplus.)		

(2)

Appropriation expenditures—interest	40,000	
Due to City Hall Bond Fund		40,000
To record liability for bond interest paid.		

GENERAL BONDED DEBT AND INTEREST FUND

Adjusting Entries

(1)

Amount to be provided for retirement of bonds	$1,000,000	
Amount to be provided for payment of interest	400,000	
General obligation bonds payable		$1,000,000
Interest payable in future years		400,000
To record liability for bond principal and interest payable in future years.		
($1,000,000 × 4% × 10 years = $400,000)		

(2)

Interest payable in future years	40,000	
Amount to be provided for payment of interest		40,000
To reduce liability for future interest payments by the amount of interest paid in current fiscal year.		

ACCOUNTING PRACTICE—PART II

May 14, 1964; 1:30 to 6:00 p.m.

Solution 1

Pine Lumber Company and Pine Lumber Corporation
WORKSHEET TO ADJUST AND CLOSE THE COMPANY'S ACCOUNTS AND CONVERT THEM TO THOSE OF THE CORPORATION
March 31, 1964

	Pine Lumber Company Trial Balance March 31, 1964		*Adjusting Entries*		*Pine Lumber Company Income Statement*		*Pine Lumber Company Balance Sheet*		*Closing and Conversion Entries*		*Pine Lumber Corporation Beginning Balances*	
	Debit	*Credit*	*Debit*	*Credit*	*Debit*	*Credit*	*Debit*	*Credit*	*Debit*	*Credit*	*Debit*	*Credit*
Cash—State Bank	$ 16,500						$ 16,500				$ 16,500	
Cash—National Bank		$ 4,600	(1)$10,000				5,400				5,400	
Accounts receivable	57,300			(2)$ 1,300 (3) 1,500			54,500				54,500	
Allowance for bad debts		5,300	(2) 2,100					$ 3,200				$ 3,200
Inventories	103,600			(4) 9,600			94,000				94,000	
Investment-Builders Co.	60,000			(1) 10,000			50,000			(a)$ 50,000		
Land	3,000						3,000				3,000	
Building	40,000						40,000				40,000	
Accumulated deprecia-tion—building		30,000		(5) 250				30,250				30,250
Equipment	22,000						22,000				22,000	
Accumulated deprecia-tion—equipment		5,600		(5) 550				6,150				6,150
Accounts payable		14,800						14,800				14,800
Mortgage payable		47,600						47,600				47,600
Liability for income taxes		3,000	(8) 3,000									
I. M. Pine, capital		174,979						174,979	(a)$ 50,000 (c) 134,162	(b) 9,183		

	Pine Lumber Company Trial Balance March 31, 1964		*Adjusting Entries*		*Pine Lumber Company Income Statement*		*Pine Lumber Company Balance Sheet*		*Closing and Conversion Entries*		*Pine Lumber Corporation Beginning Balances*	
	Debit	*Credit*	*Debit*	*Credit*	*Debit*	*Credit*	*Debit*	*Credit*	*Debit*	*Credit*	*Debit*	*Credit*
Sales		$350,000				$350,000			(b) $350,000			
Purchases	$300,000		(4) $ 9,600		$309,600					(b) $309,600		
Operating expenses	20,000				20,000					(b) 20,000		
Selling and administrative expenses	9,000		(3) 1,500		10,500					(b) 10,500		
Mortgage interest expense	479		(6) 238		717					(b) 717		
Professional fees	1,000			(7) $ 1,000								
Provision for income taxes	3,000			(8) 3,000								
	$635,879	$635,879										
Prior year adjustments				(2) 800		800			(b) 800			
Depreciation—building			(5) 250		250					(b) 250		
Depreciation—equipment			(5) 550		550					(b) 550		
Accrued interest payable				(6) 238				$ 238				$ 238
Organization expense			(7) 1,000				$ 1,000				$ 1,000	
Net income for the period					9,183			9,183				
			$28,238	$28,238	$350,800	$350,800	$286,400	$286,400				
Capital in excess of par value										(c) 34,162		34,162
Capital stock										(c) 100,000		100,000
									$534,962	$534,962	$236,400	$236,400

Adjusting Entries
(Not required)

	Debit	Credit
(1)		
Cash—National Bank	$ 10,000	
Investment—Builders Company		$ 10,000
To cancel check drawn for purchase of additional Builders Company stock.		
(2)		
Allowance for bad debts	2,100	
Accounts receivable		1,300
Prior year adjustments		800
To write off uncollectible trade account and to adjust Allowance for bad debts to $3,200, the amount of doubtful trade accounts receivable.		
(3)		
Selling and administrative expenses	1,500	
Accounts receivable		1,500
To charge to expense 1964 commission advances to a salesman who has left the Company.		
(4)		
Purchases	9,600	
Inventories		9,600
To adjust inventories recorded on books to $94,000.		
(5)		
Depreciation—building	250	
Depreciation—equipment	550	
Accumulated depreciation—building		250
Accumulated depreciation—equipment		550
To record depreciation for three months.		
(6)		
Mortgage interest expense	238	
Accrued interest payable		238
To accrue interest expense for the month of March.		
(7)		
Deferred organization expense	1,000	
Professional fees		1,000
To properly identify professional fees paid in connection with incorporation procedure.		
(8)		
Liability for income taxes	3,000	
Provision for income taxes		3,000
To reverse monthly accruals of personal income taxes.		

Closing Entries
(Not required)

	Debit	Credit
(a)		
I. M. Pine, capital	$50,000	
Investment—Builders Company		$50,000
To remove investment in Builders Company from the books. Investment not to be transferred to the new corporation.		

(b)

Sales	350,000	
Prior year adjustments	800	
Purchases		309,600
Operating expenses		20,000
Selling and administrative expenses		10,500
Mortgage interest expense		717
Depreciation—building		250
Depreciation—equipment		550
I. M. Pine, capital		9,183
To close books of Pine Lumber Company.		

(c)

I. M. Pine, capital	134,162	
Capital contributed in excess of par value		34,162
Capital stock		100,000
To record issue of 1,000 shares of capital stock, par value $100, for I. M. Pine's interest in the Pine Lumber Company.		

Solution 2

a.

The Comity Loan Company
ADJUSTING ENTRIES
December 31, 1963

(1)

Reserve for uncollectible loans	$27,500	
Retained earnings		$ 27,500
To return the appropriation, Reserve for Uncollectible Loans, to Retained Earnings.		

(2)

Liability for income taxes	13,750	
Retained earnings	13,750	
Allowance for doubtful accounts		27,500
To record provision for doubtful accounts applicable to prior years, net of income tax effect, as a direct charge to Retained Earnings. (4% × $687,500 = $27,500)		

(3)

Allowance for doubtful accounts	13,400	
Uncollectible loans charged off		13,400
To charge off uncollectible accounts to the allowance.		

(4)

		Dr.	Cr.
Provision for doubtful accounts		14,400	
Allowance for doubtful accounts			14,400

To provide an allowance for doubtful accounts of 4% of receivables at December 31, 1963.

Reserve required (4% × $712,500)	$28,500
Reserve balance ($27,500 − $13,400)	14,100
Provision	$14,400

(5)

		Dr.	Cr.
Liability for income taxes		500	
Provision for income taxes			500

To adjust 1963 provision for income taxes.

Provision for doubtful accounts (Entry #4)	$14,400
Uncollectible accounts written off	13,400
Additional 1963 expense	$ 1,000
Tax effect @ 50%	$ 500

b. **The Comity Loan Company**

STATEMENT OF INCOME AND RETAINED EARNINGS
For the Year Ended December 31, 1963

Interest income		$165,000
Operating expenses	$49,500	
Provision for doubtful accounts	14,400	63,900
Net operating income		101,100
Interest expense		59,500
Net income before income taxes		41,600
Provision for income taxes		20,800
Net income after income taxes		20,800
Retained earnings at beginning of year		108,000
Return to Retained Earnings of Reserve for Uncollectible Loans established in prior years by appropriations of Retained Earnings		27,500
Total		156,300
Dividends paid	10,000	
Provision for uncollectible loans applicable to prior years, net of income tax effect, resulting from change in method of accounting for uncollectible loans	13,750	23,750
Retained earnings, December 31, 1963		$132,550

Solution 3

a.

Hardhyt Corporation
STATEMENT OF AFFAIRS
December 31, 1963

Book Value	Assets		Appraised Value	Estimated Amount Available	Loss or Gain* on Realization
	Assets Pledged with Fully Secured Creditors				
$ 4,000	Land		$50,000		$46,000*
25,000	Building		—0—		25,000
	$30,000 Cost				
	5,000 Accumulated depreciation				
	$25,000 Book value				
	Total		50,000		
	Less fully secured claims (contra)		42,500	$ 7,500	
	Assets Pledged with Partly Secured Creditors				
10,000	Accounts receivable		10,000		
	Total (deducted contra)		$10,000		
	Free Assets				
1,000	Cash	$ 1,000			
	Less protested check	300	700	700	300
10,150	Accounts receivable	10,150			
	$20,500 Total				
	350 Allowance for bad debts				
	$20,150 Book value				
	Add protested check	300			
	Less uncollectible account	150	10,300	10,300	150*

Book Value	Liabilities and Capital		Amount Unsecured
	Liabilities with Priority		
$ 1,500	Wages payable	$ 1,500	
800	Payroll taxes payable	800	
	Estimated liquidation expense	3,200	
	Total (contra)	$ 5,500	
	Fully Secured Creditors		
42,000	Mortgage payable	$42,000	
500	Mortgage interest payable	500	
	Total (contra)	$42,500	
	Partly Secured Creditors		
25,000	Notes payable—bank	$25,000	
	Less assigned accounts (contra)	10,000	$15,000
	Unsecured Creditors		
26,000	Accounts payable	26,000	
	Defective merchandise in transit	250	26,250
20,000	Notes payable—officers		20,000

Book Value	Assets		Appraised Value	Estimated Amount Available	Loss or Gain* on Realization	Book Value	Liabilities and Capital	Amount Unsecured
$ 6,000	Inventories, expected to realize	$ 9,000					Capital	
	Less cost to complete	400	$ 8,600	$ 8,600	$ 2,600*	$ 50,000	Capital stock	
34,000	Inventories (balance)		10,500	10,500	23,500			
38,000	Machinery and equipment		18,000	18,000	20,000			
	$46,000 Cost 8,000 Accumulated depreciation $38,000 Book value							
3,000	Supplies		—0—		3,000			
5,000	Downhill Railroad bonds		900	900	4,100	(29,100)	Retained earnings	
750	Accrued bond interest receivable		—0—		750	6,200	Reserve for product guarantees	
6,000	Advertising		—0—		6,000			
	Estimated amount available			56,500	$33,900			
	Liabilities with priorities (contra)			5,500				
	Estimated amount available for unsecured liabilities			51,000				
	Estimated deficiency on unsecured liabilities			10,250				
$142,900				$61,250		$142,900	Total unsecured liabilities	$61,250

b.

COMPUTATION OF ESTIMATED SETTLEMENT PER DOLLAR OF UNSECURED LIABILITIES

$$\frac{\text{Estimated amount available for unsecured liabilities}}{\text{Total unsecured liabilities}} = \frac{\$51{,}000}{\$61{,}250} = 83\%$$

Estimated settlement per dollar of unsecured liabilities = 83% or 83¢ on the dollar.

Solution 4

a.

COMPUTATION OF THE AVERAGE MAXIMUM AMOUNT TO BE PAID PER TON OF COTTONSEED

Sales:			
Oil	— (300 × 20,000 × $.15) ..		$ 900,000
Meal	— $\left(\frac{600}{2{,}000} \times 20{,}000 \times \$50\right)$		300,000
Hulls	— $\left(\frac{800}{2{,}000} \times 20{,}000 \times \$20\right)$		160,000
Lint	— (20,000 × $3)		60,000
	Total sales		$1,420,000
Less variable costs:			
Processing	— (20,000 × $9)	$180,000	
Marketing	— [$20 (20,000 − 2,000)]	360,000	540,000
Maximum total amount that can be paid for 20,000 tons of cottonseed that would cause the Company's losses to be no greater when operating than when closed down			$880,000

$$\text{Average maximum amount per ton} = \frac{\$880{,}000}{20{,}000} = \$44 \text{ per ton}$$

b. In his discussion with management, the CPA might mention the following additional factors:

1. Costs that did not enter into the computation but would be incurred if the Company were to shut down completely. These costs would include the cost

of recruiting and training a labor force when operations began again. Possibly the layoff of the labor force would compel the Company to raise its wage level because higher rates are frequently necessary to hire workers when the work is not steady.

2. Permanent loss of part of the customers because the plant shut down and the additional expense to obtain new customers to replace them.

3. The cost of preparing the production machinery for a projected period of idleness and the subsequent cost of readying the idle machinery for use again.

4. The reasonableness of the total fixed costs. If the fixed cost data were correct for the break-even point report, probably the fixed costs would be less than $198,000 per year in the event of a complete shutdown of operations. Fixed costs such as, for example, clerical personnel in the office might be semivariable in nature. To the extent that fixed costs are semivariable, the average maximum amount per ton that can be paid will be reduced.

5. The validity of the variable costs. The question might be raised whether the plant was being operated at maximum efficiency and whether the purchase of new machinery would measurably improve the efficiency of the operations.

6. The use of the plant for processing materials other than cottonseed. Diversification might make a shutdown unnecessary.

7. The over-all financial strength of the Company. It should be weighed to determine whether it would be able to absorb the projected losses and survive as a going concern.

c. **COMPUTATION OF AVERAGE MAXIMUM AMOUNT TO BE PAID PER TON OF COTTONSEED TO REALIZE MINIMUM RETURN ON INVESTMENT**

Sales (from part a)		$1,420,000
Less costs:		
Processing		
Variable (from part a)	$180,000	
Fixed	108,000	
Marketing (variable—from part a)	360,000	
Administrative (fixed)	90,000	738,000
Amount available for purchase of cottonseed and minimum return on investment		682,000
Less minimum return on investment (25% of $968,000)		242,000
Maximum amount to be paid for cottonseed		$ 440,000

$$\text{Maximum average amount} = \frac{\$440{,}000}{20{,}000} = \$22 \text{ per ton}$$

Solution 5

Hyram and Hilda Hayrack
ESTIMATED FARM INCOME AND EXPENSE ON A CASH BASIS
For the Year Ended December 31, 1963

Income:			
Sales:			
Grain		$15,000	
Applied to repay Commodity Credit Corporation loan and interest		10,600	$25,600
Hay			700
Potatoes			13,000
Sugar beets			30,000
Cream and eggs ($440 annualized)			480
Patronage dividends		300	
Less 10% personal share of purchases		30	270
Gasoline tax refunds			500
Soil Bank payments			800
Sales of purchased livestock:			
Feeder cattle		25,000	
Less cost in 1961		8,000	17,000
Breeding herd		2,000	
Adjusted basis, June 30, 1963		4,000	(2,000)
Total income			86,350
Expenses:			
Labor		12,000	
Feed		1,300	
Seed		2,400	
Repairs to farm equipment, barns and fences		8,200	
Supplies, etc., for farm use		1,800	
Fertilizer and insecticides		1,550	
Veterinary fees and livestock medicine		100	
Gas and oil	$3,600		
Less 10% personal use	360	3,240	
Real estate taxes	4,500		
Less 10% personal use	450	4,050	
Mortgage interest		1,000	
Commodity Credit Corporation interest		600	
Utilities	1,500		
Less 10% personal use	150	1,350	
Total farm cash expenses			37,590
Farm net income before depreciation for eleven months			48,760
Deduct:			
Estimated December expense		3,000	
Depreciation for full year		23,300	26,300
Net income from farming for full year			$22,460

COMPUTATION OF DEPRECIATION FOR 1963

Depreciation as determined for items on straight-line method	$20,950
Depreciation on new beet harvester	2,350
Total depreciation for 1963	$23,300

Computation of Depreciation on New Beet Harvester

Additional first-year 20% depreciation		$ 2,000
Depreciation computed on straight-line method ($7,000 × 10% × ½)		350
Total deprcciation on new beet harvester		$ 2,350
Cost of new beet harvester		$10,000
Less:		
Investment credit	$ 700	
Salvage value	300*	
Additional first-year 20% depreciation	2,000	3,000
Adjusted basis for computation of depreciation		$ 7,000

b. The following recommendations might be made to Mr. Hayrack so that his net income will approximate $20,000 in 1963:

1. The soil conservation improvements might be made and a deduction, which is limited to 25% of the gross farm income, claimed for the amount paid in 1963. Payments received in 1964 under the Agricultural Adjustment Act would be income in 1964. Assuming that the full amount of $5,545 was claimed as a 1963 deduction, additional feeder cattle or grain in the amount of $3,545 could be sold to bring the amount of income up to $20,000.

2. If the soil conservation improvements were not made, additional expenditures totaling $2,000 might be made for livestock feed, seed and fertilizer to be used in 1964, or for repairs or other supplies to be used on the farm. Should additional equipment be needed, additional first-year 20% depreciation up to a maximum of $2,000 may be claimed as well as the customary depreciation allowance. The additional equipment would also give rise to an additional investment credit.

3. The effect of the investment credit on his income tax liability should be explained to Mr. Hayrack. Even though his taxable income for 1963 might approximate $20,000 as in prior years, his income tax liability would be reduced by the investment credit allowable. Mr. Hayrack appears to desire a fairly level net income from farming, but perhaps his primary interest is a somewhat uniform amount of income taxes to be paid.

*An alternative solution would ignore salvage value.

Solution 6

William and Mary Gardner

COMPUTATION OF TAXABLE INCOME

For the Year Ended December 31, 1963

Income:		
Law practice (see schedule 1)		$10,858
Oil wells (see schedule 2)		7,841
Dividends (see schedule 3)		1,000
Total		19,699
Deductions:		
Contributions (see schedule 4)	$ 600	
Taxes (see schedule 5)	2,000	
Exemptions (6 @ $600)	3,600	6,200
Taxable income		$13,499

COMPUTATION OF INCOME FROM LAW PRACTICE

(Schedule 1)

Income:			
Legal fees			$27,100
Reimbursement for car repairs			500
Total income			27,600
Expenses:			
Secretary's salary		$6,500	
Part-time clerical help		550	
Rent	$3,450		
Less rent from associates	2,100	1,350	
Automobile expenses and repairs		1,800	
Fees paid associates		1,500	
Filing fees and court costs		1,300	
Office expenses		900	
Country club dues and expenses (50% of $1,600)		800	
F.I.C.A. employer contributions (3⅝% × $5,350)		194	
Personal property taxes		30	
Depreciation		1,818	
Total expenses			16,742
Income from law practice			$10,858

INCOME FROM OIL WELLS
(Schedule 2)

	Total	Oil Wells A	Oil Wells B
Receipts	$20,800	$17,000	$3,800
Expenses:			
Drilling and development expense	4,275	275	4,000
Lease operations	2,725	2,425	300
Depreciation	1,284	819	465
Depletion	4,675	4,675	—0—
Total expenses	12,959	8,194	4,765
Net income	$ 7,841	$ 8,806	$ (965)

INCOME FROM DIVIDENDS
(Schedule 3)

Star Corporation, Chicago	$ 350
National Corporation, Houston	300
Total	650
Less dividends received exclusion	50
Net dividends from domestic corporations	600
Yukon Company, Ltd., Canada	400
Net income from dividends	$1,000

CONTRIBUTIONS
(Schedule 4)

Main Street Church	$500
United Fund	100
Total allowable contributions	$600

TAXES PAID
(Schedule 5)

Real estate (residence)	$ 675
Real estate (daughter's residence)	380
Personal property (home furniture)	60
State income (balance, 1962)	435
State income (estimate, 1963)	450
Total taxes paid	$2,000

SCHEDULE OF DEPRECIATION

Description	*Date Acquired*	*Basis*	*Prior Depreciation*	*Method*	*Life (years)*	*Depreciation This Year*
1962 Ford	1962	$2,900	$ 580	SYD	4	$1,015
Office furniture and equipment	Prior 1962	3,300	2,180	S/L	10	330
Office equipment	1963	1,860*	—0—	S/L	10	93
Law books	Prior 1962	3,800	2,500	S/L	10	380
Total depreciation chargeable to law practice						$1,818
Oil Well A	1960	8,400	2,669	DDB	14	$ 819
Oil Well B	1963	6,510*	—0—	DDB	14	465
Total depreciation chargeable to oil well income						$1,284

SCHEDULE OF DEPLETION

Oil Well A—27½% × $17,000 = $4,675

Oil Well B—No adjusted gross income, therefore, no depletion

*Basis after application of 7% investment credit.

AUDITING

May 14, 1964; 8:30 a.m. to 12:00 m.

Answer 1

1. B
2. D
3. A
4. C
5. B
6. A
7. A
8. C
9. D
10. B
11. B
12. D
13. C
14. B
15. D

Answer 2

The following changes may be made to improve the Kowal Manufacturing Company's system of internal control for payroll procedures:

1. A system of advice forms should be installed so that hirings, terminations, rate changes, etc., are reported to the payroll department in writing. Such forms should be approved by the foreman's superior.
2. Before an applicant is hired, his background should be investigated by contacting references to determine that he is not dishonest and has no other undesirable personal characteristics.
3. The supply of blank time cards should be removed. At the beginning of each week the payroll department should provide each worker with a time card stamped with his name.
4. A time clock should be installed and the workers required to "punch" in and out. A responsible employee should be stationed at the time clock to determine that workers are not "punching" the time cards of other workers who may be late or absent, or who may have left work early.
5. The foreman should collect the time cards at the end of the week, approve them, and turn them over to the payroll clerk. All time cards should be accounted for and any missing cards investigated.
6. If the Company has a cost system that requires the workers to prepare

production reports or to account for their time by work tickets, the time cards and the production reports or work tickets should be compared.

7. The payroll clerks' work should be arranged so that they check each other. Under the existing system of computing the payroll, the clerk who does not do the original computing should check the original work of the other clerk. As an alternative one clerk may make the original computations for the full payroll and the other clerk do all the rechecking.
8. The payroll checks should be prenumbered to control their issuance.
9. The payroll checks should be distributed to the workers by a responsible person other than the foreman. Unclaimed checks should be held in safekeeping by the payroll department until claimed by the worker.
10. A responsible person other than the chief accountant and the payroll clerks should reconcile the payroll bank account.
11. From time to time an officer of the Company should witness a payroll distribution on a surprise basis.

Answer 3

a. The CPA would determine from his evaluation of the internal control system the extent of the work to be performed under the audit program to verify the transactions recorded in the Estimated Liability for Product Guaranties account. During his audit of the Estimated Liability account and related documents and accounts the CPA would be especially watchful for evidence that the Company may be standing the expense of replacing motors no longer covered by the five-year guaranty. After the Estimated Liability account and related journal sources have been test-footed, periods of unusual account activity or the last month would be selected for auditing.

The following audit procedures would be applied to the credits to the account for the estimated liability for the guaranty costs:

1. Compare the credits and the charges to the related Provision account.
2. Compare the credits and the sales of new appliances covered by the guaranty.
3. Because the amount of the credit is determined principally from the statistical records and studies of the engineering department, sufficient tests of the records and studies should be made to give the CPA an assurance that the data are accurately and intelligently accumulated. Some effort should be made by the CPA to analytically compare these data and independently prepared statistics of sales, guaranties made good, reconditioning costs, etc.

The following audit procedures would be applied to the debits to the Estimated Liability account for the dealers' fees and the cost of the replacement motors:

1. Inspect the dealers' notices and compare them with the journal entries recording the fee charges and the cost of the motors installed under the guaranties.
2. Verify the authorized amounts of the fees by examination of documents or discussion with a responsible official. Test the journal record of fee

charges for agreement with the authorized fees.

3. Verify the unit costs of the replacement motors by the following procedures:
   (a) Compare the unit costs used in computing the charges and the unit costs used in valuing the inventory of motors.
   (b) Examine the costs of operating the motor reconditioning department, which determines the inventory value of the reconditioned motors, to ascertain that they are properly measured and fairly apportioned among the various motor models.
   (c) Compare the unit costs of the charges and of the continuous study being made by the engineering department.
   (d) In addition to auditing the unit costs of the charges, compare the charges and the entries in the perpetual records of the dealers' inventories.
4. On a test basis compare the journal entries recording the fee charges to the Estimated Liability account with the following documents or posted entries in accounts:
   (a) The charges to the Estimated Liability account for fees and for the cost of the motors installed under the guaranties.
   (b) The entries crediting the dealers' accounts with the fees earned.
   (c) The entries reducing the dealers' perpetual inventory accounts by the motors installed.
   (d) The documents showing receipt of the motors still under guaranty that were returned for reconditioning.
   (e) The statistical records kept by the engineering department.
5. Consider the exceptions taken by dealers to the CPA's requests for confirmation of their accounts and inventories of replacement motors.

After the foregoing procedures have been applied to the recurring entries in the Estimated Liability account, any nonrecurring or unusual entries should be examined.

b.

The Moss Company
FORMAT OF WORKSHEET TO TEST THE ADEQUACY OF THE BALANCE IN THE ESTIMATED LIABILITY FOR PRODUCT GUARANTIES ACCOUNT
December 31, 1963

Model Year	(A) Number of Appliances Sold Under Guaranty	(B) Anticipated Number of Replacements	(C) Replacements Made to Date	(D) Number of Replacements Expected (B-C)	(E) Cost of Replacement*	(F) Estimated Liability (DxE)
1963						
1962						
1961						
1960						
1959						
			Total estimated liability			
			Balance in Estimated Liability account			
			Account over (under) estimate			

*Service fee plus cost of replacement motor

Answer 4

The auditor's report of his examination of the financial statements of the Young Manufacturing Corporation includes the following deficiencies:

1. Disclosure of the scope of the auditor's examination by a footnote to the financial statements is improper. Even though the auditor may assist in drafting the footnotes and may insist upon changes so that they fairly present the matters being disclosed, the footnotes are the representations and responsibility of the company. Disclosure of the scope of the auditor's examination, a requirement imposed upon him by generally accepted auditing standards, should be made in the auditor's report or opinion which is his responsibility alone. The footnote, as presented, intermixed the two responsibilities.
2. The statement that the balances of the accounts receivable were "correct" should not have been made because it implies a degree of accuracy that is not intended by an auditor. The word "correct" suggests that the auditor is "certifying" the accuracy of the accounts, whereas the scope of his audit limits his attestation of the account balances to the fact that they "fairly present" the data or information.
3. Two items in the Statements of Condition, "Accounts receivable" and "Inventories," are listed as "pledged" but no footnotes or comments disclose the nature or extent of the commitments. The item "other liabilities" probably represents the liability for which the assets serve as security; its nature should be appropriately disclosed in the statements. Also the terms of the long-term mortgage should be disclosed. Therefore the auditor should disclose this information in a middle paragraph in his report and his opinion should be appropriately qualified.
4. The auditor's report is written in the first person apparently because the auditor is an individual practitioner. Although some CPAs contend that it is inappropriate for an individual to practice under a style that denotes a partnership, individual practitioners generally use "we" rather than "I" in writing their reports. The "we" used in the report is the so-called "editorial we" and is used because it is more formal, impersonal and carries more dignity. As used in auditor's reports "we" is not to be taken in its literal (plural) sense.
5. The auditor's report is deficient because the dates of the balance sheet and the period covered by the income statement are not given. These dates should be given so that the reader will clearly understand that the opinion is limited to specific financial statements. Clarification as to the statements covered by the opinion is imperative because comparative financial statements are presented.
6. The title "Balance Sheet" is used in the report, but "Statements of Condition" is employed as the title of the financial statement. Different titles should not be used because a criterion of professional work is that uniform and accurate terminology be used.
7. Although the auditor's report states that he examined the Statement of Income and Retained Earnings, the attached financial statements do not include the Retained Earnings statement. All financial statements referred to in the auditor's report should be appended to the report.

   The difference of $66,481 between the opening and closing balances of the Retained Earnings account is not reconcilable to the reported net income for the year of $52,924. Because an amount of $13,557 in the Retained Earnings

account is not accounted for, the auditor's report should contain at least a qualification on the grounds of inadequate disclosure. If the auditor's examination disclosed that the $13,557 is a net amount of charges and credits to the Retained Earnings account, some of which bear directly upon the current year's income statement, the auditor may be compelled to render an adverse opinion.

8. The opinion paragraph should contain the phrase "in our opinion" to clearly disclose that the statement as to fair presentation is a professional opinion, not a statement of fact.
9. The wording "in conformity with consistent generally accepted principles of accounting" does not have the same meaning as "in conformity with generally accepted principles applied on a basis consistent with that of the preceding year." The first wording implies that the accounting principles employed are consistent one to the other. The consistency or lack of consistency of generally accepted accounting principles is not in question. Instead, generally accepted auditing standards require the auditor to state whether the accounting principles have been applied on a basis consistent with prior years.

Answer 5 **Tuck Company**

RECONCILIATION OF RECEIPTS, DISBURSEMENTS & BANK ACCOUNT

For the Month of December 1963

	11/30/63 Beginning Recon-ciliation	*Receipts*	*Disburse-ments*	*12/31/63 Ending Recon-ciliation*
Per bank statement	$19,400	$148,700	$132,500	$35,600
Deposits in transit:				
11/30/63	1,100	(1,100)		
12/31/63		2,400		2,400
Outstanding checks:				
11/30/63	(2,300)		(2,300)	
12/31/63			4,000	(4,000)
Check of Tucker Company charged in error			(300)	300
Dishonored checks returned during December		(400)	(400)	
Adjusted bank amounts	$18,200	$149,600	$133,500	$34,300
Per books	$18,200	$149,690	$124,885	$43,005
Correction of recording of check #1501			(675)	675
Cancellation of check #1504			(800)	800
Counter check drawn by president			200	(200)
Postdated check #1575 presented for payment			10,000	(10,000)
Correction of recording of note proceeds		(90)		(90)
Bank service charges made in Dec.			30	(30)
Adjustment for check #2540			(140)	140
Adjusted book amounts	$18,200	$149,600	$133,500	$34,300

Answer 6

a. The growth of public accountancy led to the recognition of a need for a code of professional ethics to encourage the development and maintenance of high standards of professional competence, to strengthen the relationships among the members of the profession, and to promote the welfare of the general public.

The accounting profession, therefore, voluntarily adopted a code of professional ethics to regulate the actions of its members and to set standards for them. The code is based upon philosophical general ethics, which are concerned with the good of all mankind but require codification so that they can be applied to special groups such as the accounting profession.

The rules of the code have been formulated as standards of moral suasion, as tangible bases for self-disciplinary action, and as criteria for the general public to use in distinguishing between ethical and unethical practitioners. The existence of a self-administered and self-enforced code increases the confidence of the client and the general public in the CPA, his report and his services.

The integrity of the CPA is not guaranteed by the code because integrity is primarily a mental attitude. The CPA is compelled by the code, however, to keep clear of situations which might tempt him to compromise his integrity. The public is therefore reassured that the CPA will avoid exposing himself to such temptation.

b. 1. The CPA's code of professional conduct prohibits the direct or indirect offer of employment by a CPA to an employee of another public accountant without first informing the other public accountant for the following reasons:
   (a) The rule minimizes the possibility of impairment of service to clients through the unexpected loss of valuable staff members.
   (b) The practitioner is able to concentrate on improving his service to his clients because he is not under the menace of sudden loss of important members of his staff.
   (c) The CPA is encouraged to invest time and effort in training his employees because he has some assurance that the trained employee will not be taken from him without his knowledge of the prospective offer.
   (d) The profession as a whole is strengthened because ill will among individual members is avoided. Furthermore, common courtesy requires open dealings between professional colleagues.
   (e) Less scrupulous practitioners are discouraged from luring away staff assistants from their present employers who may have taught them all they know.

2. The CPA's code of professional conduct does not prohibit the employee of a CPA firm from applying for a position with another CPA firm. The initiative in negotiating must originate with the employee. Many CPAs, however, are reluctant to negotiate with the employee until the present employer is notified so that ill will may be avoided.

   If the staff man is dissatisfied with his progress with the employer and the employer is open-minded, the man might discuss the reasons for his apparent lack of progress before he casts about for another position. Fre-

quently such discussions might alert the employee to his personal shortcomings. He may be encouraged to overcome these deficiencies and to stay with his present employer.

Should the employee successfully negotiate for another position, however, the employee should give his present employer ample notice of his decision so that a replacement can be employed with minimum interruption of service to clients and so that any future professional contacts between former employer and employee will not be on a strained basis.

c. The following arguments support the rule of professional conduct that CPA firms should not be incorporated:

1. The success of the CPA is dependent upon his winning the confidence of his clients. The client's confidence is heightened by the realization that he is dealing with an individual who has special knowledge, who has been accepted by his peers, and who has subscribed to a code of ethics and can be penalized for misconduct. This confidence might be disturbed if the client were dealing with a corporation, which does not possess these special attributes, rather than with a professional partnership.
2. The services of the CPA are essentially personal in nature, and incorporation might undermine this intimate relationship between CPA and client. The client might be unable to attribute the characteristics of this personal relationship to a corporation.
3. Professional responsibility is an important element in the intrinsic value of the CPA's services. Any action that might suggest that the CPA wished to avoid this responsibility should be avoided. If this responsibility and attendant liability were limited by the corporate form of practice, the CPA might be tempted or, more importantly, the general public might suspect that the CPA was tempted to take risks which he would not assume under the noncorporate form of practice.
4. Under the corporate form laymen might participate in the fees and income of professional practice, a participation that is prohibited under the profession's rules of professional conduct. Furthermore, the controlling stockholder might be a layman free from the control of professional ethics. His principal interest might be financial gain and he might direct the policies of the corporation toward this end. The public would recognize the nonprofessional practices and the acceptance of public accounting as a profession might therefore be lost.
5. Since self-interest appears to be the sole motivation of the corporate form, the public's attitude toward public accounting as a profession might be damaged. If the accounting profession creates the impression that it is unduly concerned with its economic welfare, it might become an object of public distrust.

In addition to the foregoing ethical considerations, the following problems or drawbacks to the incorporation of CPA firms might be encountered:

(a) Many state laws preclude the incorporation of one-man practices or two-partner firms; the difference in treatment might lead to dissension within the profession.

(b) Firms in interstate practice would be confronted with a wide variety of legal requirements.
(c) The professional corporation might be subject to additional income, franchise or business taxes from which the professional partnership may now be exempt.
(d) The Treasury Department might attack the professional corporation (especially one with only a single shareholder) as a tax avoidance scheme.
(e) Some firms might be compelled to reorganize their management to comply with federal tax regulations for professional associations which require centralization of management or a central management group to make binding decisions for the association.
(f) Privileged communication might be jeopardized in those states granting this statutory privilege to CPAs.
(g) Important features of CPA partnerships are the partners' senses of personal responsibility, identity with the firm, and equality with the other partners. These highly desirable senses might be weakened under the corporate structure.
(h) The progress of CPAs under self-regulation has encouraged government agencies to become increasingly dependent upon the accounting profession. Adoption of the corporate form might reverse this trend and might even invite governmental surveillance.

Answer 7

Part a. During the course of the plant tour the CPA will remember that an important aspect of the audit will be an effective analysis of the cost system. Therefore he will observe the nature of the company's products, the manufacturing facilities and processes, and the flow of materials so that the information thus obtained can be related later to the functions of the cost system.

The nature of the company's products and the manufacturing facilities and processes will reveal to the CPA the features of the cost system that will require close audit attention. For example, the audit of a company engaged in the custom-manufacture of costly products such as yachts would require attention to the correct charging of material and labor to specific jobs, whereas the allocation of material and labor charges in the audit of a beverage-bottling plant would not be verified on the same basis. The CPA will note the stages at which finished products emerge and where additional materials must be added. He will also be alert for points at which scrap is generated or spoilage occurs. He may find it advisable, after viewing the operations, to refer to auditing literature for problems encountered and solved by other CPAs in similar audits.

His observation of the manufacturing processes will reveal whether there is idle plant or machinery that may require disclosure in the financial statements. Should the machinery appear to be old or poorly maintained, the CPA might expect to find heavy expenditures in the accounts for repairs and maintenance. On

the other hand, if he determines that the company has recently installed new equipment or constructed a new building, he will expect to find these new assets on the books.

In studying the flow of materials the CPA will be alert for possible problems that may arise in connection with the observation of the physical inventory, and he may make preliminary estimates of his audit staff requirements. In this regard he will notice the various storage areas and how the materials are stored. He may also keep in mind for further investigation any apparently obsolete inventory that he sees.

His study of the flow of materials will disclose the points at which various documents such as material requisitions arise. He will also meet some of the key manufacturing personnel who may give him an insight into production problems and other matters such as excess or obsolete materials, and scrap and spoilage. He will be alert for the attitude of the manufacturing personnel toward accounting controls. The CPA may make some inquiries about the methods of production scheduling, timekeeping procedures and whether work standards are employed. As a result of his observations, the internal documents that relate to the flow of materials will be more meaningful to him as accounting evidence.

The CPA's tour of the plant will give him an understanding of the plant terminology that will enable him to communicate fluently with the client's personnel. The measures taken by the client to safeguard assets, such as protection of inventory from fire or theft, will be an indication of the client's attention to internal control measures. The location of the receiving and shipping departments and the procedures in effect will bear upon the CPA's evaluation of the system of internal control. His over-all impression of the client's shop housekeeping and modernity of the plant will suggest the accuracy and adequacy of the accounting records that will be audited.

Part b. The following procedures may be employed by the CPA to determine whether slow-moving or obsolete items are included in the inventory:

1. When he is observing the physical inventory, the CPA should be watchful for evidence of obsolete or slow-moving inventory. This evidence might take the form of dusty or battered cartons containing the inventory. A change in the type of carton or style of printing on the carton may suggest obsolete inventory. If the inventory is not in cartons, the material itself should be examined for signs of rust, corrosion or dirt accumulation. Since slow-moving inventory is frequently moved to an out-of-the-way storage area, inventory found in relatively inaccessible locations should receive close scrutiny. Broken lot quantities of raw materials, such as half coils of steel or paper, should receive attention on the chance that the client no longer has calls for the product manufactured from that raw material.
2. Where the client stamps the approximate date of manufacture by code or batch number on the finished product, the CPA may identify slow-moving items by obtaining a key to the code.
3. In the process of testing the pricing of the inventory, where referral is made to vendors' invoices for prices, the CPA should also consider whether the invoice dates are clues that the invoiced goods may be slow-moving or obsolete.

4. Quantities of certain items listed in the opening inventory worksheets should be compared with quantities of the same items in the closing inventory worksheets. Items showing little or no change in quantity should be investigated.
5. Perpetual inventory records, when available, should be inspected to ascertain whether any slow-moving items exist.
6. Often a feature of the internal accounting control is the submitting of reports by the inventory storekeepers of slow-moving or obsolete inventories. The CPA should examine these reports if they are prepared.
7. Examination of sales records and comparison with prior years may disclose products that have been discontinued. Any inventory of these discontinued products may be classified as obsolete.
8. The rate of inventory turnover should be computed and compared with prior years and with other companies in the same industry. A lowering rate may indicate growing quantities of obsolete and unsalable merchandise.
9 Inquiries should be made at several levels of personnel to learn if they are aware of any obsolete or slow-moving merchandise. Perhaps the storekeeper or the warehouse foreman will know of such inventory which may be overlooked by the records-keeping department or inaccurately carried in the records.
10. The letter of representation by management should include a statement concerning the existence of any obsolete merchandise in the inventory. This will remind management of its responsibility to tell the auditor about obsolete merchandise, if any.

COMMERCIAL LAW

May 15, 1964; 8:30 a.m. to 12 m.

Answer 1

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

Answer 2

61. True	76. False	91. True	106. False
62. True	77. True	92. True	107. False
63. True	78. False	93. True	108. False
64. False	79. True	94. True	109. True
65. True	80. False	95. False	110. True
66. True	81. False	96. True	111. True
67. True	82. False	97. True	112. True
68. True	83. False	98. True	113. True
69. True	84. False	99. False	114. False
70. True	85. True	100. False	115. True
71. True	86. False	101. True	116. True
72. True	87. True	102. True	117. True
73. True	88. True	103. False	118. False
74. True	89. True	104. False	119. True
75. True	90. False	105. False	120. True

Answer 3

121. True	136. False	151. False	166. False
122. False	137. True	152. False	167. False
123. False	138. False	153. False	168. False
124. True	139. True	154. True	169. False
125. True	140. True	155. False	170. False
126. False	141. False	156. True	171. False
127. False	142. True	157. True	172. False
128. False	143. False	158. True	173. True
129. False	144. False	159. False	174. True
130. True	145. False	160. True	175. True
131. True	146. False	161. False	176. False
132. True	147. True	162. True	177. True
133. False	148. False	163. True	178. True
134. False	149. False	164. True	179. False
135. True	150. False	165. False	180. False

Answer 4

a. No, according to the common law. Yes, according to the Uniform Commercial Code.

The common law rules of contracts treated an option or firm offer, despite its promissory nature, as it would any other offer. That is, they required that a promise such as this be supported by a consideration in order to be legally enforceable as a contract. Since there was no consideration given for the ten-day option, the promise is not a separate contract. Thus, since it is a mere offer, it may be revoked at any time prior to acceptance. Since Dennis' revocation was received prior to acceptance, no contract would arise under the common law rules.

The Uniform Commercial Code has recognized the commercial utility of enforcing a firm offer or option even if it is not supported by consideration. It has, therefore, eliminated the common law requirement of consideration and made such firm offers irrevocable. The Code provides that "an offer by a merchant to buy or sell goods in a signed writing which by its terms gives assurance that it will be held open is not revocable, for lack of consideration, during the time stated or if no time is stated for a reasonable time, but in no event may such period of irrevocability exceed three months. . . ."

b. Yes. The use of the same means of communication that was used by the offeror entitles the offeree to benefit from the well-recognized rule of contract law that such an acceptance takes place when the acceptance is placed in the hands of the independent agency for transmittal, i.e., in the hands of the postal service. Therefore, the acceptance would take place upon posting and not upon receipt. Since the posting occurred on April 22, well within the ten-day option period, the acceptance would be timely. The fact that it was

delayed in transit is irrelevant. This conclusion would be the same under the common law and the Code.

c. Specific performance would not be available to William. The subject matter of the contract was not unique nor does it appear that there are any other circumstances which would make the recovery of damages inadequate.

Answer 5

Part a.

1. No. Where a sale has been made on approval, the title to the goods and the risk of loss does not pass to the buyer until he has in some way manifested his acceptance. However, he would be liable for the loss if he were negligent in the care of the property. Here, it is clear that the goods were stolen during the ten-day trial period. There had been no negligence on the buyer's part, and there had been no acceptance; therefore, the risk of loss is upon the seller and not upon Able.
2. No. Again title and risk of loss remain with the seller during the return shipment of the goods purchased on approval. Thus Able will not be liable for the loss.
3. Although, typically, acceptance of the goods is accomplished by an express notification of acceptance, it may also be manifested by implication.

   One obvious way in which the buyer will be deemed to have accepted the goods without notification occurs when the buyer retains the goods beyond the time indicated, or a reasonable time if no time is indicated, and fails to notify the seller of his election to return the goods.

   Another well-recognized way in which an acceptance will be manifested without notification is for the buyer to use the goods in a way which is inconsistent with the trial, e.g., making a permanent alteration in the goods or selling them to another party.

Part b.

If the buyer inspects the goods he normally loses his express warranty protection to the extent that he actually discovers defects or they are so obvious that the inspection could not but have revealed them.

Insofar as implied warranties are concerned, the buyer who has made an inspection will be precluded from asserting defects which he discovered and also those defects which an examination ought to have revealed to him.

Since warranty protection, in general, is based upon reliance on the seller's judgment, it is obvious that an inspection which reveals defects will have the effect of cutting down on the buyer's warranty protection.

Answer 6

Part a.

1. Privileged communication is a rule of evidence under which certain evidence arising out of special confidential relationships is not admissible in court.
2. The policy factor behind this rule is the social desirability of fostering free and complete discussion and exchange of information between the parties in

these special confidential relationships. This policy factor is deemed to outweigh the fact that otherwise valid evidence is being excluded.

3. a. Attorney — client
   b. Husband — wife
   c. Physician — patient
   d. Priest — penitent
   e. Accountant — client
4. The common law does not afford the accountant-client relationship the requisite status necessary to qualify as privileged communication. Thus, only in those states which have expressly changed the common law rule by statute will evidence arising out of the accountant-client relationship be excluded.

Part b.

1. No. In cases based upon negligence the courts have held that the liability of an accountant does not run to third parties who neither engaged him nor who were indicated as the beneficiaries of the audit.

   The rationale underlying this rule, which limits the accountant's liability for negligence, is that to hold otherwise would be to expose the accountant to a liability which would be indeterminate both in amount and number of people who could assert such claims. To expose the accountant to this extent of liability for mere negligence seems to be extreme in light of the circumstances surrounding the relationship between the parties.
2. Yes. Where the creditors engaged the firm to make the audit, there is a direct duty of care owed to these parties based upon either their contractual relationship or according to the common law rules of negligence.

Answer 7

a. The real owner will prevail. The basic rule is that one who takes title from a thief obtains no better title than the thief had, i.e., no title at all. The fact that the stolen goods were placed in a public warehouse, a negotiable receipt issued and the warehouse receipt then transferred to a bona fide purchaser does not change the result. The owner will be able to reclaim the goods.

b. The real owner will prevail. The basic rule stated above will again determine the rights of the respective parties. Thus, since the goods were stolen and the thief had no title to convey, Charlie cannot defeat the real owner's rights.

c. Yes, Charlie would prevail. The law makes a distinction between the theft of goods and goods obtained by fraud in the inducement. Where a party takes title from one who has committed a fraud, he may obtain better title than the one who committed the fraud had. Thus, if Charlie purchased in good faith and for value he can defeat the rights of the defrauded party. The party who committed the fraud obtained a voidable title to the goods (as contrasted with no title in the theft situation), which, when transferred to a good-faith purchaser, gives him a title which is superior to that of the prior owner of the goods.

d. Roger will prevail. Since the defect in title relates to the document of title itself (as contrasted with the title to the subject matter underlying the issuance of the document), the good faith purchaser for value of a negotiable warehouse receipt in bearer form takes title free of prior defects in the chain of title such as theft. The law, in order to foster freedom of transfer of such quasinegotiable instruments, gives the innocent purchaser superior rights to the instrument and goods than those of the prior owner of the stolen warehouse receipt.

Answer 8

Part a.

1. A trading partnership is, generally speaking, one doing a business of buying or selling for profit; those in which the business is something other than buying and selling for profit constitute the nontrading class.
2. The distinction is important for the purpose of determining the limitations on a partner's apparent authority. Thus in a trading firm, because its primary function is buying and selling for profit, each partner has the apparent authority to borrow money and execute negotiable instruments in the usual course of business. In a nontrading firm a partner's powers are more limited and a partner does not have the apparent authority to borrow money or to execute negotiable instruments for the firm.
3. The AB&S partnership will prevail. S had no express authority to endorse and pledge the stock certificates belonging to the firm. Nor did he have the apparent authority even though the firm was an acknowledged trading partnership. This is so because he was using firm property for his own personal transactions. It should be obvious to the reasonably prudent businessman that such an exercise of authority could not be undertaken without an express grant of authority. Therefore, the bank had constructive notice of the wrongdoing; such notice negates the possibility of any apparent authority S might have.

Part b.

Yes. He will be entitled to interest on the $5,000 loan for the entire period during which the money has been retained by the firm. If no express interest was agreed to by the parties, the court will allow either a reasonable interest rate or the legal interest rate to be charged for the loan.

No interest payment is due to Peter with respect to the original $15,000 capital contribution. Capital contributed to the partnership does not entitle the contributing partner to any interest unless it is expressly provided for in the partnership agreement.

As to the additional $10,000 contribution to capital, Peter will be entitled to either a reasonable interest or the legal interest from the date when this amount should have been repaid to him.

THEORY OF ACCOUNTS

May 15, 1964; 1:30 p.m. to 5 p.m.

Answer 1

Part a.

1. Capital expenditures are intended to benefit more than one accounting period. The expenditure should therefore be recorded by a charge to an asset account for allocation to the periods benefited.

   Revenue expenditures benefit the operations of the current period only. They should be recorded by charges to the appropriate expense accounts.

2. If a capital expenditure is improperly classified as an expense, assets, retained earnings and income for the period will be understated. In future periods income will be overstated by any amount that would have been amortized had the expenditure been properly capitalized. Assets and retained earnings will be understated on future balance sheets by successively smaller amounts until the error has been fully counterbalanced.

   If a revenue expenditure is improperly capitalized, assets, retained earnings and income for the period will be overstated. Income will be understated in subsequent periods as the improperly capitalized item is charged to the operations of those periods. Assets and retained earnings will continue to be overstated in subsequent balance sheets by successively smaller amounts until the improperly capitalized item has been completely written off.

3. The basic criterion for classifying outlays as revenue or capital expenditures is the period of benefit. The amount of detail necessary to maintain subsidiary records, the materiality of the expenditures, and the consistency with which various expenditures recur from period to period are other criteria generally considered in establishing a capitalization policy.

   Firms frequently establish an arbitrary amount below which all expenditures are expensed, irrespective of their period of benefit. The level at which this amount is set is determined by its materiality in relation to the size of the firm. The objective of such a policy is to avoid the expense of maintaining excessively detailed subsidiary records. Expenditures for items which fall below the set amount but are material in the aggregate should be capitalized if total expenditures for these items vary significantly from period to period. A capitalization policy that reasonably applies these criteria, although it disregards the period of benefit and is therefore lacking in theoretical justification, will not significantly misstate periodic income.

Part b.

1. The fair market value of the acquired site, as evidenced by the contract price, is $60,000. It is this amount that represents the actual bargained price of

the land in a cash transaction. To charge any portion of the option costs to the land account is to disregard the bargained price of the acquired site and, further, implies that the land is more valuable because of the options.

The purchase of the options enabled the client to delay his selection of a site until the advantages and disadvantages of each were carefully weighed. The benefits to be derived from the net advantage of the selected site over the rejected sites will accrue to the operations of the contemplated plant facility. The cost of the options should therefore be separately capitalized and allocated to the periods benefited.

It may also be argued that the cost of the options represents management's failure to plan for the acquisition of a site. Such a contention leads to the conclusion that the cost of the option is a loss and should be expensed immediately, and it supports the recording of the cost of the acquired site at $60,000.

2. The actual cost of the selected site is the sum of the contract price plus the cost of the option which was exercised to purchase the land. All costs incurred to secure title to the land are properly includable as part of its cost. However, to capitalize the cost of the options that were allowed to lapse would be inappropriate. They have no bearing on the acquisition of effective title to the selected site and should be treated as a loss.
3. The options were purchased with full knowledge that, after the relative advantages of the three locations were investigated, only one of the options would be exercised. Because the intent was to purchase only one of the three sites, the options should be viewed as an integrated plan for acquiring the site which was ultimately selected. Thus, the cost of all three options should be capitalized as a part of the cost of acquiring the selected site.

Answer 2

a. Single-year statements represent but a short segment of a firm's history. They are essentially interim reports on a going concern's continuing business activity. The allocation of costs and revenues to these short periods of time is, to a considerable extent, based upon convention, judgment, and estimates. The shorter the time period, the more difficult becomes the matching process and the more it is subject to error. Further, single-year statements may not be representative of a going concern's long-run progress because of the abnormally favorable or unfavorable economic or other conditions experienced in that year.

An analysis of single-year statements does not, therefore, provide information concerning trends and the changing relationships that occur over time. For this reason the information generated by the application of analytical procedures to a set of single-year statements is of limited interpretive value. Information concerning trends and relationships in the periodic changes in financial position and operating results can best be preseted by the use of comparative statements.

Financial statements also have limitations for analytical and interpretive purposes by virtue of the inherent limitations of the accounting function. Many factors which significantly affect the progress and success of a firm are not

of a financial character, and are not, therefore, capable of being expressed directly in financial statements. Included among these factors are general economic conditions, labor relations, customer attitudes, and the like. The preparation of comparative statements would not alleviate these limitations.

b. Changes or inconsistencies in accounting methods, policies, or classifications during the years covered by comparative statements may result in the misinterpretation of reported trends or changing relationships. For example, a change in a firm's depreciation or inventory valuation methods, even though the alternative procedures are acceptable, could easily destroy the comparability of corresponding items in two or more of the periods covered.

   Material errors, and their correction in a subsequent period, material nonrecurring gains or losses, mergers or other acquisitions, and changes in corporate activities can also contribute to the misinterpretation of corresponding items on comparative statements.

   To avoid the misinterpretations which may result from these factors, footnotes, explanations and accountants' qualifications which appeared on the individual statements for the years covered should be repeated or referred to in the comparative statements to the extent that they continue to be required for full disclosure.

   Changing price levels during the periods covered may also distort comparative statements. To begin with, even the items on a comparative balance sheet or income statement that pertain to a specific year are not all expressed in dollars having the same purchasing power. For example, in an era of rising prices a given year's depreciation charges will represent older dollars having greater purchasing power than other income statement items. Inventory methods other than Lifo also add to the inflationary distortion of the income statement. Similarly, balance sheet items for a given year are expressed in dollars of varying purchasing power.

   Added to these vertical distortions which exist within the individual years covered by comparative statements are horizontal distortions in the trends and relationships of corresponding items between years. An upward trend in sales, for example, may actually represent a constant level of or even decline in physical volume which is being sold at increasingly higher prices.

   Because of the misunderstanding which is likely to result from conventionally prepared comparative statements during periods of fluctuating price levels, their usefulness as an analytical and interpretive tool can be severely restricted. Price level fluctuations can completely destroy the comparability of the data contained in the statements.

   Supplementary comparative statements fully adjusted for the effects of fluctuations in the price level would restore the comparability of the financial position and operating data and thereby enhance their usefulness as tools of analysis and interpretation.

Answer 3

a. Cash flow is the excess of funds received from revenue over the funds used for out-of-pocket expenses. It is the net income from operations, adjusted

by adding back expense items that currently do not use funds, such as depreciation, depletion, write-off of prepaid expenses, etc., and by deducting revenue items that do not currently provide funds, such as amortization of deferred income. The calculation outlined above results in the amount that is shown on the funds statement as "Funds provided by operations."

b. 1. No reliance can be placed upon cash flow as a substitute for or improvement upon net income, properly determined by accrual accounting, as an indication of the results of operations. The portion of the cash flow obtained from adjustments for noncash entries is merely a part of the cycle of investing in an asset, recovering its cost from revenue-generating operations, and reinvesting in a new asset. This aspect of the cash flow has no effect upon the retained earnings of the company. It follows that only net income can be related to the stockholders' investment to determine the success of the business operations.

2. A company that is breaking even might have a large cash flow because of large charges to expense that did not require cash disbursements (note that the source of cash flow is not noncash expenses but, generally speaking, revenues). If the company has a net income, then its cash flow will be even larger. In the latter case the net assets of the company are increased by the amount of the net income.

The ability of a company steadily to expand depends on its earnings (or additional investment of capital funds), not on its cash flow. A company that is breaking even will be able to expand its physical plant to some extent because the cash flow resulting from its disinvestment in existing units can be used to acquire one or more additional units before existing units are retired if, and only if, the units of physical property needed for expansion are low enough in cost to be acquired from funds derived from the disinvestment process. This kind of expansion could not be "steady"; that is to say, the portion of cash flow not represented by net income would have very definite limits for financing expansion of plant because its use merely maintains the investment in plant.

The ability of a company regularly to pay dividends depends on the availability of both cash and an owners' equity balance to which dividends may legally be charged. A large cash flow would tend to make cash available. The portion of cash flow represented by net income would tend to build up a retained earnings balance to which dividends could usually be charged. If a firm can legally pay dividends and does so regularly even though it is breaking even, it will be reducing its net assets by paying out cash made available through the conversion of prior years' investments into liquid assets.

Finally, the ability of a company steadily to expand or regularly to pay dividends is affected not only by those two competing uses for funds but also by other competing demands. For example, if amortizable investments in assets have been financed by debt, debt retirement may require heavy uses of cash. Similarly, the desire to retire preferred or even common stock may affect the ability to pay dividends or to expand. Cash flow information has little, if any, significance unless it is related to the

entire financial situation as shown in a funds statement. Only by analyzing cash flow in this context can conclusions be drawn about its availability for specific purposes.

c. Some of the uses to which funds statements may be put by the readers of the financial statements include the following:
   1. The effectiveness of management's control over business operations may be weighed. If management has set forth plans for the projected use of funds obtained, say, through additional financing or through the "generation" of cash by earnings, readers will be able to compare the actual uses to which the funds were put with management's projected use of them.
   2. The adequacy of the capitalization of the business may be measured. A knowledge of a company's movement of funds would be of material assistance to the readers in their estimation of the amount of capital, both temporary and permanent, required for current and subsequent years.
   3. Comparisons of cash "generation" may be made between companies and between industries. These comparisons will serve as a guide to investors interested in the financial ability of companies to maintain dividend payments, to meet debt servicing requirements, to replace physical plant, and to finance expansions and increased working capital needs.
   4. An evaluation of a company's financial policies and decisions is facilitated by disclosing information not readily obtainable from other financial statements. For example, funds statements which cover several years of operations will show past financing methods, dividend policies, capital expenditure decisions, and the like, enabling the reader to evaluate their effect on the company's growth and profitability.
   5. Reporting important sources and uses of funds makes a material contribution to an understanding of the financial aspects of a company's operations, such as how profits were used, why dividends were not increased, why additional debt was incurred, and why working capital decreased.

Answer 4

a. 1. The entire amount paid in prior to default may be refunded to the subscriber.

Common stock, subscribed	$1,000	
Excess of paid-in capital over stated value, subscribed	4,000	
Subscriptions receivable		$3,000
Cash		2,000

   2. The amount paid in may be refunded to the subscriber less the expense of resale and less any excess of the original subscription price over the resale issue price.

Common stock, subscribed	$1,000	
Excess of paid-in capital over stated value, subscribed	4,000	
Subscriptions receivable		$3,000
Payable to defaulting subscriber		2,000*

*Expenses and losses on resale are charged to this account before any refund is made.

3. The entire amount paid in may be forfeited by the subscriber.

Common stock, subscribed	$1,000	
Excess of paid-in capital over stated value, subscribed	4,000	
Subscriptions receivable		$3,000
Paid-in capital from forfeited subscription		2,000

4. The corporation may issue the number of shares which the subscriber has in effect paid for in full.

Common stock, subscribed	$1,000	
Excess of paid-in capital over stated value, subscribed	4,000	
Subscriptions receivable		$3,000
Excess of paid-in capital over stated value		1,600
Common stock		400

b. 1. Where there is no reason to doubt their collectibility, subscriptions receivable are traditionally regarded as legitimate corporate assets to be classified as current if the collections are expected within the current period or as noncurrent if collectible after the current period.

Support for this treatment is based on the fact that the corporation has an enforceable claim against the subscribers to its stock. Also, the subscribers usually acquire the full status of a stockholder even though the certificates are not issued until full payment is received.

An exception to the foregoing treatment of subscriptions receivable as an asset is required when their collectibility is doubtful or when there is reason to believe that the uncollected balances will not be called. Under these circumstances it is considered appropriate to treat the receivables as a deduction from stockholders' equity.

2. The treatment of subscriptions receivable as a contra to stockholders' equity, irrespective of when they are expected to be collected, is based on the view that no real assets are acquired until the potential stockholders actually invest in the corporation. To treat potential capital from subscribers to the corporation's stock as though it were an existing resource of the firm is to disregard the fact that no exchange of property has taken place. Such a treatment makes no distinction between the economic resources currently devoted to the business purposes of the corporation and those which will in the future be so devoted. A subscription contract is an agreement to invest in a corporation and does not in itself constitute an investment. The contract is executory in nature and no exchange of values occurs until the subscriber makes payments on the contract.

Moreover, stockholder equity is regarded as representing sources of capital. To treat subscriptions receivable as an asset and capital stock subscribed as an equity is to say that the asset of which the latter is a source is its own promise to invest.

The logical conclusion based on this viewpoint is that subscriptions receivable should be treated as a contra to stockholders' equity (or as a footnote disclosure item). To treat it otherwise is to overstate both assets and stockholders' equity.

Answer 5

Part a.

1. Reasons for a manufacturing company's investing in securities include the following:

    (a) To obtain, or improve relations with, important suppliers or sales outlets.
    (b) To acquire control of other companies.
    (c) To make profitable use of funds temporarily available because of
        (1) Seasonal variations in the level of business activity.
        (2) Accumulation for a special purpose, such as dividend payment, capital expenditure project, or tax payment.
        (3) The issue of stocks or sale of bonds, the proceeds of which are to be permanently invested in the relatively near future.
    (d) To invest cash that is transferred to contractual or voluntary funds, such as bond retirement funds, pension funds, plant expansion funds, etc.
    (e) To invest cash balances which are maintained as a margin of safety over the usual working capital requirements.
2. To be classified as a current asset an investment must be temporary in nature and readily marketable. Also, the purpose of the investment must be such that the company intends to convert it into cash within the normal operating cycle of the business. Investments which do not satisfy these criteria must be excluded from current assets.

Part b.

The three methods of classifying the bond sinking fund on the Walker Company's balance sheet are as follows:

1. Report the entire amount of the sinking fund as an asset, including the investment in the Company's own bonds.
2. Report the entire fund as an offset to the bond liability account.
3. Report the Company's bonds held without cancellation in the fund as an offset to the bond liability account and the balance of the fund as an asset.

The first method treats the Company's own bonds held without cancellation in the fund the same as any other investment made by the trustee. This treatment is supported on the grounds that the trustee controls the sinking fund and that his activities are separate and distinct from those of the Company. Further, the bonds have not been cancelled and retired and are still outstanding liabilities of the Company.

The inherent weakness of this treatment is that it presents the Company's own securities on its balance sheet as an asset. The method therefore overstates the Company's assets and liabilities to the extent that the sinking fund contains its own bonds.

The second method is based on the view that, because the sinking fund is outside the control of the Company and can only be used for the specific purpose of eventually retiring the bonds, all contributions to the fund have the effect of reducing the Company's net liability. Even though all of the

bonds are still outstanding, the Company is considered to have discharged its liability for them to the extent that it has made irrevocable payments to the sinking fund. Whether the trustee invests the cash deposited with him in the Company's own bonds or in other securities which will later be used to retire the outstanding bonds is regarded as being irrelevant to the determination of the intrinsic nature of a bond sinking fund. This method may be appropriate in cases where the bond sinking fund indenture specifically states that deposits with the trustee relieve the issuing corporation of all further obligation. Unless such a contractual provision exists, however, contributions to the fund do not reduce the bond liability and the portion of the fund not invested in treasury bonds should not be deducted from the bond liability on the balance sheet.

The third method is theoretically sound. Even though the bond sinking fund is outside the control of the Company and the trustee is contractually obligated to retire the bonds, there is no reduction in the Company's liability to outsiders until the trustee actually acquires the bonds. The setting up of a bond sinking fund and subsequently making payments to it is only an arrangement which facilitates the retirement of the Company's bonds; it does not in itself constitute a reduction in the Company's liability. For example, regular interest charges must be met as long as the bonds are outstanding regardless of the amount and timing of the Company's payments to the sinking fund.

However, when bonds are acquired by the trustee and held without cancellation in the fund they can no longer be considered as an outstanding liability of the issuing company. Even though the Company may continue to pay interest on these bonds held without cancellation in the fund, no interest expense is incurred because the amount paid, disregarding discounts or premiums, is offset by an identical amount of sinking fund income reported by the trustee. Thus, even though the bonds are held without cancellation, their acquisition by the trustee fulfills the intended purpose of the fund. The substantive effect on the Company's indebtedness to outsiders and net interest expense is the same as if the bonds were formally retired.

Answer 6

a. Standard costs are forecasts of what costs (inputs) should be for a product or service (outputs) under specified conditions. They are determined by detailed engineering, time and motion study or other analyses of input-output relationships.

Basic standards serve as reference points from which to measure long-run changes in both actual performance and current standards. They are changed only when the underlying operating conditions are altered. Variances between basic standards and actual performance are not a measure of efficiency, rather they are a measure of long-run cost trends.

Current standards are based on conditions expected during the period for which they are established. The level at which they are established represents

the best performance efficiency reasonably attainable under the expected conditions. Because current standards are revised in response to changing conditions, variances between appropriately set current standards and actual performance represent efficient or inefficient departures from the desired level of performance.

b. The advantages of a standard cost system include the following:
   1. Because the setting of standards requires a thorough analysis of all cost functions, the process in itself often discloses inefficiencies.
   2. The process of setting standards forces management to plan efficient and economical operations.
   3. Standard costs establish clearly defined lines of cost responsibility and authority.
   4. By providing a clear idea as to what constitutes acceptable job performance, standard costs are likely to be an important aid to management in obtaining acceptable performance.
   5. Variances between actual performance and standard costs facilitate control through the application of the exceptions principle.
   6. Faster reporting of operating data is possible; the shortened time gap between action and the availability of control information thereon helps management to prevent the development of unfavorable cost trends.
   7. Standard cost information is more useful than historical cost in arriving at product and service pricing decisions.
   8. Standard costs contribute to the development of an effective system of budgetary control.

c. 1. Deferral of variances is supported on the grounds that, if the standards in use are based on normal price, efficiency, and output levels, positive and negative variances can be expected to offset one another in the long run. Because variance account balances at any given point in time are due to recurring seasonal and business cycle fluctuations, and because periodic reporting requirements result in arbitrary cut-off dates, variance account balances at a particular cut-off date are not assignable to the operating results of the period then ended. They will cancel out over recurring seasonal and business cycle fluctuations and should therefore be carried to the balance sheet. This method is appopriate for interim statements no matter what method is used for annual statements.
   2. If variances appear as charges or credits on the income statement, they are regarded as appropriate charges or credits in the period in which they arise because they are considered to be the result of favorable or unfavorable departures from normal (standard) conditions. They are disclosed separately from cost of goods sold at standard and thus provide management with unobscured information permitting immediate corrective action.

      Inventory valuations and cost of goods sold should not be distorted by variances which represent abnormal efficiencies or inefficiencies. Standard cost represents that amount which is reasonably necessary to produce

finished products and should therefore be considered the best measure of cost of goods manufactured and inventory valuation as long as the underlying operating conditions remain unchanged.

3. Those who advocate allocation of variances between inventories and cost of goods sold regard standard costs as a useful tool for purposes of managerial control, not as substitutes for actual historical costs in the financial statements. They believe that only actual historical costs should be used for financial reporting, even though they are greater or less than standard costs and without regard to the reasons for their differences from standard costs. Standard cost variances are not gains or losses but costs (or reductions therein) of goods manufactured and, as such, should be allocated between inventories and cost of goods sold. To treat them as gains or losses in the period in which they arise distorts both the inventory and gross profit figures. This distortion would be even greater if the standards are lacking in accuracy or reliability. Further, to substitute standard costs for actual historical costs in the financial statements represents an unwarranted sacrifice of objectivity.

Answer 7

a. Cost, which has been defined generally as the price paid or consideration given to acquire an asset, is the primary basis for accounting for inventories. As applied to inventories, cost means, in principle, the sum of the applicable expenditures and charges directly or indirectly incurred in bringing an article to its existing condition and location. These applicable expenditures and charges include all acquisition and production costs but exclude all selling expenses and that portion of general and administrative expenses not clearly related to production.

b. Market, as applied to the valuations of inventories, means the current bid price prevailing at the date of the inventory for the particular merchandise in the volume in which usually purchased by the company. The term is applicable to inventories of purchased goods and to the basic elements of cost (materials, labor and overhead) of goods that have been manufactured. Therefore, market means current replacement cost except that it should not exceed the net realizable value (estimated selling price less predicted cost of completion and disposal) and should not be less than net realizable value reduced by an allowance for a normal profit margin.

c. The usual basis for carrying forward the inventory to the next period is cost. Departure from cost is required, however, when the utility of the goods included in the inventory is less than their cost. This loss in utility should be recognized as a loss of the current period, the period in which it occurred. Furthermore, the subsequent period should be charged for goods at an amount that measures their expected contribution to that period. In other words, the subsequent period should be charged for inventory at prices no higher than those which would have been paid if the inventory had been obtained at the beginning of that period. (Historically, the lower of cost or market

rule arose from the accounting convention of providing for all losses and anticipating no profits.)

In accordance with the foregoing reasoning the rule of "cost or market, whichever is lower" may be applied to each item in the inventory, to the total of the components of each major category, or to the total of the inventory, whichever most clearly interprets operations. The rule is usually applied to each item, but if individual inventory items enter into the same category or categories of finished product, alternative procedures are suitable.

d. The arguments against the use of the lower of cost or market method of valuing inventories include the following:

1. The method requires the reporting of estimated losses (all or a portion of the excess of actual cost over replacement cost) as definite income charges even though the losses have not been sustained to date and may never be sustained. Under a consistent criterion of realization a drop in selling price below cost is no more a sustained loss than a rise above cost is a realized gain.
2. A price shrinkage is brought into the income statement before the loss has been sustained through sale. Furthermore, if the charge for the inventory write-down is not made to a special loss account, the cost figure for goods actually sold is inflated by the amount of the estimated shrinkage in price of the unsold goods. The title "Cost of Goods Sold" therefore becomes a misnomer.
3. The method is inconsistent in application in a given year because it recognizes the propriety of implied price reductions but gives no recognition in the accounts or financial statements to the effect of price advances.
4. The method is also inconsistent in application in one year as opposed to another because the inventory of a company may be valued at cost at one year end and at market at the next year end.
5. The lower of cost or market method values the inventory in the balance sheet conservatively. Its effect on the income statement, however, may be the opposite. Although the income statement for the year in which the unsustained loss is taken is stated conservatively, the net income on the income statement of the subsequent period may be distorted if the expected reductions in sales prices do not materialize.
6. In the application of the lower of cost or market rule a prospective "normal profit" is used in determining inventory values in certain cases. Since "normal profit" is an estimated figure based upon past experiences (and might not be attained in the future), it is not objective in nature and presents an opportunity for manipulation of the results of operations.

Answers to Examinations, November 1964

ACCOUNTING PRACTICE—PART I

November 4, 1964; 1:30 to 6:00 p.m.

Solution 1

1. C	11. D
2. E	12. D
3. A	13. C
4. A	14. D
5. D	15. C
6. B	16. C
7. A	17. D
8. B	18. B
9. D	19. D
10. E	20. A

Solution 2

a.

The Skelton Fuel Company

COMPUTATION OF CORRECTED INCOME PER BOOKS

For the Years Ended June 30, 1964 and 1963

	1964 Debit (Credit)	*1963 Debit (Credit)*	*1964 Account Requiring Adjustment*	
Income per books	$(12,800)	$(10,500)		
1963 budget plan adjustments	3,800	(3,800)		
1964 budget plan adjustments	(5,400)		$5,400	Accounts receivable
1963 receivables not recorded	2,000	(2,000)		
1963 bad debts	(900)	900		
1964 bad debts (1% × $95,000)	950		(950)	Allowance for bad debts
1963 unearned revenue on service contracts (200 × $16)	(3,200)	3,200		
1964 unearned revenue on service contracts (300 × $16)	4,800		(4,800)	Service contract unearned revenue
1963 fuel oil inventory understatement	1,300	(1,300)		
1964 spare parts inventory understatement	(500)		500	Inventory repair parts
Corrected income per books	$ (9,950)	$(13,500)		

b.

Account	Debit	Credit
Accounts receivable	$7,000	
Provision for bad debts	900	
Burner service and repairs	3,200	
Inventory, fuel oil	1,300	
Accounts receivable—credit balances		$1,200
Fuel oil sales—budget plan		3,800
Fuel oil sales—regular		2,000
Allowance for bad debts		900
Service contract unearned income		3,200
Fuel oil delivered		1,300

Worksheet entry to correct 1963 financial statements.

c.

(1)

Account	Debit	Credit
Fuel oil sales—budget plan	3,800	
Fuel oil sales—regular	2,000	
Fuel oil delivered	1,300	
Administrative expense—bad debts		900
Burner service and repairs		3,200
Prior year adjustments		3,000

To record adjustments affecting results of prior year operations.

(2)

Account	Debit	Credit
Accounts receivable	5,400	
Administrative expense—bad debts	950	
Burner service and repairs	4,800	
Inventory, repair parts	500	
Fuel oil sales—budget plan		5,400
Allowance for bad debts		950
Service contract unearned income		4,800
Burner parts and supplies		500

To record adjustments affecting current year's operations.

Solution 3

The Azure Company
WORKSHEET
For the Year Ended December 31, 1963

	Trial Balance		Adjustments and Eliminations		Home Income Statement	Branch Income Statement	Combined Balance Sheet
	Home	Branch	Debit	Credit			
Debits							
Cash	$ 17,000	$ 200	(1) $ 1,700				$ 20,700
			(2) 1,800				
Inventory—Home	23,000		(5) 30,000	(5) $ 23,000			30,000
Inventory—Branch		11,550	(7) 16,170	(7) 11,550			16,170
Sundry assets	200,000	48,450					248,450
Branch current account	60,000			(1) 1,700			
				(8) 58,300			
Purchases	190,000			(5) 190,000			
Purchases from Home		105,000	(3) 5,000	(4) 10,000			
				(7) 100,000			
Freight in from Home		5,500	(6) 250	(7) 5,750			
Sundry expenses	42,000	24,300			$ 42,000	$ 24,300	
Cost of goods sold—Home			(5) 83,000		83,000		
Cost of goods sold—Branch			(7) 101,530			101,530	
	$532,000	$195,000			$125,000	$125,830	$315,320
Credits							
Sundry liabilities	$ 35,000	$ 3,500		(6) 250			$ 38,750
Home current account		51,500	(8) 58,300	(2) 1,800			
				(3) 5,000			
Sales	155,000	140,000			155,000	140,000	
Sales to Branch	110,000		(4) 10,000				
			(5) 100,000				
Allowance for mark-up in Branch inventory	1,000		(7) 1,000	(7) 1,400			1,400
Capital stock	200,000						200,000
Retained earnings	31,000						31,000
Net income—Home					(30,000)		30,000
Net income—Branch						(14,170)	14,170
	$532,000	$195,000	$408,750	$408,750	$125,000	$125,830	$315,320

The Azure Company
ADJUSTING AND ELIMINATING ENTRIES
(Not Required)

(1)

	Debit	Credit
Cash	$ 1,700	
Branch current account		$ 1,700

To record cash deposits made by Branch in December and recorded on books of Home in January.

Date of Deposit	*Amount*
December 30, 1963	$1,100
December 31, 1963	600
Total	$1,700

(2)

	Debit	Credit
Cash	1,800	
Home current account		1,800

To record reimbursement check en route to the Branch.

(3)

	Debit	Credit
Purchases from Home	5,000	
Home current account		5,000

To record shipment in transit at December 31, 1963.

(4)

	Debit	Credit
Sales to Branch	10,000	
Purchases from Home		10,000

To remove interoffice mark-up on sales and purchases.

Computation of Mark-up

Sales	$110,000
Home cost of sales ($110,000 ÷ 110%)	100,000
Mark-up	$ 10,000

(5)

	Debit	Credit
Inventory, Home, December 31	30,000	
Cost of goods sold, Home	83,000	
Sales to Branch	100,000	
Inventory, Home, January 1		23,000
Purchases		190,000

To record Home inventory at December 31 and to close opening inventory and purchases to cost of goods sold.

(6)

	Debit	Credit
Freight in from Home	250	
Sundry liabilities		250

To record freight in on shipment in transit.

(7)

	Debit	Credit
Inventory, Branch, December 31	16,170	
Allowance for mark-up in Branch inventory at January 1	1,000	
Cost of goods sold, Branch	101,530	
Inventory, Branch, January 1		11,550
Allowance for mark-up in Branch inventory at December 31		1,400
Purchases from Home		100,000
Freight in from Home		5,750

To record Branch inventory at December 31 and to close sundry accounts to cost of goods sold.

Computation of December 31 Inventory

Inventory on hand at billing value	$10,400
Shipment in transit	5,000
Total	15,400
Freight in (5% × $15,400)	770
Total Branch inventory	$16,170

Computation of Allowance for Mark-up

Billing value of inventory	$15,400
Cost of inventory ($15,400 ÷ 110%)	14,000
Allowance for mark-up	$ 1,400

(8)

Home current account	58,300	
Branch current account		58,300
To eliminate interoffice current accounts.		

Solution 4

The Standard Mercantile Corporation

CASH FORECAST

For the Three Months Ending March 31, 1964

	January	*February*	*March*
Beginning cash	$100,000	$ 91,400	$ 6,900
Cash receipts:			
Sales—current month	216,000	252,000	360,000
—1st previous month	240,000	108,000	126,000
—2nd previous month	54,000	72,000	32,400
—Obsolete inventory	25,000	—	—
Total	635,000	523,400	525,300
Disbursements:			
Purchases—prior month	370,000	342,000	288,000
Fixed expenses	100,000	100,000	100,000
Variable expenses—current month	25,200	29,400	42,000
—prior month	24,000	10,800	12,600
Property taxes	—	—	25,000
Cash dividends	—	—	20,000
Advertising costs	—	10,000	15,000
Equipment replacements	3,000	3,000	3,000
Income taxes	—	—	60,000
Loan principal	20,000	20,000	240,000
Loan interest	1,400	1,300	1,200
Total	543,600	516,500	806,800
Ending cash balance (deficiency)	$ 91,400	$ 6,900	$(281,500)

Sales Price of Obsolete Inventory

Cost	$30,000
Customary sales price ($30,000 ÷ 60%)	$50,000
Sales price, 50% thereof	$25,000

Computation of Monthly Purchases

	January	*February*
Estimated sales:		
January	$ 360,000	
February	420,000	
March	600,000	$ 600,000
April	540,000	540,000
May		480,000
Total for three months	$1,560,000	$1,620,000
Required inventory at 1st of succeeding month at cost of sales ratio (60%)	$ 936,000	$ 972,000
Month's sales at cost of sales ratio (60%)	$ 216,000	$ 252,000
Change in required inventory	108,000	36,000
Adjustment for January 1 deficiency	18,000	
Purchases for month (to be paid in following month)	$ 342,000	$ 288,000

Adjustment for Deficiency in January 1 Inventory

Estimated sales:		
January		$ 360,000
February		420,000
March		600,000
Total for three months		$1,380,000
Required inventory at January 1 at cost of sales ratio (60%)		$ 828,000
Inventory on hand	$840,000	
Less obsolete inventory	30,000	810,000
Deficiency in January 1 inventory		$ 18,000

Income Taxes Payment

Total estimated income tax for 1963	$210,000
Less	100,000
Total 1963 payments	110,000
Actual tax liability for 1963	230,000
Balance due	$120,000
Amount of March payment, 50% thereof	$ 60,000

Solution 5

a.

The Du-Rite Corporation

COMPUTATION OF ACTUAL COST OF GOODS MANUFACTURED
For the Year Ended December 31, 1963

	Material	*Labor*	*Overhead*	*Total*
Cost of goods sold at standard cost	$300,000	$100,000	$200,000	$600,000
Finished goods inventory	60,000	20,000	40,000	120,000
Add adjustments				
Variances	21,082	23,970	(15,510)	29,542
Purchase discounts	(6,640)			(6,640)
Scrap sales			(8,460)	(8,460)
Actual cost of goods manufactured	$374,442	$143,970	$216,030	$734,442

Computation of Allocation of Adjustments

	Material		*Labor*		*Overhead*	
	Amount	*%*	*Amount*	*%*	*Amount*	*%*
Work-in-process	$ 75,000	17	$ 7,500	6	$ 15,000	6
Finished goods	60,000	14	20,000	16	40,000	16
Cost of sales	300,000	69	100,000	78	200,000	78
Total	$435,000	100%	$127,500	100%	$255,000	100%

Material variance = (14% + 69%) × $25,400 = $21,082
Labor variance = (16% + 78%) × $25,500 = $23,970
Overhead variance = (16% + 78%) × ($16,500) = ($15,510)
Purchases discount = (14% + 69%) × ($8,000) = ($6,640)
Scrap sales = (16% + 78%) × ($9,000) = ($8,460)

b.

Computation of Ending Inventories at Standard Cost and at Actual Cost

	Material	*Labor*	*Overhead*	*Total*
Inventories at standard cost				
Work-in-process	$ 75,000	$ 7,500	$15,000	$ 97,500
Finished goods	60,000	20,000	40,000	120,000
Total	135,000	27,500	55,000	217,500
Add adjustments				
Variances	7,874	5,610	(3,630)	9,854
Purchase discounts	(2,480)			(2,480)
Scrap sales			(1,980)	(1,980)
Total inventories at actual cost	$140,394	$33,110	$49,390	$222,894

Material variance = (17% + 14%) × \$25,400 = \$7,874
Labor variance = (6% + 16%) × \$25,500 = \$5,610
Overhead variance = (6% + 16%) × (\$16,500) = (\$3,630)
Purchase discounts = (17% + 14%) × (\$8,000) = (\$2,480)
Scrap sales = (6% + 16%) × (\$9,000) = (\$1,980)

c.

COMPUTATION OF FINISHED GOODS INVENTORY AT THE LOWER OF COST OR MARKET

Cost of finished goods on hand (1,000 units × \$180)	\$180,000
Less anticipated loss on reduction to lower of cost or market of 200 units under contract	4,800
Finished goods inventory at lower of cost or market	\$175,200

Computation of Anticipated Loss on Reduction to Lower of Cost or Market of Special Sales Contract

Contract price (200 × \$175)		\$35,000
Less:		
Shipping expense (200 × \$5)	\$1,000	
Sales commission (8% × \$35,000)	2,800	3,800
Net realizable value		31,200
Cost (200 × \$180)		36,000
Anticipated loss on reduction to lower of cost or market		\$ 4,800

ACCOUNTING PRACTICE—PART II

November 5, 1964; 1:30 to 6:00 p.m.

Solution 1

1. E	11. A
2. B	12. C
3. A	13. A
4. A	14. C
5. B	15. B
6. B	16. C
7. C	17. D
8. B	18. C
9. E	19. E
10. E	20. C

Solution 2

A, B, C and D

STATEMENT OF PARTNERS' CAPITAL ACCOUNTS
For the Year Ended December 31, 1963

	Total	*A*	*B*	*C*	*D*
Opening balances, January 1, 1963	$53,000	$20,600	$10,600	$21,800	
Add:					
20% of fees billed to personal clients	9,000	4,400	2,400	2,200	
D's share of fees	1,600				$1,600
Distribution of balance	28,600	11,440	10,010	7,150	
	92,200	36,440	23,010	31,150	1,600
Deduct:					
Withdrawals	17,900	5,200	4,400	5,800	2,500
Uncollectible receivables	1,650	1,200	450		
Excess rent	900			900	
Total deductions	20,450	6,400	4,850	6,700	2,500
Balances, December 31, 1963	$71,750	$30,040	$18,160	$24,450	$ 900*

*Overdraft

Computation of Apportionment of Income

Total fees			$60,000
Less:			
Expenses exclusive of depreciation		$19,350	
Less excess rent chargeable to C (6 × $150)		900	
		18,450	
Add depreciation			
(10% × $13,000)		1,300*	
(10% × $5,000 × ½)		250	
Total		20,000	
Add bad debt write-off		800	20,800
Net income for 1963			39,200
Net income apportionment			
Fees billed to personal clients			
A — 20% of $22,000		4,400	
B — 20% of $12,000		2,400	
C — 20% of $11,000		2,200	
$45,000		9,000	
D's share of fees			
Gross fees from new business after April 1	$12,000		
Less apportioned expenses (20,000/60,000 × $12,000)	4,000		
Net income	$ 8,000		
20% thereof		1,600	10,600
Balance to be divided per agreement			$28,600
Apportionment of balance			
A — 40% of $28,600			$11,440
B — 35% of $28,600			10,010
C — 25% of $28,600			7,150
			$28,600

*An alternative computation of depreciation would be based on the net book value of the depreciable assets on the assumption that they were recorded on the partnership books at their net book value (cash less accumulated depreciation).

Solution 3

a.

The Rees Company
COMPUTATION OF INCENTIVE BASE
For the Year Ended December 31, 1963

Net income for 1962 before provisions for federal income taxes and incentive compensation reserve		$394,000
Deduct:		
Credit to incentive compensation reserve	$ 28,000	
Provision for federal income taxes [.50 ($394,000 – $28,000)]	183,000	211,000
Net income for 1962		183,000
Less dividends paid		50,000
Basis for determining incentive base		$133,000
25% thereof		$ 33,250
Incentive base for 1962		80,000
Incentive base for 1963		$113,250

b. 1.

Computation of Incentive Plan Net Earnings for 1963 in Excess of the Incentive Base for 1963

I = Net income

$$I = .5\ [\$565{,}000 - .1\ (\$100{,}000) - .2\ (I - \frac{\$20{,}000}{2} - \$100{,}000)]$$

$I = \$262{,}273$

Net income		$262,273
Less: Short-term gains on sale of investments	$ 20,000	
Less taxes thereon	10,000	
	10,000	
Incentive base for 1963	100,000	110,000
Incentive plan net earnings for 1963 in excess of the incentive base for 1963		$152,273

2.

Computation of Credit to the Incentive Compensation Reserve for 1963

Credit computed on incentive plan net earnings in excess of the incentive base (.20 × $152,273)	$30,454.60
Credit computed on incentive base (10% × $100,000)	10,000.00
Total credit to the incentive reserve for 1963	$40,454.60

Solution 4

a.

The Luxury Sales Company
COMPUTATION OF SUGGESTED ADJUSTMENT
THE ALLOWANCE FOR DEFAULTED CONTRACTS ACCOUNT
as of July 31, 1964

1963 contracts:		
Loss on defaulted contracts in 1963		$ 500
Written off in 1964		7,500
Total		8,000
Less:		
Sales of repossessed merchandise in 1964	$1,600	
Repossessed merchandise inventory on hand	400	2,000
Net write-offs of 1963 contracts		$ 6,000
Experience rate of contract write-off $\frac{\$6,000}{\$150,000} = 4\%$		
1964 contracts:		
Installment contract sales		$250,000
Anticipated write-offs (4% × $250,000)		$ 10,000
Net write-offs ($3,000 − $350)		2,650
Expected additional write-off of 1964 contracts on books		7,350
Allowance for defaulted contracts on books		4,500
Suggested increase in Allowance for Defaulted Contracts account		$ 2,850

b.

The Luxury Sales Company
COMPUTATION OF TAXABLE INCOME ON
THE INSTALLMENT SALES METHOD
For the Year Ended July 31, 1964

Sales		$250,000
Cost of goods sold:		
Opening inventory	$ 32,250	
Purchases	155,000	
Total	187,250	
Less ending inventory	42,250	
Cost of goods sold (58%)		145,000
Gross margin (42%)		105,000
Less:		
Deferred gross margin (42% × $80,000)	33,600	
Gross margin on defaulted contracts (42% × $3,000)	1,260	34,860
Realized gross margin on 1964 sales		70,140
Realized gross margin on 1963 sales (see schedule)		20,600
Total realized gross margin		90,740
Losses on defaults (see schedule)		3,890
Net realized gross margin		86,850
Less selling and administrative expenses		70,000
Net taxable income		$ 16,850

Computation of Realized Gross Margin on 1963 Sales

Beginning balance, 1963 contracts		$63,000
Less: Contracts written off	$7,500	
Ending balance	4,000	11,500
Net collections		$51,500
Realized gross margin (40%)		$20,600

Computation of Losses on Defaults

1963 contracts:		
Contracts written off		$7,500
Deferred gross margin applicable (40%)		3,000
Basis of defaulted contracts		4,500
Less: Repossessed merchandise sold	$1,600	
Repossessed merchandise on hand	400	2,000
Net loss on 1963 contract defaults		2,500
1964 contracts:		
Contracts written off	3,000	
Gross margin applicable (42%)	1,260	
Basis of defaulted contracts	1,740	
Less sales of repossessed merchandise	350	
Net loss on 1964 contract defaults		1,390
Net loss on defaults in 1964		$3,890

Solution 5

GENERAL FUND

January 1, 1963

Estimated revenues	$ 116,000	
Unappropriated surplus	55,120	
Appropriations		$ 171,120
To record estimated revenues and appropriations for 1963.		
Taxes receivable	112,000	
Revenues		112,000
To record tax levy.		

February 28, 1963

Cash	49,500	
Expenditures	500	
Taxes receivable		50,000
To record tax receipts from County Treasurer.		

April 1, 1963

Cash	22,500	
Revenues		10,000
Appropriation expenditures		12,500
To record receipt of $10,000 premium on sale of bonds and interest of $12,500 collected by Bond Fund with the sale of the bonds.		

May 1, 1963

Cash	2,000	
Revenues		2,000
To record receipt of interest on temporary investments.		

July 1, 1963

Expenditures	25,000	
Cash		25,000
To record payment of interest on bonds.		

August 31, 1963

Cash	59,400	
Expenditures	600	
Taxes receivable		60,000
To record tax receipts from County Treasurer.		

December 31, 1963

Expenditures	115,000	
Cash		115,000
To record operating expenses paid during the year.		

BOND FUND

January 1, 1963

Bonds authorized and unissued	$1,000,000	
Appropriations		$1,000,000
To record authorization to issue bonds for new school.		

April 1, 1963

Cash	1,022,500	
Premium on bonds		10,000
Accrued interest expense		12,500
Bonds authorized and unissued		1,000,000
To record sale of bonds.		
Premium on bonds	10,000	
Accrued interest expense	12,500	
Cash		22,500
To record transfer of premium and accrued interest to the general fund.		

April 2, 1963

Expenditures	47,000	
Cash		47,000
To record expenditure for new school site.		

April 3, 1963

Encumbrances	950,000	
Reserve for encumbrances		950,000
To record contract for construction of the new school.		

November 1, 1963

Expenditures	200,000	
Reserve for encumbrances	200,000	
Cash		200,000
Encumbrances		200,000
To record part payment on new school contract and to reduce the related encumbrance.		

GENERAL FIXED ASSETS

April 2, 1963

Land	$ 47,000	
Investment in general fixed assets: From bonds		$ 47,000
To record purchase of land for school.		

November 1, 1963

Buildings—work in progress	200,000	
Investment in general fixed assets: From bonds		200,000
To record partial completion of new school building being acquired through the bond fund.		

GENERAL BONDED DEBT AND INTEREST

April 1, 1963

Amount to be provided for bond retirement	$1,000,000	
Amount to be provided for interest payment	325,000	
Serial bonds payable		$1,000,000
Interest payable in future years		325,000
To record sale of school bonds.		

July 1, 1963

Interest payable in future years	25,000	
Amount to be provided for interest		25,000
To record general fund's payment of interest on bonds.		

Solution 6

a.

The Gercken Corporation
COMPUTER INSTALLATION
COMPARISON OF ESTIMATED ANNUAL INCOME
UNDER PURCHASE AND RENTAL PLANS

Purchase plan	*1965*	*1966*	*1967*
Sales	$220,000	$260,000	$260,000
Expenses			
Operating	90,000	80,000	80,000
Maintenance, property taxes and insurance	20,000	20,000	20,000
Depreciation	40,000	40,000	40,000
Total expenses	150,000	140,000	140,000
Income before taxes	70,000	120,000	120,000
Federal income taxes @ 50%	35,000	60,000	60,000
Reported net income	35,000	60,000	60,000
Less: Opportunity cost	28,875	15,750	750
Net income after allowing for opportunity cost*	$ 6,125	$ 44,250	$ 59,250
Rental plan			
Sales	$220,000	$260,000	$260,000
Expenses			
Operating	90,000	80,000	80,000
Rent ($85,000, plus 5% of sales)	96,000	98,000	98,000
Total expenses	186,000	178,000	178,000
Income before taxes	34,000	82,000	82,000
Federal income taxes @ 50%	17,000	41,000	41,000
Net income	$ 17,000	$ 41,000	$ 41,000

*An alternative solution would provide for a return on the reinvestment of cash recovered.

Computation of Opportunity Cost of the
Investment Under the Purchase Plan*

	Year 1	*Year 2*	*Year 3*
Initial investment in computer	$230,000	$230,000	$230,000
Recovered and reinvested during			
Year 1 ($ 75,000** recovered × ½ for 1st year)	37,500	75,000	75,000
Year 2 ($100,000** recovered × ½ for 2nd year)		50,000	100,000
Year 3 ($100,000** recovered × ½ for 3rd year)			50,000
Total recovered and reinvested	37,500	125,000	225,000
Average unrecovered investment in computer	$192,500	$105,000	$ 5,000
Opportunity cost @ 15%	$ 28,875	$ 15,750	$ 750

*An alternative solution would reduce the initial investment in the computer by the amount of the cumulative cash rental payments in the belief that the benefit foregone if the computer is purchased is 15% of the difference between the cash available for reinvestment under the purchase plan and the cash available for reinvestment under the rental plan.

**Reported net income plus depreciation

b.

The Gercken Corporation
COMPUTER INSTALLATION
ANNUAL CASH FLOWS UNDER THE PURCHASE AND RENTAL PLANS

	A *Purchase Plan*	*B* *Rental Plan*	*A-B* *(Not Required)*
Annual Cash Flows			
Beginning of year 1 (initial investment)	$(230,000)		$(230,000)
Year 0-1	$ 75,000*	$17,000	$ 58,000
Year 1-2	$ 100,000*	$41,000	$ 59,000
Year 2-3	$ 100,000*	$41,000	$ 59,000
End of year 3 (salvage)	$ 110,000		$ 110,000

*Reported net income plus depreciation.

c.

The Gercken Corporation
COMPUTER INSTALLATION
PRESENT VALUES OF THE CASH FLOWS
UNDER THE PURCHASE AND RENTAL PLANS

	A *Purchase Plan*	*B* *Rental Plan*	*A-B* *(Not Required)*
Present value of cash flows at 15%			
Year 0-1 (present value – .93)	$ 69,750	$15,810	$ 53,940
Year 1-2 (present value – .80)	80,000	32,800	47,200
Year 2-3 (present value – .69)	69,000	28,290	40,710
End of year 3 (present value – .66)	72,600		72,600
Totals	291,350	76,900	214,450
Less: Initial investment (present value – 1.00)	230,000		230,000
Net present values	$ 61,350	$76,900	$(15,550)

d. The comparison in part "a" shows that the computer should be purchased because, even after allowing for opportunity cost, the estimated income of $109,625 ($6,125 + $44,250 + $59,250) under the purchase plan exceeds the estimated income of $99,000 ($17,000 + $41,000 + $41,000) under the rental plan by $10,625.

The comparison in part "c" shows that the computer should be rented. When discounted at 15%, the net present values of the cash flows are $61,350 under the purchase plan and $76,900 under the rental plan. Thus, the Company will be $15,550 ($76,900 – $61,350) better off by renting the computer and otherwise investing the $230,000 at 15% than by purchasing it.

[(Not required.) The net advantage of the rental plan over the purchase plan is also shown in column "A-B" by an analysis of the incremental cash flows under the purchase plan. When discounted at 15%, the present value of the incremental cash flows under the purchase plan is only $214,450, or $15,550 less than the $230,000 investment required to purchase the computer. Thus, the increased cash flows under the purchase plan result in less than a 15% return on the required investment of $230,000.]

The computer should be rented. The comparison in part "a" fails to consider the time value of money. In so doing, even though the opportunity cost of investing in the computer is considered, it results in the wrong decision.

AUDITING

November 5, 1964; 8:30 a.m. to 12:00 m.

Answer 1

1. A	9. C
2. D	10. A
3. B	11. B
4. C	12. B
5. A	13. A
6. D	14. C
7. B	15. B
8. D	

Answer 2

a. In auditing and expressing opinions on financial statements the CPA is required at all times to maintain his independence of thought and action. Indepedence is a major part of the CPA's professional integrity—the quality that makes his opinion valuable to third parties who will be relying on the financial statements on which he gives his opinion.

Independence is an attitude of mind that goes much deeper than surface compliance with visible standards. It results in unbiased judgment and objective consideration of all the factors involved in planning and conducting his examination and in arriving at and expressing his opinion. It results in his rising above the interests of his client in deference to the interests of readers and users of the statements.

The requirement for independence of action places upon the CPA the responsibility for assessing his relationships with the enterprise. These relationships must be evaluated by the same criterion that a third party in possession of all the facts would apply, that is, whether the CPA has placed himself in a position where there would be pressures to subordinate his decisions or judgments to his personal financial interests or the suasions of others.

b. The following rules of professional conduct are generally considered to be concerned with the CPA's independence:

1. A CPA shall not express an opinion on the financial statements of any enterprise unless he and his firm are in fact independent with respect to such enterprise. Lack of independence is indicated if the CPA or a member of his firm, during his professional engagement or at the time he is

expressing his opinion, has a direct financial interest or commitment to acquire a financial interest in a client or has a connection with a client as a promoter, underwriter, voting trustee, officer, key employee or director (a directorship with certain nonprofit organizations is excepted).

2. A CPA shall not render professional services for a fee contingent upon the findings or results of such services (excepted are cases involving the findings of taxing authorities in tax matters and cases where courts or other public authorities fix the fees). This rule compels the CPA to avoid situations where he might profit personally from the manner in which the audited statements are presented.
3. A CPA may be held guilty of an act discreditable to the profession if, in expressing his opinion on the financial statements, he knowingly fails to disclose a material fact necessary to be disclosed to make the statements not misleading or if he knowingly fails to report any material misstatements. He would also be guilty if he is materially negligent in his examination or in making his report, fails to gather sufficient evidence, expresses an opinion that is not justified by his findings, or fails to disclose any material departure from generally accepted accounting principles or omission of generally accepted auditing procedures. Committing any of these acts deemed discreditable under this broad rule may be construed as evidence that the CPA has compromised his independence.
4. CPAs are prohibited from engaging in a business or occupation incompatible or inconsistent with public accounting. The rule requires the CPA to keep clear of situations where the public might believe his independence is subject to question. For example, if a CPA is also an insurance salesman, his independence in arriving at his findings in his investigations of his client's insurance coverage might be questioned.

c. The acceptance by the CPA of the unsecured interest bearing notes in payment of unpaid fees would not be construed as discrediting the CPA's independence in his relations with his client because the notes are merely a substitution for an open account payable. The rule of professional conduct that prohibits a CPA from having any financial interest in a client does not extend to the liability for the CPA's fee. If liability for the CPA's fee was considered to be financial interest in a client, the present form of the CPA-client relationship would not be permitted to continue because often (frequently in engagements for continuing audits) the client's statements being audited include a liability for the CPA's services.

d. 1. Under the conditions cited the CPA cannot render an independent opinion on the financial statements of The Rocky Hill Corporation. The basic premise underlying the rules of professional conduct pertaining to independence is that the CPA should make a conscious effort to refrain from any relationships with a client that might leave his professional independence open to question where he intends to express an opinion on the financial statements.

In this case the CPA has twice violated his profession's rules of professional conduct. By being the client's secretary he has been an officer in

the company during the period of his professional engagement. Secondly, by temporarily resigning and then resuming the position upon expressing his opinion (which does not cure the first violation), he has violated the spirit of the rules of professional conduct pertaining to independence because he is not in fact independent with respect to his client.

2. Though the CPA merely assumed an officership with a client as a temporary measure, the rules of professional conduct pertaining to independence provide for no exceptions. The CPA is not in a position to render an opinion on the financial statements of The Rocky Hill Corporation covering the period that he was an officer. After the CPA has resigned and has become in fact independent, he may express his opinion on statements covering subsequent periods.

Answer 3

a. The audit program for the examination of Pate Corporation's Capital Stock account would include the following procedures:

1. Examine the articles of incorporation, the bylaws and the minutes of the board of directors from the inception of the Corporation to determine the provisions or decisions relating to the capital stock such as classes of stock, par value or stated value, authorized number of shares, authorization for the sale of new issues or additional sales of unissued stock, declarations of stock split-ups and dividends in the form of cash or stock, and granting of stock options or stock rights. Determine that the accounting records are in accord with these provisions or decisions and that appropriate disclosure is made by footnote if necessary. Extract pertinent data for the auditor's permanent file.
2. Examine the stock certificate stub book and determine whether the total of the open stubs agrees with the Capital Stock account in the general ledger. Examine cancelled stock certificates which are generally attached to the corresponding stub. Information on the stubs regarding the number of shares, date, etc. for both outstanding and cancelled stock certificates should be compared with the Capital Stock account. All certificate numbers should be accounted for and, if the CPA deems it necessary, confirmation of the number of certificates printed should be obtained from the printer. A test check should be made to determine that the proper amounts of original issue and capital stock transfer taxes have been affixed to the stubs and the cancelled certificates. The stockholders shown in the stock certificate stub book should be compared with the stockholders' ledger if one is maintained.
3. Analyze the Capital Stock account from the Corporation's inception and verify all entries. Trace all transactions involving the transfer of cash either to the cash receipts or the cash disbursements records. If property other than cash was received in exchange for capital stock, trace the recording of the property to the proper asset account and consider the reasonableness of the valuation placed on the property. Transactions showing the sale of stock at a discount or premium should be traced to

the Capital Contributed in Excess of Par Value account. If capital stock has been sold at a discount, consideration should be given to the possible violation of state laws and the client's attention should be directed to the matter. Should the analysis of the Capital Stock account disclose that the Corporation has engaged in treasury stock transactions, determine that the increases or decreases in net assets resulting from these transactions have not been placed in the Retained Earnings account.

The audit procedures to be applied to the examination of the Capital Contributed in Excess of Par Value account are usually applied at the same time that the Capital Stock account is being examined because the two accounts are interrelated. The account should be analyzed and the entries verified when the related entries in the Capital Stock account are verified. If an entry is not related to Capital Stock account entries, as in the case of a write-off of a deficit as the result of a quasi-reorganization, authorization for the entry and the supporting material should be examined.

The following audit procedures would be applied to the Retained Earnings account:

1. Analyze the account from its inception. Consider the validity of the amounts representing income or loss that were closed from the Profit and Loss account. Amounts representing appraisal increments or writing up of assets should be considered for reasonableness, and the increase should be reported separately from retained earnings in the stockholders' equity section of the balance sheet.
2. Any extraordinary gains or losses carried directly to the Retained Earnings account should be investigated and their treatment reviewed in relation to generally accepted accounting principles.
3. Entries recording the appropriation of retained earnings or the return of such appropriations should be reviewed for reasonableness, and authorization for the entries should be traced to the proper authority. Similarly, actions of the board of directors that affected retained earnings should be traced to the account analysis.
4. Conditions, such as loan covenants or contingent liabilities, that were uncovered during the audit that might require or make desirable the placing of restrictions on retained earnings should be brought to the client's attention, and provision should be made for proper disclosure in the financial statements.
5. Entries recording cash or stock dividends should be traced to the minutes of the board of directors for authorization and interchecked to the Cash account or the Capital Stock account. A separate computation should be made by the CPA of the total amount of dividends paid based upon his schedules of outstanding stock as an over-all test of the validity of the distributions. If stock dividends have been distributed, the amount removed from retained earnings should be reviewed for compliance with generally accepted accounting principles.

b. In conducting his audit the CPA verifies retained earnings as he does other

items on the balance sheet for several reasons. A principal reason is that the verification is an assurance or double check that no important item was overlooked in the examination of the accounts that were the contra or balancing part of the entry recorded in retained earnings. An example of an important item that may be overlooked would be a balance sheet account that was closed during the year under audit and the ledger card for the account removed from the general ledger current file. Another reason is that, though the entry in the contra account may have been examined, the auditor may have overlooked that the balancing part of the entry was to retained earnings, a treatment that may have been contrary to generally accepted accounting principles; his examination of retained earnings would bring this noncompliance to his attention.

Still another reason for examining the retained earnings account is to determine whether any portion of the balance in the account may be subject to restriction by state law or other authority. Since the account is the basis for the payment of dividends, it is important to determine that the balance is composed of income realized from transactions free from any restrictions.

Answer 4

a. 1. "Lapping" is a defalcation in which a cash shortage is concealed by delaying the crediting of cash receipts to the proper accounts receivable. The first step in the fraud is to withhold from a bank deposit cash remitted by a customer. A few days later, because the customer must receive credit for his remittance, the first customer's account is credited with an amount from a remittance made by a second customer. The process requires the continuous shifting of shortages from account to account and the crediting of subsequent receipts to the wrong account receivable.

2. "Kiting" is a procedure employed to conceal cash shortages from employers and auditors, to conceal bank overdrafts from the bank or banks affected, or to pad a cash position. All kiting procedures are designed to take advantage of the "float" period during which a check is in transit between banks.

A shortage in cash in bank may be concealed by depositing in the bank a transfer check drawn on another bank. The transfer check, not recorded as a deposit or disbursement, brings the bank account into agreement with the books of account. The check is recorded a few days later and the shortage "reappears" unless the process is repeated. A similar effect may be obtained by depositing unrecorded fictitious N.S.F. checks.

If a depositor desires to write a check for which he does not have funds on deposit, he can deposit a transfer check large enough to cover the payment, even though the transfer check itself creates an overdraft. The transfer process may be repeated indefinitely or may be terminated by a deposit of sufficient funds to cover the overdraft. Since the purpose of this procedure is to conceal an overdraft from the bank, the transfer check may or may not be recorded on the books on the date that it was drawn.

"Kiting" to pad a cash position typically occurs at the end of a fiscal period; a check transferring funds from one bank to another is deposited and recorded on the date drawn but is not recorded as a disbursement until the following period. In this case the credit on the books would probably be made to a revenue account and the subsequent debit to an expense account.

b. (1) The following audit procedures would be used to uncover lapping:

1. Confirm accounts receivable and give close attention to exceptions made by customers about payment dates. The confirmation procedure is better applied as a surprise at an interim date so that if a person is engaged in lapping he will not have been able to bring the "lapped" accounts up to date. If the confirmations are always prepared at year end, the audit step may be anticipated by the person doing the lapping and the shortage given a different form such as kiting of checks.
2. Make a surprise count of the cash and customers' checks on hand. The deposit of these funds should be made under the auditor's control, and the details of the deposit should later be compared with the cash receipts book and the accounts receivable records.
3. Compare the details of remittance lists (if prepared), stamped duplicate deposit slips and entries in the cash receipts book. Since deposit slips are easily altered, some auditors prepare duplicate deposit slips for deposits made a few days before and after the examination date and have these slips authenticated by the bank. These authenticated duplicate deposit slips are compared to remittance lists and to entries in the cash book. The reliability of these authenticated deposit slips is subject to question, as explained in "c" below.
4. Compare the check vouchers received with the customers' checks with stamped duplicate deposit slips, the entries in the cash book and postings to the accounts receivable records. If the client stamps the voucher with the date it was received, in making the comparisons particular attention should be given to the stamped dates and recording dates in the cash receipts book.

b. (2) Kiting might be uncovered by the following audit procedures:

1. As a surprise count of cash and customers' checks on hand is made, as a test for lapping determine that checks representing transfers of funds are properly recorded on the books.
2. Prepare a schedule of the bank transfers made for a few days before and after the examination date. The schedule should show that, for a given check, the date of disbursement recorded on the books, the date of receipt recorded on the books, and the dates of withdrawal and deposit shown on the bank statements should all be in the same accounting period and within reasonable proximity of each other.
3. Prepare a schedule comparing the deposits per bank statement and deposits per books for a few days before and after the examination

date. For comparable deposits the schedule should show that the amounts of the deposits are the same and the dates of deposit are within reasonable proximity of each other and in the same accounting period except for deposits which are properly accounted for as being in transit.

4. Obtain cut-off bank statements directly from the bank covering the seven to ten day period after the balance sheet date. Examine the checks returned with the cut-off statements and pay particular attention to dates of the transactions stamped by the banks on the backs of the checks. These stamped dates should not be earlier than the dates of the checks or the dates of disbursement recorded on the books. Protested (N.S.F.) checks should be investigated to determine they are not fictitious checks deposited temporarily to cover a shortage.

c. (1) For some time CPAs have been placing less reliance upon authenticated duplicate deposit slips as accounting evidence because the details on deposit slips are not checked when deposits are made but rather the total is merely verified as correct by adding the cash and checks being deposited. Accordingly the falsification of the details of the deposit might easily be accomplished, especially when a large number of items make up the deposit, so long as the total of the deposit is correct. Therefore, in assessing the reliability of authenticated duplicate deposit slips as accounting evidence, the CPA should ascertain from the bank whether its tellers are required to compare the amounts of individual checks with the details of the deposit slips.

Even though it may be an audit step of limited value, CPAs continue to request that duplicate deposit slips be authenticated because an occasional wrongdoing is uncovered by the procedure and the subsequent checking of the details. Another reason for undertaking the audit step is that the embezzler might be prevented from preparing an incorrect deposit slip by the belief that the bank might check the listing of the checks against the checks themselves. In this case the CPA's comparison of the authenticated and correct deposit slip with the cash receipts records would disclose the irregularity.

c. (2) In lieu of placing complete reliance upon authenticated duplicate deposit slips, several additional audit procedures are available to the CPA. For example, he might make a surprise count of the cash and checks on hand at the balance sheet date and then control the deposit of the funds and later check the recording of the deposit and determine that no irregular checks were included in the deposit. Another procedure that might be employed as a surprise during the period of interim work is to intercept deposits on a test basis. This would involve obtaining the daily deposit after it had been prepared and checking the deposit slip with the items being deposited. Yet another procedure, which may be used where the bank makes microfilms of the checks being deposited, is for the CPA to inspect these microfilms when he has a strong belief that an irregularity exists.

Answer 5
a.

The Boller Manufacturing Corporation
NOTES TO FINANCIAL STATEMENTS
December 31, 1963

Note 1. (Referenced to the titles of the statements)

The financial information relative to 1962 has not been audited. [Note: If this footnote is not prepared, the CPA would make this disclosure in his report.]

Note 2. (Referenced to Inventories)

Inventory is stated at the lower cost or market. Cost was determined under the last-in, first-out method of accounting.

Note 3. (Referenced to Land and to Building)

The Company's land and building may be in the path of a new highway that will be constructed in the general area. The exact route of the highway has not been established. The estimated values are the amounts that the Company's officers expect to realize from the sale of the assets to the highway department.

Note 4. (Referenced to Goodwill and Deficit)

The goodwill of $30,000 represents the total cost of the Company's institutional advertising campaign that took place in 1958 when the Company began doing business. The Company's officers believe that the Company is continuing to benefit from the goodwill developed by the campaign.

Note 5. (Referenced to Deficit and Net Income)

By reason of prior years' losses, no provision was necessary for federal income taxes on 1963 and 1962 income. Without benefit of the loss carryforwards, net income would have been $7,500 in 1963 and $5,000 in 1962. As of December 31, 1963 loss carryforwards of approximately $5,000 are available as offsets against otherwise taxable income for fiscal years through December 31, 1966. The Company's income tax returns have not been reviewed by the taxing authorities since the Company began doing business in 1958.

b. To the Board of Directors
The Boller Manufacturing Corporation

(Scope paragraph not required)

The estimated values placed upon land and building by the officers have not been verified because the highway projected for the general area has created an unsettled real estate market. Accordingly we express no opinion on these estimated values.

The deferral of the absorption of advertising cost incurred in 1958 for an indefinite period as set forth in footnote #4 is not in accordance with generally accepted accounting principles. The revenues received in the years following 1958 should have been charged for the benefits derived from the advertising expenditures. Whether any benefits were still obtainable in 1963 is subject to serious question. If the full amount of the deferred advertising costs had been charged to revenue received since 1958, the amount of the deficit at December 31, 1963 would be $45,000.

In our opinion, except that failure to charge off the deferred 1958 advertising costs has resulted in an overstatement of assets and an understatement of the amount of the deficit as described in the foregoing paragraph, the accompanying financial statements present fairly the financial position of The Boller Manufacturing Corporation at December 31, 1963, and the results of its operations for the period then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

S/ John Doe

Answer 6

a. 1. The following audit procedures may be applied to Company records and documents to discover evidence of defalcations being committed by the buyer.

(a) Make a detailed review of the internal controls relating to purchasing to ascertain whether there are any weaknesses that might permit the buyer to commit an irregularity. The review should include the determination that the controls are actually being observed and that approvals and countersignatures are not being given perfunctorily. The auditor's tests should then be concentrated in the areas of weakness.

(b) Examine a representative sample of purchase orders issued by the buyer to determine that they have been prepared and issued in accordance with established company policy, particularly with respect to the countersignature of purchase orders over $200. Determine whether any orders for amounts in excess of $200 were split into two or more orders to evade the $200 limitation.

(c) Compare the representative sample of purchase orders with their related approved requisitions to ascertain that the purchase orders issued were for goods and services required by the business and are supported by an authorized document originated outside of the purchasing department.

(d) Test the authenticity of the suppliers by reference to telephone directories, purchasing directories, credit-rating publications, etc. This step will disclose any dummy or fictitious vendors through which the buyer might later obtain funds.

(e) Review the disbursing procedures and examine paid checks, giving particular attention to the payee and the endorsement. This step will indicate whether the buyer has access to checks and might reveal any irregularity in their negotiation.

2. To discover evidence indicating possible collusion between the buyer and authentic suppliers, the following audit steps might be applied:

(a) Note whether one supplier appears to be heavily favored over others for goods available from many suppliers.

(b) Compare the prices on vendors' invoices for like items.

(c) Compare prices on purchase orders and invoices with suppliers' catalogs, price lists, etc.

(d) Examine competitive bids received by the purchasing department. If necessary, arrange to have bids obtained directly from suppliers, including some not dealt with by the client.

(e) If the review of pricing data reveals that certain suppliers offer quantity discounts, rebates, etc., ascertain that the Company receives all such allowances to which it is entitled.

(f) Inspect vendors' invoices and receiving reports, and trace receipts to perpetual inventory records for assurance that the material was received.

(g) Compare the perpetual inventory records and the materials on hand for agreement. Also review the results of the taking of the physical inventory. Determine if any shortages discovered resulted from non-receipt of materials.

(h) As an over-all check on the purchasing function, compare the activity in the accounts recording the buyer's purchases with activity in prior periods and account for any unusual fluctuations. In addition, review the perpetual inventory records for evidence of unbalanced inventory or unnecessary accumulation of material.

b. Inasmuch as it would not have been possible for the loss to have been made good within the fiscal year in which the defalcation occurred, the effect of the defalcation should be reported in the financial statements. Regardless of whether or not redress will be made, the cost or expense accounts that were involved should be relieved of these excess charges. The presence of these excess charges distorts the cost or expense accounts and, where the excess charges are inventoriable, distorts the cost of the ending inventories. In addition to relieving the cost or expense accounts, depending upon the circumstances, one of the following would be necessary:

1. If there is assurance that the loss will be made good by the buyer, the offending suppliers, or the insurance company providing fidelity bond coverage, a receivable for the amount that will be recovered should be established. If the CPA deems it necessary, disclosure of the defalcation should be made in a footnote.
2. If there is no assurance that the loss will be recovered, the amount of the loss should be set forth as a separate item in the income statement. Should the income statement be prepared in accordance with the current operating performance concept, the loss would be reported, net of related income tax effect, in the statement of retained earnings. In either presentation proper footnote disclosure may be made.

There would be no effect upon the CPA's report if adequate disclosure was made in the financial statements. If adequate disclosure was not made, the CPA would issue either a qualified opinion or an adverse opinion. An adverse opinion would be issued if the CPA judged that the effect of the defalcation created so material an exception to the fairness of presentation that a qualified opinion was not justified. If an adverse opinion is issued the CPA may see fit to render a piecemeal opinion on those financial statement items that are not affected by the defalcation. The reason for rendering a qualified or adverse opinion would be disclosed in a middle paragraph of the CPA's report.

The CPA would also prepare a detailed report to management in which he gave the findings of his investigation. In this report he would indicate the weaknesses in the system of internal control that permitted the defalcations to occur and remain undetected, and he would probably suggest changes that would strengthen the system so that there would be less likelihood of a future defalcation.

Answer 7

The Borow Corporation

a.

COMPUTATION OF GROSS PROFIT RATIO

For the Eleven Months Ended May 31, 1964

Sales		$840,000
Cost of goods sold		
Inventory, July 1, 1963	$ 87,500	
Purchases	675,000	
Purchases adjustments:		
Shipments received in May but recorded in June	7,500	
Unsalable shipments, no credit memos received at May 31, 1964	(1,000)	
Deposit with vendor, recorded as purchase	(2,000)	
Adjusted purchases to May 31, 1964	679,500	
Goods available for sale	767,000	
Physical inventory, May 31, 1964	95,000	
Cost of goods sold		672,000
Gross profit		$168,000
Gross profit ratio		20%

b.

COMPUTATION OF COST OF GOODS SOLD DURING JUNE 1964

Sales for year ended June 30, 1964	$960,000
Less sale of rain-damaged shipment	10,000
Net sales	950,000
Less sales for eleven months ended May 31, 1964	840,000
Net sales for June 1964	110,000
Less estimated gross profit at 20%	22,000
Cost of goods sold during June	$ 88,000

c.

COMPUTATION OF INVENTORY AT JUNE 30, 1964 BY THE GROSS PROFIT METHOD

Inventory, May 31, 1964	$ 95,000
Purchases to June 30, 1964 per general ledger	800,000
Adjustments:	
Unsalable shipments, no credit memos received at June 30, 1964	(1,500)
Deposit made with vendor and charged to purchases in April 1964. Product was shipped in July 1964	(2,000)
Cost of rain-damaged shipment	(10,000)
Adjusted purchases to June 30, 1964	786,500
Less adjusted purchases to May 31, 1964 (from schedule a)	679,500
Adjusted purchases for June	107,000
Goods available for sale during June	202,000
Less cost of goods sold during June (from schedule b)	88,000
Inventory at June 30, 1964	$114,000

COMMERCIAL LAW

November 6, 1964; 8:30 a.m. to 12 m.

Answer 1

1. False
2. True
3. False
4. True
5. False
6. False
7. False
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Answer 2

61. False
62. True
63. False
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71. True
72. True
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114. True
115. False
116. False
117. True
118. True
119. False
120. False

Answer 3

121. True	136. False	151. True	166. True
122. False	137. True	152. False	167. True
123. True	138. True	153. True	168. True
124. False	139. False	154. True	169. False
125. True	140. True	155. True	170. True
126. True	141. True	156. False	171. False
127. True	142. False	157. True	172. False
128. True	143. False	158. True	173. False
129. True	144. False	159. True	174. False
130. False	145. True	160. True	175. True
131. True	146. True	161. True	176. False
132. True	147. False	162. False	177. True
133. True	148. True	163. True	178. False
134. True	149. False	164. False	179. True
135. False	150. False	165. True	180. False

Answer 4

a. 1. Basic to the distinction between the employer-employee relationship and that of the independent contractor is the degree of right to control retained over the physical conduct of the person performing the service. An employee is subject to control by his employer concerning the method of his performance; an independent contractor is a person who contracts to do a certain job according to his own judgment and methods. The independent contractor has the right to employ his own workmen and direct and control their actions independently of the other party to the contract. Thus, the independent contractor is free from any superior authority in the other party to the contract to say how the agreed upon work shall be done; as a primary contracting party he need only answer as to the result of his work.

2. Yes, Henry will recover. State laws governing workmen's compensation afford a method of compensating employees or their estates for accidental injuries or death due to and arising in the course of their employment. This right to recover is not barred by the employee's negligent conduct, even though such conduct consists of gross negligence. It is the fact that the injury occurred during the course of the employment (which the given facts describe) that gives the employee the right to recovery under the Workmen's Compensation Act.

b. 1. The two essential elements of a common law artisan's lien are (1) a debt or obligation owing to the lien claimant in respect to the services he has performed on the property and (2) possession of the property by the lien claimant.

2. The common law artisan's lien is a possessory lien which gives the lien claimant the right to retain possession of the debtor's property until the debt has been discharged. Should the debtor fail to discharge the debt, the property may be sold as prescribed by law and the funds used to satisfy the debt.

3. Yes. Ordinarily, if the lien claimant surrenders possession to the debtor, the lien is lost. However, this surrender of the property must be a voluntary act on the part of the lien claimant and not an action induced by artifice or fraud. Where the latter occurs, although possession has been parted with, the lien is not extinguished. Here, the debt was due and owing on April 15. Taylor allowed Richard to retake possession of the sloop for a few hours on the fraudulent misrepresentation of Richard. Hence, the lien is not extinguished.

Answer 5

a. 1. The right of subrogation. Subrogation is the right of the surety, after he has paid the debt in full, to have and make use of all the remedies which the creditor had against the principal debtor and all the collateral the principal debtor had given the creditor. Subrogation is a substitution of the surety for the creditor in the relationship of the parties, or it has been considered by some to be a form of equitable assignment.

2. No, Stewart is not entitled to the stocks. In order for a surety to avail himself of the right of subrogation, it is necessary that the entire debt be paid. Here, the debt owing to Leonard, the creditor, was $1,040 of which only $1,000 was paid by Stewart. Moreover, even if Stewart had paid the entire debt ($1,040), he would in this case not be entitled to the right of subrogation. This right is not available to one who is not legally bound to answer for the principal debtor's obligation, and this rule applies even when one mistakenly believes that he is a surety. Stewart signed the note after the loan had been made and without receiving the requisite fresh consideration to make his promise legally binding. Technically, therefore, Stewart was merely a "volunteer" and has no right to recover the stocks.

b. No, Stanley's claim is not valid and he is obliged to pay. A valid and enforceable extension agreement between the principal debtor and creditor constitutes a change in the contract between them. If there is such a change, it is no longer the obligation for which the surety agreed to answer, and where the noncompensated surety does not consent to it or the creditor's rights against the surety are not expressly reserved, the noncompensated surety is discharged. Here, however, there was no legally binding agreement to extend the time of payment for a fixed or determinable time. The mere inaction on the part of Charles following Paul's request for an extension of time does not constitute the requisite legally binding extension agreement which would release the surety.

c. 1. Sam may obtain contribution from Seth in the amount of $6,000. Sam and Seth were co-sureties even though they guaranteed David's credit in different amounts. The total liability of the sureties was $30,000 ($10,000 for Sam, $20,000 for Seth). Accordingly, Sam is liable for one third of the $9,000 loss, and Seth is liable for two thirds of the loss. Upon payment by Sam of the full amount he can recover Seth's contributive share of $6,000.

2. Sam is now entitled to contribution from Seth to the extent of $4,000. The

security held by Sam is held for the benefit of all co-sureties. Security in the amount of $3,000 reduces the total loss to $6,000, of which Sam must pay $2,000 and Seth $4,000.

Answer 6

a. Yes, Ernest will prevail in a Uniform Commercial Code jurisdiction. He will prevail in a Negotiable Instrument Law jurisdiction if Charles is estopped to deny the real defense of lack of delivery of an incomplete instrument because he was negligent.

Ernest would qualify as a holder in due course. He took the check, a bearer instrument, in good faith and without notice and both the Uniform Commercial Code and the Negotiable Instrument Law recognize an antecedent indebtedness as value. As a holder in due course he is not subject to the personal defenses which might be asserted by Charles.

The two jurisdictions differ, however, on the question of whether the above facts (i.e., nondelivery of an incomplete instrument) give rise to a personal or a real defense.

Under the Uniform Commercial Code the two separate personal defenses (i.e., nondelivery of an instrument and the unauthorized completion of an incomplete instrument) do not, when coupled, become a real defense as is the rule under the Negotiable Instrument Law. Therefore, since the Uniform Commercial Code would hold that Charles has only a personal defense it will be cut off against a holder in due course such as Ernest.

The Negotiable Instrument Law would treat the two personal defenses as a real defense which is assertable even against a holder in due course. However, the courts are quick to hold in cases such as this that the defendant's conduct constituted negligence and thus the defendant is barred from asserting the real defense. The facts of this case seem to constitute a proper situation for the application of the estoppel approach.

b. Yes. Charles could recover. A depositor's bank must not only honor valid orders to pay, it must, in addition, follow the depositor's orders in regard to stopping payment. Since there is no exculpation or "hold harmless" clause mentioned in this situation, the depositor, Charles, is entitled to have his account credited for the amount of the wrongful payment.

Answer 7

a. No. The law of insurance does not require an actual physical delivery of the policy; the requirement may be satisfied by a constructive delivery.

Most jurisdictions would find that a "delivery" had taken place when the insurer issued the policy and sent it to the broker. The question is chiefly one of intent and it would seem that the requisite intent to deliver is present here.

In any event, a constructive delivery would be found in light of the subsequent forwarding of the policy to Parker via the mails even in those jurisdictions which might be hesitant in finding a fulfillment of the delivery requirement by the sending of the policy to the broker.

b. Fox Corporation will prevail. The law has long recognized that a corporation has an insurable interest in its "key" employees. Certainly a man at the vice presidential level would qualify as a key man and the corporation could validly insure his life.

   The fact that Harrold no longer is in the employ of Fox Corporation does not affect the Fox Corporation's right of recovery of the face value of the policy. It is a basic rule of life insurance law that valid insurable interest need only be present at the time of the taking out of the policy. The underlying rationale is that a life insurance policy is a form of investment and the policy holder has the right to continue his interest in the policy.

c. 1. Yes, each party may recover something. Each has an insurable interest in the building—Martin has a 20-year leasehold interest and Patrick owns the underlying fee simple estate. As such both have legally recognized insurable interests.
   2. Each may recover, but only to the extent of the fair market value of their respective interests.

Answer 8

Part a.

1. Third party beneficiary. Although the bank is not a party to the contract between Henry Manufacturing Company and the CPA firm it may nevertheless be able to maintain an action against the CPA firm as a third party beneficiary under the contract between Henry Manufacturing Company and the CPA firm. It will in all probability win such action based upon ordinary negligence.

   Normally liability does not run to third parties for engagements in which CPAs are guilty of ordinary negligence. However, where the CPAs are aware of the fact that a specific third party is going to rely upon the report and it is intended for his benefit, liability may be imposed. From the facts of this case it is clear that the CPA firm knew that the report was intended for the bank's benefit and that the bank would rely upon the report.
2. The ancient doctrine of privity will undoubtedly be the chief legal argument made by the attorney for the local CPA firm. However, as indicated above, it will probably not be successful.
3. Yes. If the CPA firm gives an unqualified opinion on financial statements without taking any action to verify the accounts receivable, it would be pretending knowledge when it had none and would therefore be guilty of gross negligence which, in this case, would be deemed constructive fraud by pretending knowledge when it had none. Where fraud is present, the firm is liable to third parties, such as creditors, who suffer damages by reliance upon its opinion. These third parties need not be parties to the contract nor those intended as third party beneficiaries.

Part b.

The three sources are court decisions, standards established by the profession and the special standards established by state and federal regulatory agencies (e.g., the S.E.C., I.R.S.).

THEORY OF ACCOUNTS

November 6, 1964; 1:30 p.m. to 5 p.m.

Answer 1

1. Because its nonaccounting connotations are apt to mislead lay readers of the balance sheet, the term "reserve" should not be used to identify the allowance for doubtful accounts. Also, it is desirable to disclose the amount of the allowance for doubtful accounts parenthetically, in a footnote, or as a deduction from gross receivables. A knowledge of the amount of shrinkage in accounts receivable due to anticipated bad debts permits an appraisal of the Company's credit policy and collection success.

2. The pricing method used to value inventories should be disclosed. Because of the available number of equally acceptable inventory pricing methods, and because these various methods can give materially different results, it is impossible to evaluate the significance of inventory amounts without knowing the methods used to produce them.

3. The classification of "investment securities" among current assets is ambiguous. If the securities held by the Company are intended to be a long-term commitment, then, irrespective of their marketability, they should not be included among current assets. The specific purpose, if any, of long-term investments should be disclosed by using descriptive captions and, if necessary, footnotes. Material differences between investment costs and current market values (or between investment costs and the Company's equity in the net assets of affiliated companies, as the case may be) should also be reported.

   If the securities held represent only a temporary commitment of idle cash, however, then the caption "temporary investments" is more descriptive of their short-term nature. In accordance with the practice of classifying current assets in their order of liquidity, temporary investments should be listed immediately following cash. Further, if, as in this case, temporary investments are valued at cost, their market values should be stated parenthetically.

4. The cost of the land which has been acquired for use as a future store site should be reclassified as an investment. Property, plant and equipment should include only those assets which are devoted to the firm's operations.

5. Intangibles are inadequately disclosed. Each major class of intangibles (e.g., patents, research and development costs, copyrights, goodwill, etc.) should be listed separately together with its valuation basis. To combine them all under one nondescriptive caption is not only uninformative but also casts doubt upon the integrity of the entire statement.

6. Prepaid expenses should be included among current assets because they represent expenditures which would otherwise have to be made during the next operating cycle, though some companies still show them in categories such as "Other assets."

7. The bookkeeper's treatment of the contingent liability on discounted notes receivable results in the overstatement of both notes receivable and current liabilities by $75,000. The contingent liability on a discounted note receivable represents a potential liability to the Company which will materialize only upon default by the drawer of the note. The $75,000 should therefore be reported as an offset to notes receivable, and the contingent liability should be mentioned parenthetically or in a footnote.

8. It is inaccurate to say that retained earnings "have been set aside to finance expansion." Appropriations of retained earnings are merely a means of disclosing a company's reasons for retaining in the business the increases in assets which have resulted from prior and current earnings. Only assets themselves can be "set aside" to finance expansion. Equities identify the sources of a firm's assets but disclose nothing as to their composition. (Although it is conceivable that some of the assets have been set aside for expansion, the statements contain no such indication.)

9. The income statement is improperly dated. Because it is an operating statement, it should be dated so as to indicate the period of time to which it pertains. In this case it should be dated "for the year ended June 30, 1964."

10. Interest income and interest on serial bonds are improperly classified. Both should appear below net operating income as other income and expense. Interest income is unrelated to the primary revenue producing activity of the firm and its present classification distorts both gross margin and net operating income. Interest on serial bonds should appear after net operating income because the latter figure is intended as a measure of management's success in profitably utilizing the total resources of the firm, irrespective of their source.

11. Sales returns and allowances should be shown as a deduction from gross sales. Selling expenses are expired costs which are incurred to produce sales revenues. Sales returns and allowances do not represent revenue producing costs; rather they represent an adjustment of gross revenue and should be treated as a contra thereto.

12. The Company's commitment under the long-term lease is inadequately disclosed. At a minimum, the financial statements or notes thereto should show the annual or total rent to be paid and the expiration date of the lease. Other principal details such as purchase or renewal options and sale and leaseback provisions should be also disclosed.

13. The provision for Federal income taxes bears no logical relationship to the Company's net income figure. The portion of the tax provision in excess of that which can be attributed to the reported net income should be separately

disclosed and reported in accordance with the nature of the item(s) which gave rise to it. The absence of a statement of retained earnings together with the way in which the excess portion of the tax provision is reported precludes an informed appraisal of the Company's over-all operating results, including nonrecurring gains and losses.

14. Current liabilities are understated by $50,000, the amount of the 5% serial bonds that mature within one year. Unless current maturities on long-term debt will not require the use of current assets, they must be classified as a current liability.

Answer 2

Part a.

1. The theoretical superiority of the allowance method over the direct write-off method of accounting for bad debts is two-fold. First, since revenue is considered to be realized and is therefore recognized at the point of sale on the assumption that the resulting receivables are valid liquid assets merely awaiting collection, periodic income will be overstated to the extent of any receivables that eventually become uncollectible. The proper matching of revenue and expense requires that gross sales in the income statement be partially offset by a charge to bad debt expense that is based on an estimate of the receivables arising from gross sales that will not be converted into cash.

   Second, accounts receivable on the balance sheet should be stated at their estimated net realizable value. The allowance method accomplishes this by deducting from gross receivables the allowance for doubtful accounts. The latter is a derivative of the charges for bad debt expense on the income statements.

2. (a) The percentage of sales method. Under this method bad debt expense is charged and the allowance for uncollectible accounts is credited with a percentage of the current year's credit or total sales. The rate is determined by reference to the relationship between prior years' credit or total sales and actual bad debts arising therefrom. Consideration should also be given to changes in credit policy and current economic conditions. Although the rate should theoretically be based on and applied to credit sales, the use of total sales is acceptable if the ratio of credit sales to total sales does not vary significantly from year to year.

   The percentage of sales method of providing for estimated uncollectible receivables is intended to charge bad debt expense to the period in which the corresponding sales are recorded and is, therefore, designed for the preparation of a fair income statement. Due to annually insignificant but cumulatively significant errors in the experience rate which may result in either an excessive or inadequate balance in the allowance account, however, this method may not accurately report accounts receivable at their estimated net realizable value. This can be prevented by periodically reviewing and, if necessary, adjusting the balance in the allowance ac-

count. The materiality of any such adjustment would govern its treatment for reporting purposes.

It should be noted that the necessity of such adjustments of the allowance account indicates that bad debt expenses have not been accurately matched against related sales. Further, even when the experience rate does not result in an excessive or inadequate balance in the allowance account, this method tends to have a smoothing effect on reported periodic income due to year to year differences between the amounts of bad debt write-offs and estimated bad debts.

(b) The aging method. With this method each year's debit to the expense account and credit to the valuation account is determined by an evaluation of the collectibility of open accounts receivable at the close of the year. An analysis of the accounts according to their due dates is the usual procedure. For each of the age categories established in the analysis, average percentage rates may be developed on the basis of past experience and applied to the accounts in the respective age categories. This method may also utilize individual analysis for some accounts, especially those that are considerably past due, in arriving at estimated uncollectible receivables. On the basis of the foregoing analysis the balance in the valuation account is then adjusted to the amount estimated to be uncollectible.

This method of providing for uncollectible accounts is quite accurate for purposes of reporting accounts receivable at their estimated net realizable value in the balance sheet. From the standpoint of the income statement, however, the aging method may not match accurately bad debt expenses with the sales which caused them because the charge to bad debt expense is not based on sales. The accuracy of both the charge to bad debt expense and the reported value of receivables depends on the current estimate of uncollectible accounts. The accuracy of the expense charge, however, is additionally dependent upon the timing of actual write-offs.

3. A major part of accounting is the measurement of financial data. Changes in values should be recognized as soon as they are measurable in objective terms in order that accounting may provide useful information on a periodic basis.

Accountants have had to develop a philosophy regarding an acceptable degree of uncertainty in order to make their work useful. The accountant's term "objectivity" does not imply certainty. Estimates can be objective, though by definition they are not certain. To be considered objective, they must be based on evidence that is reliable and subject to vertification by another competent investigator. This kind of criterion permits the preparation of meaningful periodic financial statements through such conventions as the sales method of revenue recognition and the allowance method of accounting for bad debts.

The very existence of accounts receivable is based on the decision that a credit sale is an objective indication that revenue should be recognized. The alternative is to wait until the debt is paid in cash. If revenue is to be recognized and an asset recorded at the time of a credit sale, the need for fairness in the statements requires that both expenses and the asset should be adjusted for the estimated amounts of the asset that experience, which is subject to

verification by competent investigators, indicates will not be collected.

The client may be correct in saying that the evidence supporting write-offs permits a more nearly accurate decision than that which supports the allowance method. The latter method, however, is "objective" in the sense in which accountants use the term and is justified by the need for fair presentation of receivables and income. The direct write-off method is not wholly objective; it requires the use of judgment in determining when an account has become uncollectible.

Part b.

The receivable due from the Morgan Company should be written off to an appropriately named loss account and reported after income from operations in the income statement. This treatment looks behind the loss of the receivable to the reason therefor; classifies the transactions as a nonoperating, abnormal, and nonrecurring loss; and measures the loss by the amount of the receivable. The loss may properly be reduced by the portion of the allowance for bad debts at the end of the preceding year that was allocable to the Morgan Company account. (If the loss, alone or in combination with other items that are clearly not identifiable with or do not result from the usual or typical operations of the current period, is so material that its inclusion in the income statement would impair the significance of net income to such a degree that misleading inferences might be drawn therefrom, it should be excluded from the income statement.)

Estimates for doubtful accounts are based on a firm's prior bad debt experience with due consideration given to changes in credit policy and forecasted general or industry business conditions. The purpose of the allowance method is to anticipate only that amount of bad debt expense which can be reasonably forecasted in the normal course of events; it is not intended to anticipate bad debt losses which are abnormal and nonrecurring in nature.

Answer 3

a. The principal transactions or items that reduce the amount of retained earnings include the following:
   1. Operating losses.
   2. Stock dividends.
   3. Dividends distributing corporate assets.
   4. Recapitalizations such as quasi-reorganizations.
   5. Extraordinary items of material amount which are not clearly identifiable with or do not result from the typical business operations of the period. Such items would include the following:
      (a) Charges related to prior years.
      (b) Losses from sales of assets not considered to be stock in trade.
      (c) Losses not usually insured against, such as losses from wars, riots, and earthquakes.
      (d) Write-off of intangible assets.
      (e) Write-off of unamortized bond discount, premium or issue expense at the time of retirement or refunding before maturity.

b. The principal reason for making the distinction between contributed capital and earned capital in the stockholders' equity section is to enable stockholders and creditors to identify dividend distributions as actual distributions of earnings or as returns of capital. This identification is necessary to comply with the various state statutes which provide that there should be no impairment of the corporation's legal or stated capital by the return of such capital to owners in the form of dividends. This concept of legal capital generally provides a measure of protection to creditors and imposes a liability upon the stockholders in the event of such impairment.

   A knowledge of the distinction between contributed capital and earned capital provides a guide to the amount of dividends that may be distributed by the corporation. Assets represented by the earned capital, if in liquid form, may properly be distributed as dividends; but invested assets represented by contributed capital should ordinarily remain for continued operation of the corporation. If assets represented by contributed capital are distributed to shareholders, the distribution should be identified as a return of capital and hence in the nature of a liquidating dividend.

   A knowledge of the amount of capital that has been earned over a period of years after adjustment for dividends is also of value to the stockholders in judging dividend policy and obtaining an indication of past profits to the extent not distributed as dividends.

c. The acquisition and reissuance of its own stock by a corporation results only in the contraction or expansion of the amount of capital invested in it by stockholders. In other words, an acquisition of treasury shares by a corporation is viewed as a partial liquidation and their subsequent reissuance is viewed as an unrelated capital-raising activity.

   To characterize as gain or loss the changes in owners' equity resulting from a corporation's acquisition and subsequent reissuance of its own shares at different prices is a misuse of accounting terminology. When a corporation acquires its own shares, it is not "buying" anything nor has it incurred a "cost." The price paid merely represents the amount by which the corporation has reduced its net assets or "partially liquidated." Similarly, when the corporation reissues these shares it has not "sold" anything. It has merely increased its total capitalization by the amount received.

   Thus it is the practice of referring to the acquisition and reissuance of treasury shares as a buying and selling activity that gives the superficial impression that, in this process, the corporation is acquiring and disposing of assets and that, if different amounts per share are involved, a gain or loss results. It is obvious, however, that when a corporation "buys" treasury shares it is not acquiring assets; nor is it disposing of any assets when these shares are subsequently "sold."

Answer 4

Part a.

A subsidiary should be excluded from a consolidation if

1. Its operations are unrelated to those of the parent and other subsidiaries.

2. It is a foreign subsidiary and fund restrictions exist, the exchange rate is volatile, or there are other conditions which jeopardize the realization of the subsidiary's assets.
3. Control of the subsidiary is not assured, regardless of the percentage of stock owned by the consolidated group.
4. Control, though assured, is likely to be temporary (e.g., a subsidiary which is soon to be sold.)
5. Control does not rest with the majority interests (e.g., a subsidiary in legal reorganization).

Part b.

a. 1. The underlying premise supporting the first treatment is that consolidated statements are developed for the purpose of reporting on the proprietory interests of the controlling group alone. Minority interests are viewed as being outside interests and are not regarded as an element of ownership in the consolidated statements. The intercompany profit in inventories applicable to these "outsiders" is regarded as being realized, and the amount of the elimination of intercompany profits in inventories should therefore be limited to the amount allocable to the controlling interests. The amount of the profit applicable to the minority interests is not eliminated from consolidated inventories because, to this extent, consolidated inventories were acquired from "outside" interests and their cost to the controlling interests should properly include the profit realized by these "outsiders."

   Some accountants have argued that the minority's share of intercompany profits in inventories should not be eliminated because the amount of their interest, as shown on the consolidated statements, should be in agreement with its book value on the subsidiary's own statements. While it is true that this will result from the above treatment, it should be noted that it is only a result. It is not essential to the central argument which supports the elimination of only the controlling interests' share of intercompany profits in inventories.

2. The elimination of the entire amount of intercompany profits in inventories with the portion applicable to minority interests deducted therefrom is supported on the premise that consolidated statements are prepared for the purpose of reporting the financial position and results of operations of affiliated companies as though they were a single entity. The combined ownership interests of both the controlling and minority groups are regarded as making up the consolidated entity. Minority interest groups are not considered to be "outsiders"; rather, they are regarded as just another element of the consolidated entity's ownership.

   This view regarding the underlying purpose of consolidated statements requires that all intercompany profits in inventory be eliminated because, when the minority interests are conceived of as being just another element of consolidated ownership, their share of intercompany profit in inventory does not represent a sale by an outside group to the consolidated interests and cannot, therefore, be considered to be realized.

   The elimination of intercompany profit in inventories should be charged

to the controlling and minority equity accounts in proportion to their respective interests therein. Unless this is done, neither the controlling nor the minority equities on the consolidated balance sheet will be stated at an amount which reflects their respective interests in the consolidated net assets.

3. With regard to the basis for the valuation of consolidated inventories the effect of this treatment is the same as that of the second treatment. With regard to the amount of the minority's equity on the consolidated balance sheet, the effect of this treatment is the same as that of the first treatment. This treatment attempts to combine the underlying premises of the first two treatments and, in so doing, becomes logically inconsistent. The only support for this treatment is that, when the minority's share of intercompany profits in consolidated inventories is immaterial in amount, it is expedient.

b. The first two treatments can be logically supported on the basis of their respective underlying assumptions regarding the purpose and nature of consolidated statements. The respective merits of these two approaches must therefore be examined in terms of the theoretical propriety of their underlying assumptions.

While the first treatment is logically supportable on the basis of its underlying assumption, the assumption fails to recognize that the total resources of the affiliated companies are under the administrative control of the majority interests. In other words, all of the resources of the affiliated companies, including the minority interests' share, are being managed as though they were divisions or branches of a single company. Because of this, and because consolidated statements are prepared primarily for the use of the controlling interests, the basis of accounting for the consolidated assets should be no different from that which would be used if divisions or branches of a single company were being combined.

The fact that consolidated statements are prepared primarily for use by the controlling interests does not require that minority interests be regarded as "outside" interests to be excluded from the owners' equity section of the consolidated balance sheet, nor is this treatment desirable. Such treatment implies that minority interests represent a sort of legal liability on the consolidated balance sheet; but, in fact, it is much more realistic to regard them as having a status similar to preferred stock without preferences. The absence of a voice in the management of the affiliated companies does not give the minority interests any of the characteristics of a liability merely because the managing interests overlook nominal legal distinctions and develop a set of statements which summarizes all of the assets, liabilities and ownership equities of the affiliated companies.

The theoretical propriety of not eliminating the minority's share of intercompany profits in consolidated inventories evaporates when minority interests are properly viewed as a special element of proprietorship instead of a liability. The basis of accounting for consolidated inventories ceases to be a function of the existence of minority interests and, instead, permits their valuation on a basis consistent with the assumption that the separate legal entities are merely branches of a single economic entity.

To charge consolidated retained earnings for the entire amount of

intercompany profits in consolidated inventories (the third treatment) is justifiable only on the grounds of immateriality and expediency. The defect in this treatment is that, instead of relying upon an underlying assumption regarding the purpose and nature of consolidated statements, it uses a piecemeal approach. It justifies the elimination of the entire amount of intercompany profit in inventory on the grounds that consolidated inventories should be valued at cost to the consolidated entity. Cost to the consolidated entity depends, however, on whether minority interests are regarded as an element of ownership in the consolidated statements (the second treatment) or whether they are regarded as an outside interest (the first treatment). Charging consolidated retained earnings with the entire amount of the elimination results in a consolidated balance sheet in which neither the minority nor the controlling interest is reported at an amount which represents its equity in the net assets of the affiliated companies.

Answer 5

a. The nominal interest rate, expressed as a percentage of the face value, is the periodic payment promised in a bond indenture. The effective interest rate is the rate at which bonds can be sold in the market. The nominal and effective rates of interest will be the same only when bonds are sold at face value. If bonds sell at less than face value (a discount), the effective rate is higher than the nominal rate. If bonds sell at more than face value (a premium), the effective rate is lower than the nominal rate.

b. The $25,000 difference is the adjustment of the nominal interest rate specified in the bond indenture to the market rate. In other words, for an investment of $975,000 the Company's bondholders will receive annual interest payments of $40,000, plus $25,000 more than they invested when the bonds mature. Though earned throughout the life of the bond contract the bondholders do not receive this portion of the "effective" interest until maturity.

c. The $10,000 increase in the market value of the bonds from January 1 to June 30 is primarily the result of a decrease in the rate of interest at which the Company's bonds will trade in the market. The decrease in the market rate of interest at which the bonds will trade may be due to a general change in the conditions of the bond market, to a change in the Company's credit rating, or to a combination of the two.

A minor portion of the increase is due to the fact that the bonds were issued at a discount and are now six months closer to maturity. This portion of the increase is due only to the passage of time and would have taken place without any change in the market rate of interest. In other words, assuming no change in the market rate of interest, the market value of the bonds will increase gradually from $975,000 to $1,000,000 at maturity because of the increase in the present value of the unpaid but accruing interest (discount) of $25,000.

Assuming the discount is accumulated on an interest basis, this portion of the increase in the market value of the bonds will be reported in the Com-

pany's financial statements. The portion of the increase in the market value of the bonds which is due to the decrease in the market rate of interest, though not reported in the financial statements, is significant because only by comparing the effective rate of interest at which the bonds were issued with the current market rate of interest can the Company judge whether or not the rate they are paying is advantageous to them. If the market rate is lower it may be to the Company's advantage to refund the old issue.

d. 1. $975,625. This basis for valuing the bond liability—its effective amount as at the date of the issue, plus accumulated discount on a straight-line basis for the six months since then—is theoretically superior to the other two. It would, however, be more precise to accumulate the discount on an interest basis.

The Company actually borrowed $975,000, and the immediate liability incurred cannot be more nor less than this amount. The present value of the bond liability is less than maturity value because the effective rate of interest is greater than the nominal rate which appears on the face of the bonds. The actual difference between the present value of the bond liability at the date of issue ($975,000) and its maturity value ($1,000,000) represents that portion of the effective interest on the amount borrowed ($975,000) that will not be paid until maturity. As this amount is accumulated by charges to interest expense and credits to the bond liability, the effective amount of the liability gradually approaches maturity value.

It should be noted that bond issue costs are disregarded in computing the effective amount of the bond liability. Though they are usually added to the discount or deducted from the premium, bond issue costs should properly be treated as an asset. Such costs are incurred in the process of acquiring borrowed funds and should be amortized over the period during which the funds are used.

2. $1,000,000. This basis for valuing bond liabilities, the amount due at maturity, is widely used in practice. Its use is frequently supported on the grounds that it represents the amount of the true legal liability, since it is this amount that would be due and payable in the event of default. This support disregards the accounting assumption of the going concern and, instead, emphasizes liquidation values.

This valuation basis is also supported on the grounds that the discount represents prepaid interest and should therefore be classified as an asset. This argument has no merit because the discount represents unpaid interest, not prepaid interest. Any bookkeeping entry which classifies discount as prepaid interest does so only by failing properly to adjust the amount borrowed to its effective amount.

The practice of recording bond liabilities at maturity value and setting up the discount as a deferred charge is defensible only if the amounts involved are not material and it can be shown that this treatment is expedient.

3. $1,780,000. The basis for this alternative—the total amount the Company is obligated to repay over the remaining life of the bonds ($1,000,000

at maturity, plus 39 semiannual interest payments of $20,000 each)—has no justification. It would require the difference between the amount actually borrowed ($975,000) and the total amount the Company became obligated to repay ($1,800,000) to be treated as an asset or a loss when the bonds were issued. To assume that assets were acquired in excess of the amount actually borrowed or that a loss was incurred in an arm's length transaction is indefensible. The original bondholders invested $975,000 for the right to receive $1,800,000 under the conditions stipulated in the contract (an annuity of $20,000 for forty periods and $1,000,000 at the end of the fortieth period). Thus, at the date of issuance the Company incurs a liability equal to the amount of the bondholders' investment. The difference between this amount and $1,800,000 is the total amount of interest which will accrue with the passage of time. It does not exist at the date the bonds are issued.

Except for the materiality of the amounts involved, the use of this alternative as a valuation basis suffers from the same theoretical shortcomings as does the use of face value when bonds are issued at a discount.

Answer 6

a. 1. (1) *Fixed costs.* Fixed costs are costs which, for a given period of time and for a specified range of output or capacity, do not change in response to changes in volume. They are incurred as a function of time. Examples of costs which are usually fixed for a given time period and range of output or capacity include rent, property taxes, and salaries.

Variable costs. Variable costs are costs which change proportionally in response to changes in volume. Examples of variable costs include direct labor, direct materials, and sales commissions.

(2) Because fixed costs are constant in total, changes in the number of units of output will change the amount of fixed cost associated with each unit. As output increases the fixed cost per unit becomes progressively smaller.

The total amount of a variable cost changes in proportion to changes in the volume of output. Thus, by definition, every change in the number of units of output will change total variable cost by the same "fixed" amount per unit. All costs are variable in the long run in the sense that they may be changed in response to substantial changes in a firm's capacity, state of technology, product lines, and the like.

2. (1) *Depreciation.* Depreciation is the amount by which the economic utility of a tangible capital asset is impaired due to physical deterioration, inadequacy and obsolescence. It is recognized by allocating the cost or other basis of the asset (less salvage, if any) over its estimated useful life in a systematic and rational manner.

(2) Depreciation is a fixed cost when it is allocated to the periods benefited on a time basis. Most methods of computing depreciation are

based on time, and it is therefore usually and properly viewed as a fixed cost. However, depreciation can also be computed on a production basis, such as machine or kilowatt hours. When depreciation is computed on a production basis, its amount depends entirely on the volume of output and it therefore is a variable cost.

b. 1. (1) Dollars of revenue and costs.
(2) Volume of output, expressed in units, per cent of capacity, sales, or some other measure.
(3) Total expense line.
(4) Variable expense area.
(5) Fixed expense area.
(6) Breakeven point.
(7) Loss area.
(8) Profit area.
(9) Revenue line.

2. An analysis of the expected behavior of a firm's expenses and revenues for the purpose of constructing a breakeven chart is usually restricted to the output levels at which the firm is likely to operate. Assumptions about the level of fixed expenses, the rate of variable expenses and selling prices are based on the operating conditions and managerial policies which will be in effect over the expected output levels. These expected output levels represent the firm's relevant range, and the cost-volume-profit relationships shown in a breakeven chart are applicable only to output levels within this range. The behavior of fixed expenses, variable expenses and selling prices at levels of output below or above the relevant range is likely to result in an entirely different set of cost-volume-profit relationships because of changed operating conditions or managerial policies. The fact that the expense and revenue lines on a breakeven chart are typically extended past the upper and lower limits of the relevant range should not, therefore, be interpreted to mean that they are valid for these levels of output.

A breakeven chart showing cost-volume-profit relationships for all levels of output could, of course, be developed. The shapes of the expense and revenue lines in such a chart could not, however, be expected to even approximate straightline (linear) patterns. By restricting the underlying expense and revenue behavior assumptions in breakeven analyses to a relatively narrow output range—the range over which the firm is likely to operate—it is possible to assume linear behavior patterns without any significant distortions in cost-volume-profit relationships, and thereby simplify the analysis. If the range over which a firm is likely to operate is quite wide, it may be desirable, if not necessary, to develop a number of breakeven charts, each having its own relevant range for which the underlying cost and revenue behavior assumptions are valid.

Answer 7

a. The following arguments are made for adjusting financial statements for changes in price level:

1. Failure to allow for the effects of changes in price level is unrealistic and

causes significant errors in the determination of income and the presentation of balance sheet amounts. These errors arise from reliance on the premise that the monetary unit, the dollar, is stable. The dollar is not stable, however, and changes in its value result in the assembly of basically non-additive amounts for balance sheet purposes and nonuniform costs for income computations.

2. Readers of the financial statements can make a better appraisal of management's effectiveness in the preservation of the current dollar equivalent of the capital invested in the business. The readers can also make a more useful analysis of the company's earning power in terms of current economic conditions. In addition, such analyses as return on stockholders' equity and return on total capital employed would be made more meaningful.
3. Computation of the gain or loss on monetary items provides information that is useful in judging how effective monetary management has been.
4. If the computation of depreciation based on costs adjusted for the effect of price level changes were permitted for tax purposes, depreciation charges would permit recovery of purchasing power that would more nearly equal the cost of new assets to replace the old.
5. The values of nearly all items, as reported on the balance sheet, would more closely approximate current values.
6. The public would be better informed regarding the effect of inflation or deflation upon the national economy in general and, more specifically, upon corporate profits, prices, etc.
7. More accurate information would be made available for governmental use in developing economic policies regarding such matters as business pricing policies, income taxation, business profits, and antitrust actions. In the cases of public utilities, transportation companies, and other companies whose rates are set by government action, a more equitable method of determining the amount of capital investment and, hence, the amount of return, would be afforded by financial statements adjusted for price level changes.
8. The soundness of management's decisions concerning the business depends on the accuracy of the information upon which they are based. In those cases in which information in published financial statements is relied upon wholly or in part as a basis for management's decisions, it is argued that better decisions will be made if the financial statements have been adjusted for price level changes. To rely on "information" in unadjusted financial statements is frequently to rely on misinformation, not information.

b. The following arguments are advanced for preparing financial statements only on the basis of unadjusted historical cost:
   1. Financial statements prepared on this basis provide a measure of management's accomplishments based on verifiable evidence. Such statements have been the principal communication between management and stockholders, and their limitations are so well-recognized that readers make allowances therefor.
   2. The use of unadjusted historical cost is deeply imbedded in matters of law and, to a considerable extent, in income tax matters.

3. No method of adjusting for price level changes has been generally accepted; for example, there is no general agreement, among those who advocate price level adjustments, as to which price index should be used. The application of price indexes on a subjective basis might result in varying results that would be confusing to readers of the statements. Of comparable importance, also, is the possibility of statement manipulations and other malpractices if price indexes could be applied on a subjective basis.
4. The importance of the price level problem may well be exaggerated because, in view of technological improvements, a substantial part of a typical manufacturing company's fixed assets have been recently acquired and are, therefore, valued virtually at current price levels. The turnover of inventories results in their being stated at values that approximate current costs (except for inventories valued on the LIFO basis).
5. Price level adjustments might upset the market price of corporate capital stock if investors should come to the conclusion that a less favorable financial picture is presented.
6. The use of historical costs (unadjusted for price level changes) and the placement of all information concerning values other than such costs only in footnotes permits readers of the financial statements to make whatever use of the book values they deem appropriate in making financial analyses of the statements.
7. Placing financial statements on a current price level might contribute to the inflation of prices with unforeseeable consequences for the national economy as a whole.
8. No need exists for the placing of similar assets on a common price level as is maintained by advocates of price level adjustments. Average costs have traditionally been employed by accountants with satisfactory results.

c. Changes in the prices of specific goods and services occur with fluctuations in the markets for them and may occur when the purchasing power of the dollar is stationary or when it is moving up or down. Measures of the general price level indicate the average purchasing power of the dollar and hence the amount of general inflation or deflation.

Changes in the prices of specific goods and services may be measured by appraisal procedures or by the application of price indexes especially prepared for them. For example, a price index based on the movements of the prices of the factors that enter into construction costs would be suitable for estimation of changes in the reproduction cost of a new building. On the other hand, an index based on the movement of the prices of all goods and services (or of goods and services selected to be representative of all) would be suitable for estimating changes in the purchasing power of the dollar.

The book value of the building cited above could be adjusted by means of either the construction index or the general price level index. Only the latter adjustment would properly be called a "price level adjustment" because the former index may not bear any relationship to the general price level.

Answers to Examinations, May 1965

ACCOUNTING PRACTICE—PART I

May 12, 1965; 1:30 to 6:00 p.m.

Solution 1

1. C	11. B
2. E	12. D
3. D	13. D
4. D	14. A
5. B	15. B
6. B	16. B
7. C	17. A
8. B	18. E
9. C	19. D
10. D	20. E

Solution 2

The Dieck Corporation

WORKSHEET TO CONVERT TRIAL BALANCE AMOUNTS FROM PESOS TO DOLLARS

December 31, 1964

	Pesos		Conversion	Dollars	
	Debit	*Credit*	*Rate*	*Debit*	*Credit*
Cash	P 25,000		2.40	$ 60,000	
Accounts receivable	20,000		2.40	48,000	
Allowance for bad debts		P 500	2.40		$ 1,200
Due from The Wiend Corporation	30,000		Reciprocal balance	70,500	
Inventories, December 31, 1964	110,000		2.40	264,000	
Prepaid expenses	3,000		2.40	7,200	
Machinery and equipment	210,000		See worksheet	424,000	
Allowance for depreciation		79,900	See worksheet		160,200
Accounts payable		22,000	2.40		52,800
Income taxes payable		40,000	2.40		96,000
Notes payable		60,000	2.20		132,000
Capital stock		50,000	2.00		100,000
Retained earnings		100,600	12/31/63 balance		212,000
Sales-domestic		170,000	2.30		391,000
Sales-foreign		200,000	Reciprocal balance		471,000
Cost of sales	207,600		2.30	477,480	
Depreciation	22,400		See worksheet	45,200	
Selling and administrative expenses	60,000		2.30	138,000	
Gain on sale of assets		5,000	See worksheet		15,640
Provision for income taxes	40,000		2.30	92,000	
Exchange adjustment (to balance)				5,460	
	P728,000	P728,000		$1,631,840	$1,631,840

Conversion of Machinery and Equipment, Allowance for Depreciation and Depreciation

Machinery and Equipment	*Pesos*	*Conversion Rate*	*Dollars*
January 1, 1963—acquired	P204,000		
December 31, 1964—disposal	14,000		
Balance	190,000	2.00	$380,000
December 31, 1963—purchase	20,000	2.20	44,000
Total	P210,000		$424,000

Allowance for Depreciation			
For assets acquired January 1, 1963:			
Recorded on books at acquisition	P42,000	2.00	$ 84,000
Annual depreciation @ 10%—1963	20,400	2.00	40,800
Annual depreciation @ 10%—1964	20,400	2.00	40,800
Total	82,800		165,600
Less disposal	4,900	2.00	9,800
Total	77,900		155,800
For assets acquired December 31, 1963:			
Annual depreciation @ 10%—1964	2,000	2.20	4,400
Total	P79,900		$160,200

Depreciation for 1964			
For assets acquired January 1, 1963	P20,400	2.00	$ 40,800
For assets acquired December 31, 1963	2,000	2.20	4,400
Total	P22,400		$ 45,200

Conversion of Gain on Sale of Assets

Cost of assets	P14,000	2.00	$ 28,000
Accumulated depreciation	4,900	2.00	9,800
Net book value	9,100	2.00	18,200
Proceeds of sale	14,100	2.40	33,840
Gain on sale	P 5,000		$ 15,640

Solution 3

Four Partners' Discount Stores

WORKSHEET TO ADJUST AND COMBINE THE PARTNERSHIPS' ACCOUNTS

a.

June 30, 1964

	Down & Short Trial Balance June 30, 1964		*Need & Want Trial Balance June 30, 1964*		*Adjusting and Combining Entries*		*Four Partners' Discount Stores Beginning Balances*	
Cash	$ 20,000		$ 15,000				$ 35,000	
Accounts receivable	100,000		150,000				250,000	
Allowance for doubtful accounts		$ 2,000		$ 6,000	(2) $ 1,500	(1) $ 1,000		$ 7,500
Merchandise inventory	175,000		119,000		(3) 21,000		315,000	
Land	25,000		35,000				60,000	
Buildings and equipment	80,000		125,000				205,000	
Allowance for depreciation		24,000		61,000		(4) 15,040		100,040
Prepaid expenses	5,000		7,000				12,000	
Accounts payable		40,000		60,000		(5) 4,000		104,000
Notes payable		70,000		75,000				145,000
Accrued expenses		30,000		45,000		(6) 2,000		77,000
Down, Capital		95,000			(1) 400	(7) 1,416		90,000
					(4) 6,016			
Short, Capital		144,000			(1) 600	(7) 624		135,000
					(4) 9,024			
Need, Capital				65,000	(5) 1,200	(2) 450		67,500
					(6) 600	(3) 6,300		
					(7) 2,450			
Want, Capital				139,000	(5) 2,800	(2) 1,050		157,500
					(6) 1,400	(3) 14,700		
						(7) 6,950		
	$405,000	$405,000	$451,000	$451,000				
Goodwill					(7) 6,540		6,540	
					$53,530	$53,530	$883,540	$883,540

Adjusting and Combining Entries (Not Required)

(1)

		Debit	Credit
Down, Capital		$ 400	
Short, Capital		600	
Allowance for doubtful accounts			$ 1,000
To adjust Allowance for Doubtful Accounts to 3% of receivables.			
Allowance required (3% × $100,000)	$ 3,000		
Allowance provided	2,000		
Adjustment	$ 1,000		

(2)

		Debit	Credit
Allowance for doubtful accounts		1,500	
Need, Capital			450
Want, Capital			1,050
To adjust Allowance for Doubtful Accounts to 3% of receivables.			
Allowance required (3% × $150,000)	$ 4,500		
Allowance provided	6,000		
Adjustment	$(1,500)		

(3)

		Debit	Credit
Merchandise inventory		21,000	
Need, Capital			6,300
Want, Capital			14,700
To adjust inventory to FIFO valuation method.			
$119,000 ÷ 85% =	$140,000		
LIFO inventory valuation =	119,000		
Adjustment	$ 21,000		

(4)

		Debit	Credit
Down, Capital		6,016	
Short, Capital		9,024	
Allowance for depreciation			15,040
To adjust the Allowance for Depreciation account to an accumulation of depreciation for 3 years computed by the double-declining balance method.			
Corrected accumulated depreciation	$39,040		
Depreciation provided	24,000		
Adjustment	$15,040		

(5)

		Debit	Credit
Need, Capital		1,200	
Want, Capital		2,800	
Accounts payable			4,000
To record unrecorded merchandise purchase.			

(6)

	Dr.	Cr.
Need, Capital	600	
Want, Capital	1,400	
Accrued expenses		2,000
To record vacation pay accrual. ($100 × 10 × 2)		

(7)

	Dr.	Cr.
Need, Capital	2,450	
Goodwill	6,540	
Down, Capital		1,416
Short, Capital		624
Want, Capital		6,950
To adjust capital accounts to opening balances as agreed.		

Computation of Distribution of Goodwill

	Total	*Down*	*Short*	*Need*	*Want*
Unadjusted book balances	$443,000	$95,000	$144,000	$65,000	$139,000
Adjustments					
#1	(1,000)	(400)	(600)		
#2	1,500			450	1,050
#3	21,000			6,300	14,700
#4	(15,040)	(6,016)	(9,024)		
#5	(4,000)			(1,200)	(2,800)
#6	(2,000)			(600)	(1,400)
Adjusted book balances	443,460	88,584	134,376	69,950	150,550
Opening capital balances	450,000	90,000	135,000	67,500	157,500
Distribution of goodwill	$ 6,540	$ 1,416	$ 624	$(2,450)	$ 6,950

Computation of Opening Capital Balances

Down	(20% × $450,000)	$ 90,000
Short	(30% × $450,000)	135,000
Need	(15% × $450,000)	67,500
Want	(35% × $450,000)	157,500
Total Opening Capital		$450,000

X = total partnership capital

(.20 + .30) X = $225,000

X = $450,000

b.

Computation of Cash Settlements Between Partners

Settlement Between Down and Short	*Total*	*Down*	*Short*
Adjusted capital balances, excluding goodwill	$222,960	$88,584	$134,376
Goodwill, distributed in profit and loss ratio	2,040	816	1,224
Total	225,000	89,400	135,600
Opening capital accounts	225,000	90,000	135,000
Settlement between partners	—0—	$ (600)	$ 600

Settlement Between Need and Want	*Total*	*Need*	*Want*
Adjusted capital balances, excluding goodwill	$220,500	$69,950	$150,550
Goodwill, distributed in profit and loss ratio	4,500	1,350	3,150
Total	225,000	71,300	153,700
Opening capital accounts	225,000	67,500	157,500
Settlement between partners	—0—	$(3,800)	$ 3,800

Solution 4

a.

The Dopern Company
EQUIVALENT PRODUCTION REPORT FOR JANUARY

	Production	*Equivalent Production*	
	Units	*Material*	*Direct Labor & Overhead*
Started and completed in January	900	900	900
Work-in-process, January 31			
Material (75% × 200)	200	150	
Direct labor and overhead (80% × 200)	200		160
Total equivalent production		1,050	1,060

b.

COMPUTATION OF UNDER- OR OVERAPPLIED OVERHEAD AT JANUARY 31

Overhead incurred during January	
Indirect labor	$1,790
Power	220
Supplies	330
Fixed costs	2,000
Total overhead incurred	4,340
Overhead applied during January	
Indirect labor	1,790
Power	220
Supplies	330
Fixed costs (1,060 × $2)	2,120
Total overhead applied	4,460
Overapplied overhead at January 31	$ 120

c.

COMPUTATION OF THE COST OF GOODS SHIPPED AND WORK-IN-PROCESS INVENTORY AT JANUARY 31

	Amount To Be Accounted For	*Direct Material*	*Conversion Costs*
Total costs to be accounted for	$37,940	$23,100	$14,840
Equivalent units		1,050	1,060
Cost per equivalent unit		$22	$14
Distribution of costs			
Units completed and shipped (900 × $36)	$32,400		
Work in process			
Materials (200 × 75% × $22)	3,300		
Conversion costs (200 × 80% × $14)	2,240		
Cost of work-in-process	5,540		
Total costs accounted for	$37,940		

d. The variances computed in the performance report are misleading because the budget was based on a volume of 1,000 whole units whereas actual performance

was 1,050 equivalent production units for direct material and 1,060 equivalent production units for labor and overhead.

The performance report would have been more useful if the budget had been adjusted to the actual volume level encountered. If the budget had been so adjusted and if all variable costs varied in direct proportion to the volume, all variances except direct materials and indirect labor would have been favorable because volume increased by 6% and all variances except direct materials and indirect labor were less than 6% of budget.

More meaningful variances would have resulted if the variances had been analyzed to determine if they arose from price or efficiency factors. For example,

the adjusted unfavorable direct materials variance of 10% $\dfrac{\left(\dfrac{\$20{,}000}{1{,}000}=\dfrac{\$23{,}100}{1{,}050}\right)}{\dfrac{\$20{,}000}{1{,}000}}$

was probably due to a material price variance because information is given that there was no loss of materials.

Solution 5

Frank Manufacturing Corporation

STATEMENT OF SOURCE AND APPLICATION OF FUNDS
For the Year Ended December 31, 1964

Funds Were Provided by:		
Operations:		
Net income	$89,600	
Add charges to operations not requiring working capital:		
Depreciation	56,100	
Amortization of organization expense	1,500	
Deduct credits to operations not requiring working capital:		
Amortization of investment credit	(2,100)	$145,100
Other sources:		
Exchange of common stock for future plant site	35,000	
Sale of common stock	80,000	115,000
Total funds provided during year		260,100
Funds Were Applied to:		
Exchange of common stock for future plant site	35,000	
Purchase of new building	183,000	
Reduction of long-term notes payable	18,000	
Reduction of mortgage payable	3,600	
Payment of cash dividends	18,200	
Total funds applied during year		257,800
Increase in working capital		$ 2,300

Schedule of Changes in Working Capital Accounts

	Balances, December 31 1964	1963	Changes in Working Capital Increase	Decrease
Current assets				
Cash	$ 33,500	$ 27,000	$ 6,500	
Accounts receivable	89,900	79,700	10,200	
Inventories	136,300	133,200	3,100	
Prepaid expenses	4,600	12,900		$ 8,300
Total	264,300	252,800		
Current liabilities				
Accounts payable	3,000	7,800	4,800	
Notes payable	8,000	5,000		3,000
Mortgage payable	3,600	3,600		
Accrued liabilities	6,200	4,800		1,400
Liability for income taxes	87,500	77,900		9,600
Total	108,300	99,100	24,600	22,300
Working capital	$156,000	$153,700		
Increase in working capital				2,300
			$24,600	$24,600

Computation of Charges for Depreciation

Accumulated depreciation, December 31, 1964	$155,600
Accumulated depreciation, December 31, 1963	117,000
Difference	38.600
Add fully depreciated assets retired in 1964	17,500
Charges for depreciation in 1964	$ 56,100

Computation of Proceeds from Sale of Common Stock

Increase in Capital Contributed in Excess of Par Value		$109,000
Increase attributable to		
Exchange of stock for land ($35,000-$10,000)	$ 25,000	
Stock dividend ($36,000-$12,000)	24,000	49,000
Sale of common stock		60,000
Add par value (20,000 shares @ $1)		20,000
Proceeds from sale of common stock		$ 80,000

Computation of Cost of New Building

	1964	1963
Buildings and equipment, net	$551,900	$425,000
Add accumulated depreciation	155,600	117,000
Buildings and equipment at cost	707,500	542,000
Deduct equipment retired in 1964		17,500
		524,500
Difference—cost of new building		183,000
Total	$707,500	$707,500

ACCOUNTING PRACTICE—PART II

May 13, 1965; 1:30 to 6:00 p.m.

Solution 1

a.

Joseph Doan, Seller

ADJUSTING JOURNAL ENTRIES

(1)

Depreciation	$ 2,500	
Allowance for depreciation—building		$ 2,500
To record depreciation for six months on apartment sold.		

(2)

Suspense	45,610	
Allowance for depreciation—building	20,000	
Purchase money mortgage receivable	84,000	
First mortgage payable	106,000	
Land		25,000
Building		200,000
Real estate tax expense		250
Insurance expense		200
Interest expense		300
Gain on sale of property		29,860
To record sale of apartment building.		

b. COMPUTATION OF TAXABLE CAPITAL GAIN FOR 1964 ON THE INSTALLMENT SALE METHOD

Computation of Gain on Sale

Selling price		$250,000
Cost of building	$200,000	
Less depreciation claimed	17,500	
Adjusted basis of building	182,500	
Cost of land	25,000	
Selling expenses ($100 + $5 + $35)	140	
Real estate agent commission	15,000	222,640
Gain on sale		$ 27,360

Computation of Contract Price

Selling price	$250,000
Less first mortgage assumed	106,000
Contract price	$144,000

Computation of Profit Ratio

$$\frac{\text{Gain on sale}}{\text{Contract price}} = \frac{\$27{,}360}{\$144{,}000} = 19\%$$

Computation of Amount Paid Upon Closing

Contract price		$144,000
Less: Paid directly by buyer	$10,000	
Purchase money mortgage	84,000	94,000
Amount paid upon closing		$ 50,000

Computation of Taxable Gain for 1964 on the Installment Sale Method

Cash payments received:	
Paid directly by buyer	$10,000
Paid upon closing	50,000
Purchase money mortgage payments (5 @ $1,000)	5,000
Total	65,000
Profit ratio	19%
Taxable gain on the installment sale method	$12,350

Solution 2

The Margul Corporation
COMPUTATION OF LIABILITY FOR INCOME TAXES
For the Year Ended December 31, 1964

Income per books		$75,300
Add unallowable deductions and additional income:		
Provision for bad debts	$ 2,700	
Writeoff of organization expense	2,900	
Loss on sale of treasury stock	500	
Excess depreciation recorded on books	652	6,752
Total		82,052
Deduct nontaxable income and additional deductions:		
Bad debt writeoffs less recoveries ($2,800 less $300)	2,500	
Proceeds of life insurance policy	13,000	
Dividends-received deduction (85% × $2,800)	2,380	17,880
Total		64,172
Adjust for long-term gain and loss on sales of assets:		
Add loss on sale of Kravit Corp. stock		200
Deduct amount of gain on sale of forming machine to be excluded from ordinary income		(600)
Total ordinary income		$63,772
Income tax @ 50%		$31,886
Long-term capital gain:		
Gain on sale of forming machine (see schedule)	$ 600	
Less loss on sale of Kravit Corp. stock	200	
Net long-term capital gain	$ 400	
Income tax @ 25%		100
Total		31,986
Less investment credit (7% × $9,000)		630
Liability for income taxes		$31,356

Computation of Gain on Sale of Forming Machine
To Be Excluded From Ordinary Income

Sales price			$10,800
Cost		$12,000	
Depreciation allowed:			
Prior to January 1, 1962	$1,800		
After December 31, 1961	2,400	4,200	
Adjusted basis			7,800
Total gain			3,000
Less ordinary gain			2,400
Long-term capital gain			$ 600
Gain recorded on books			$ 3,000
Amount to be reported as ordinary gain			2,400
Amount of gain to be excluded from ordinary income			$ 600

Depreciation Schedule

Description of Property	*Cost or Other Basis*	*Date Acquired*	*Depreciation Allowed or Allowable in Prior Years*	*Method of Computing Depreciation*	*Rate (%) or Life*	*Depreciation for This Year*
Miscellaneous equipment	$ 80,000	7/1/57	$52,000	S/L	10 years	$ 8,000
Factory building	135,000	7/1/57	19,500	S/L	45 years	3,000
Trucks (2)	8,800	7/1/60	7,700	S/L	4 years	1,100
Shaping machine	10,000	1/2/63	930*	S/L	10 years	1,008
Electrical wiring	3,800	7/1/63	190	S/L	10 years	380
Grinding machine	9,000	7/1/64	—		Additional 1st year	1,800
	$246,600			S/L	10 years	360
				Total		15,648
				Depreciation recorded on books		16,300
				Excess depreciation on books		$ 652

*Alternative solution:

Cost of machine		$ 10,500
Investment credit allowable	$735	
Salvage value	500	1,235
Basis for depreciation		$ 9,265
Depreciation @ 10%		$ 927

Solution 3

The Dawn Mining Company

ANALYSIS ACCOUNTING FOR CHANGE IN GROSS PROFIT
For Year Ended December 31, 1964

Analysis of increase in sales:		
Increase due to increase in sales price ($3 × 105,000)		$315,000
Less: Decrease due to decrease in tons sold ($8 × 24,000)	$192,000	
Decrease due to volume-price factor ($3 × 24,000)	72,000	264,000
Increase in sales		51,000
Analysis of decrease in cost of goods sold:		
Decrease due to decrease in unit mining cost ($.50 × 105,000)	52,500	
Decrease due to decrease in tons sold ($9 × 24,000)	216,000	
	268,500	
Less increase due to volume-price factor ($.50 × 24,000)	12,000	
Decrease in cost of goods sold		256,500
Increase in gross profit		$307,500

Computation of Decrease in Tons Sold

Tons sold in 1963 ($840,000 ÷ $8)	105,000
Tons sold in 1964 ($891,000 ÷ $11)	81,000
Decrease in tons sold	24,000

Solution 4

a. 1. COMPUTATION OF ESTIMATED NET PROFIT AFTER EXPANSION OF RHODE ISLAND FACTORY

Rhode Island Factory:		
Sales		$500,000
Deduct costs and expenses:		
Fixed costs:		
Factory	$ 57,500	
Administration	18,400	
Allocated home office expense	35,000	
Variable costs $\left(50,000 \times \frac{\$100,000}{20,000}\right)$	250,000	
Additional shipping expense (30,000 × $2)	60,000	420,900
Estimated net profit from operations		79,100
Illinois Factory, estimated net profit from operations		76,000
Estimated net profit from operations		$155,100

2. COMPUTATION OF ESTIMATED NET PROFIT AFTER PLACING GEORGIA FACTORY CUSTOMERS ON A COMMISSION BASIS

Net profit from operations, 1964:	
Rhode Island Factory	$ 20,000
Illinois Factory	76,000
Commission on Georgia sales (30,000 × $1.60)	48,000
Total	144,000
Deduct home office expense allocated to Georgia Factory in 1964	21,000
Estimated net profit from operations	$123,000

(Solution 4 continued on p. 208)

Solution 5

Adam Corporation and Subsidiaries
CONSOLIDATED STATEMENTS WORKING PAPER
For the Year Ended December 31, 1964

	Trial Balances, December 31, 1964			Adjustments and Eliminations	
Debits	*Adam Corporation*	*Seth Corporation*	*Cain Corporation*	*Debit*	*Credit*
Cash	$ 82,000	$ 11,000	$ 27,000		
Accounts receivable	104,000	41,000	143,000		(1)$ 12,000
Inventories	241,000	70,000	78,000		(3) 8,670
Investment in Seth Corp.	150,000				(6) 150,000
Investment in Cain Corp.	175,000				(7) 175,000
Investments—other	185,000				
Fixed assets	375,000	58,000	99,000		(4) 4,000
Accumulated depreciation	(96,000)	(7,000)	(21,000)	(4)$ 500	
Cost of sales	820,000	300,000	350,000	(3) 8,670	(2) 130,000 (4) 500
Operating expenses	60,000	35,000	40,000		
Total	$2,096,000	$508,000	$716,000		
Credits					
Accounts payable	$ 46,000	$ 33,000	$ 24,000	(1) 12,000	
Sales	960,000	275,000	570,000	(2) 130,000	
Gain on sales of assets	9,000			(4) 4,000	
Dividend income	18,000			(5) 11,200	
Capital stock, $20 par					
Adam	500,000				
Seth		200,000		(6) 150,000	
Cain			100,000	(7) 80,000	
Retained earnings					
Adam	563,000			(8) 10,000	
Cain			12,000	(7) 56,000	(5) 11,200 (9) 44,000
Appropriation for contingency			10,000	(7) 8,000	(8) 10,000
Total	$2,096,000	$508,000	$716,000		
Excess of cost over book value—Goodwill				(7) 31,000	
Consolidated income					
Consolidated Income					
Reduction of income for earnings of Cain, first half of year				(9) 44,000	
Allocation of income to minority interests:					
Full year. Seth Corporation = 25% ($275,000 − $300,000 − $35,000) (loss)					
Last half of year: Cain Corporation = 20% ($570,000) − $350,000 − $40,000) − 20% ($44,000)					
Balance to controlling interest					
Minority interest of Seth to balance sheet					
Minority interest of Cain to balance sheet					
				$545,370	$545,370

*An alternative solution would allocate the gross profit on intercompany sales included in inventories at year end to minority interests.

Consolidated Income Statement		*Minority Interest*		*Consolidated Balance Sheet*	
Debit	*Credit*	*Seth Corp.*	*Cain Corp.*	*Debit*	*Credit*
				$ 120,000	
				276,000	
				380,330	
				185,000	
				528,000	
					$ 123,500
$1,348,170					
135,000					
					91,000
	$1,675,000				
	5,000				
	6,800				
					500,000
		$(50,000)			
			$(20,000)		
					553,000
			(11,200)		
			(2,000)		10,000
				31,000	
$1,483,170	$1,686,800				
203,630					
$1,686,800	$1,686,800				
	$ 203,630				
$ 44,000					
	15,000	15,000			
27,200			(27,200)		
147,430					147,430
		35,000			35,000*
			60,400		60,400*
$ 218,630	$ 218,630	—0—	—0—	$1,520,330	$1,520,330

(Solution 4 continued from p. 205)

b. COMPUTATION OF ESTIMATED CANADIAN UNIT SALES PRICE THAT WOULD RESULT IN A 10% PROFIT ON SALES

Material	$193,600
Labor	90,000
Overhead	80,000
Administration	30,000
Total costs	$393,600

X = Unit sales price
.08 X = Sales commission
.1 X = Anticipated profit

$$\frac{393{,}600 + 40{,}000\ (.08\ X + .1\ X)}{40{,}000} = X$$

Unit sales price = $12

c. COMPUTATION OF BREAKEVEN POINT IN SALES FOR CANADIAN SUBSIDIARY

	Total Cost	*Per Cent Variable*	*Fixed Cost*	*Variable Cost*
Material	$193,600	100%		$193,600
Labor	90,000	70	$27,000	63,000
Overhead	80,000	64	28,800	51,200
Administration	30,000	30	21,000	9,000
Sales commission (8% × $440,000)	35,200	100		35,200
Total	$428,800		$76,800	$352,000

S = Breakeven sales

$$S = \$76{,}800 + \frac{352{,}000}{440{,}000} S$$

S = $384,000

Journal Entries
(Not required)

(1)

Accounts payable	$ 12,000	
Accounts receivable		$ 12,000
To eliminate intercompany receivables and payables arising from billings for executive services.		

(2)

Sales	130,000	
Cost of sales		130,000
To eliminate intercompany sales.		

(3)

Cost of sales	8,670	
Inventories		8,670
To eliminate intercompany profit in inventory.		

	Inventory	*Gross Profit Ratio*	*Gross Profit in Inventory*
Adam sold to Cain	$15,000	20%	$ 3,000
Seth sold to Cain	10,000	10%	1,000
Cain sold to Adam	20,000	See below*	4,670
	$45,000		$ 8,670

*Inventory at lower of cost or market	$20,000
Add writedown to market	1,900
Inventory at cost	21,900
Gross profit ratio	30%
Intercompany gross profit included in inventory at cost	6,570
Less writedown to lower of cost or market	1,900
Intercompany gross profit to be eliminated	$ 4,670

(4)

Gain on sales of assets	4,000	
Accumulated depreciation	500	
Fixed assets		4,000
Cost of sales		500
To eliminate intercompany profit in fixed assets and the depreciation computed on the intercompany profit.		

(5)

Dividend income	11,200	
Retained earnings—Cain Corporation		11,200
To eliminate intercompany dividend. (80% of $14,000)		

(6)

Capital stock—Seth Corporation	150,000	
Investment in Seth Corporation		150,000
To eliminate 75% of net worth of Seth Corporation at January 1, 1964.		

(7)

Capital stock—Cain Corporation	80,000	
Retained earnings—Cain Corporation	56,000	
Appropriation for contingency—Cain Corporation	8,000	
Excess of cost over book value—goodwill	31,000	
Investment in Cain Corporation		175,000
To eliminate 80% of the Cain Corporation's net worth at date of acquisition, July 1, 1964 as follows:		

Current assets	$165,000
Fixed assets (net)	60,000
Liabilities	(45,000)
Net assets	$180,000
80% thereof	$144,000
Cost of investment	175,000
Excess of cost over book value	$ 31,000

(8)

Retained earnings (consolidated)	$10,000	
Appropriation for contingency		$ 10,000
To provide an appropriation from consolidated retained earnings for contingent loss from law suit.		

(9)

Reduction of income for earnings of Cain Corporation, first half of year	44,000	
Retained earnings, Cain Corporation		44,000
To provide for reduction of income for earnings of Cain Corporation for the first half of the year.		

Solution 6

Town of Nihill

Worksheet to Establish Balance Sheets for Funds and Groups of Accounts June 30, 1964

Debits	Balance Per Books	Adjustments Debit	Adjustments Credit	General Fund	Library Endowment Principal Fund	Library Fund	Fixed Assets	Water Utility Fund	Bond Fund	General Bonded Debt and Interest
Cash	$ 36,200			$22,800	$ 7,600	$200		$ 1,000	$ 4,600	
Taxes receivable	21,900		$(4) 800	21,100						
Accounts receivable	9,000							9,000		
Investments	84,200		(1) 40,000		44,200					
Prepaid expenses	21,000							21,000		
Fixed assets	245,400	$(1) 69,900					$207,300	108,000		
Bonds authorized—unissued		(5) 100,000							100,000	
Amount to be provided for retirement of bonds		(6) 200,000								$200,000
Amount to be provided for payment of interest		(6) 63,000								63,000
Total debits	$417,700			$43,900	$51,800	$200	$207,300	$139,000	$104,600	$263,000
Credits										
Accounts payable	$ 6,500		(7) 700					$ 7,200		
Bonds payable	200,000									$200,000
Unappropriated surplus	211,200	(1) 285,400 (2) 51,800 (3) 200 (4) 2,200 (5) 4,600 (7) 24,500 (8) 500	(6) 200,000	$42,000						
Allowance for uncollectible taxes receivable			(4) 1,400	1,400						
Investment in fixed assets			(1) 207,300				$207,300			
Library endowment principal fund balance			(2) 51,800		$51,800					
Unappropriated surplus—Library Fund			(3) 200			$200				
Appropriations—Bond Fund			(5) 104,600						$104,600	
Interest payable in future years			(6) 63,000							$ 63,000
Fund balance—Water Utility Fund			(1) 108,000 (7) 22,000					130,000		
Unappropriated surplus—Water Utility Fund			(7) 1,800					1,800		
Reserve for encumbrances			(8) 500	500						
Total credits	$417,700			$43,900	$51,800	$200	$207,300	$139,000	$104,600	$263,000
		$ 802,100	$ 802,100							

Worksheet Entries
(Not required)

(1)

		Dr.	Cr.
Fixed assets		$ 69,900	
Unappropriated surplus		285,400	
Investments			$ 40,000
Investment in fixed assets			207,300
Fund balance—Water Utility Fund			108,000

To remove library building from Investments account and to apportion fixed assets to General Fixed Assets and Water Utility Fund.

Fair market value of bequeathed house	$ 40,000
Cost of converting to library	9,000
Cost of library building	49,000
Cost of books purchased from endowment funds	1,900
Cost of books purchased from general funds	19,000
Total library assets	69,900
Other fixed assets	245,400
Total	315,300
Less water utility fixed assets	108,000
Investment in fixed assets	$207,300

(2)

Unappropriated surplus	51,800	
Library Endowment Principal Fund Balance		51,800

To remove Library Endowment Principal from Unappropriated Surplus account.

Cash bequest	$ 50,000
Gain on sale of securities	1,800
Library Endowment Principal	$ 51,800

(3)

Unappropriated surplus	200	
Unappropriated surplus—library		200

To remove Unappropriated Surplus—Library from Unappropriated Surplus.

Library fund endowment income (cash)	$2,100
Expenditures	1,900
Unappropriated surplus (cash)	$ 200

(4)

Unappropriated surplus	2,200	
Taxes receivable		800
Allowance for uncollectible taxes receivable		1,400

To write off taxes receivable identified as requiring abatement and establish Allowance for Uncollectible Taxes Receivable account.

(5)

Bonds authorized—unissued	100,000	
Unappropriated surplus	4,600	
Appropriations—Bond Fund		104,600

To record general obligation bonds authorized but not issued and to remove from Unappropriated Surplus unexpended portion of the proceeds of bonds sold.

(6)

Amount to be provided for retirement of bonds	200,000	
Amount to be provided for payment of interest	63,000	
Unappropriated surplus		200,000
Interest payable in future years		63,000

To record liability for bonds and interest payable in current year and future years.

(7)

Unappropriated surplus	24,500	
Accounts payable		700
Unappropriated surplus—Water Utility Fund		1,800
Fund Balance—Water Utility Fund		22,000

To include in accounts payable an unrecorded liability and to remove from Unappropriated Surplus the portion applicable to the Water Utility Fund.

Cash	$ 1,000
Accounts receivable	9,000
Prepaid expenses	21,000
Total	31,000
Accounts payable	6,500
Total to be removed from Unappropriated Surplus	$ 24,500
Investment in water utility	$130,000
Price of plant and equipment (J/E #1)	108,000
Balance applicable to Water Utility Fund	$ 22,000

(8)

Unappropriated surplus	500	
Reserve for encumbrances		500

To record encumbrance for stationery.

AUDITING

May 13, 1965; 8:30 a.m. to 12:00 m.

Answer 1

a. Instructions to be given to the assistant regarding the examination of the securities kept in the safe deposit box include the following:

1. A copy of the client's inventory of the contents of the box should be obtained and used in connection with the inspection of the securities. Comparing the contents of the box and the inventory will provide assurance that all securities listed in the inventory are on hand. (The validity of the inventory will be determined by examination of the transactions pertaining to investments.) The copy of the inventory, after being checked, should be added to the CPA's working papers as evidence of work performed.
2. The bank's record of persons entering the deposit box should be examined to determine that only authorized persons have had access to the box and that there was no entry to the box between December 31 and January 11. Entry to the box between those dates may be an indication that a security was returned to safekeeping after being "borrowed" at year end. The security may have been "borrowed" and used as collateral to obtain cash to cover a shortage at December 31.
3. The assistant should be instructed to insist that the treasurer be present while the securities are being examined. His presence will deter any future claim that, if a security is missing at a later date, the assistant took it. If it is necessary for the treasurer to leave before the examination of securities has been completed, the securities should be returned to the security of the safe deposit vault before he leaves and, to retain control of the securities, the assistant should seal the inner box to be certain that no securities are added or removed. If an emergency arises that compels the treasurer to depart at once and to leave the securities in the sole possession of the assistant, the treasurer should examine the securities upon his return and state in writing that all securities had been returned to safekeeping. Some auditors prefer to obtain a signed statement that

all investments counted were returned at the completion of the count made in the presence of the custodian. In any event the working papers should note the date of the count and the name of the witness to the count.

4. The following details of the securities should be examined:
   (a) The name of the registered owner appearing on each security other than bearer bonds should be noted to determine that the Demot Corporation is the registered owner and that securities belonging to another owner have not been substituted. (An exception is the case in which the name of a nominee appears on the certificate to avoid revealing the company as owner.) If the box also contains securities owned by others and held as collateral, a power of attorney signed by the owner should be attached to permit transfer to Demot Corporation if the need should arise.
   (b) The dates stamped on stock certificates giving the dates that the certificates were prepared should be noted and subsequently compared with cash disbursements to determine that no unreasonable time elapsed between the disbursement dates and the certificate dates. An unreasonable time lapse may be an indication of a temporary diversion of cash.
   (c) The name of the corporation issuing the security and the class of the security (Class A, Par Value, 1st Preferred, etc.) should be noted for assurance that a lower-priced security (perhaps somewhat similar in corporate name or a different security of the issuing corporation) has not been substituted for a higher-priced security. If the client's inventory description of the security is incomplete, careful identification is also necessary for subsequent determination of current market value.
   (d) The face value of bonds and the number of shares represented by each stock certificate should be compared with the inventory to determine that the entire amount of the Corporation's holdings of each security is on hand.
   (e) The serial numbers of the securities should be compared with those on the inventory and, for those securities carried over from the prior year, compared with the serial numbers of securities listed in the prior year's working papers. A change in serial numbers that can not be properly explained may be an indication of manipulation of the securities. Verification of serial numbers also helps establish the cost of securities sold under either the FIFO or specific identification cost method.
   (f) The certificate should be read to ascertain the interest rates and payment dates for bonds and the dividend rates and payment dates, if given, for preferred stocks. This information may be used later in the verification of investment income.
   (g) Bonds should be examined to determine maturity dates. Maturity dates are needed for checking the computation of the amortization of bond premiums or discounts. In addition, the maturity dates will disclose whether any bonds on hand have matured. The presence of matured

bonds may be a sign of either internal control weakness or that the bonds are in default.

(h) Coupon bonds should be inspected to determine that no past-due interest coupons are unclipped and all future interest coupons are attached. The presence of past-due coupons may be caused by poor internal control and may indicate an understatement of interest income. On the other hand, past-due coupons may indicate the interest is in default and that the principal is uncollectible. Missing future interest coupons may be an indication of an irregularity.

(i) The auditor should be alert for any obvious alterations to securities or forged certificates. Although he is not held responsible for the genuineness of the certificates, any apparent forgeries (or exceptions noted in the foregoing audit procedures) may point out the need for obtaining confirmations from the corporations issuing the certificates.

(j) The auditor should also examine the reverse side of the certificates to determine whether they have been endorsed for transfer. The presence of an endorsement may be an indication that the security had been converted temporarily for some use, perhaps fraudulent, in the past.

(k) Any worthless securities on hand should also be examined and compared with the client's inventory and with prior year working papers. Any missing securities should be noted for subsequent followup to determine that the client had received the funds derived from the sale or redemption of securities deemed worthless in error.

b. The treasurer's entry into the safe deposit box on January 4 has violated the auditor's control over liquid assets which must be counted simultaneously or kept under control until counted to avoid the substitution of a counted asset for an uncounted asset in an attempt to conceal a shortage. The auditor would probably apply the following additional procedures:
   1. Reconcile bank balances at both year end and at the count date.
   2. Obtain a bank confirmation as of the count date.
   3. Examine cash entries between year end and the count date for any unusual entries.
   4. Examine all investment transactions taking place between the balance sheet date and the count date to verify the amount of the investments at the balance sheet date.
   5. If the client keeps a large fund of cash on hand, make a surprise count of the cash fund.
   6. Review the transactions since year end relating to any other liquid assets, such as mortgages owned, to determine if any substitutions have been made.

Answer 2

a. The following additional footnotes might be recommended by the auditor to be appended to the financial statements:

Note 1. (Referenced to Deferred Social Security Taxes) Effective in the cur-

rent fiscal year Ash Corporation adopted the policy of allocating ratably to costs and expenses the total estimated social security taxes expense for the calendar year of 1964. Costs and expenses were charged with these taxes as they accrued in prior fiscal years which resulted in higher charges in the first half as compared to the second half of the calendar year. This change results in deferred charges to future operations at September 30, 1964 and an increase in reported net income for the year then ended of $10,000 (after giving effect to applicable income taxes).

Note 2. (Referenced to Retained Earnings) A number of claims and lawsuits have been filed against Ash Corporation for damages alleged to have resulted from the use of certain products. The outcome of these claims and lawsuits cannot be predicted; but management believes that losses, if any, incurred in excess of the product liability insurance will not have a material effect upon the Company's financial position.

b. In general, disclosure of information about a company's affairs need not be made unless such disclosure is necessary for the statements to be not misleading.

The change in the policy of taking physical inventory does not require disclosure because the change is internal and administrative in nature and, so long as the inventory is fairly stated, of no consequence to the reader of a financial statement.

If the decision to shut down the marginal division had been made, the auditor would have to evaluate the decision's significance to a reader of the financial statements; since no decision has been made, there is no need to reveal the management's consideration of the shutdown.

c. To the Stockholders of Ash Corporation:

We have examined the consolidated balance sheet of Ash Corporation and its subsidiary, Worth Corporation, as of September 30, 1964, and the related statements of consolidated income and retained earnings for the fiscal year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. It was not practicable to confirm an account receivable of material amount, but we satisfied ourselves by other auditing procedures.

We did not examine the financial statements of Worth Corporation, a consolidated subsidiary, which statements were examined by other independent auditors whose report thereon has been furnished to us. Our opinion expressed herein, insofar as it relates to the amounts included for Worth Corporation, is based solely upon such report.

In our opinion the accompanying consolidated financial statements, subject to the outcome of the pending litigation described in footnote No. 2, present fairly the financial position of Ash Corporation and its subsidiary, Worth Corporation, at September 30, 1964, and the results of their operations for the fiscal year then ended in conformity with generally accepted accounting principles applied on a consistent basis, except for the change, which we approve, described in footnote No. 1.

/s/ John Doe, CPA

Answer 3

a. 1. If the auditor finds that a client's staff member who possesses needed information is frequently out of the office (perhaps for good reasons), the auditor should prepare a list of the questions or information he desires for presentation to the client's employee, and then carry on his audit program until the staff member returns. The auditor may have the fault of continually interrupting the client's staff with questions that should be accumulated and asked at one time. Indeed, numerous questions by an auditor may be a strong indication of his lack of competence in accounting matters.

On the other hand, if the absences are seriously impeding the progress of the audit and the offending personnel are reluctant to cooperate, the controller-office manager should be advised of the problem. If he fails to take the necessary corrective measures, an official outranking the controller should be warned that the situation may result in an increase in the auditor's fee.

2. Although it is generally held not to be within the province of the auditor to comment upon the deportment of his client's office staff, in this instance he must draw the attention of a responsible official to the laxity in the disciplinary control of the office staff.

Management expects the auditor to report any weaknesses that he uncovers in his study of the system of internal control and his observation of its operation. The report, usually prepared as a letter, would bring management's attention to the three-week delay in accounting work which is conducive to manipulative practices such as lapping of accounts. Inasmuch as management might conclude in error that the delay arose from a heavy office workload, the report should clearly state that the backlog was caused by office malpractices. The report should also point out the possibility of theft because several employees responsible for safeguarding the company's assets, the supply room attendant and the showroom technicians, are frequently out of the office. The frequent absences of office personnel from the office should be mentioned to illustrate the auditor's statement that the office is inefficiently managed and also, if necessary, to provide grounds for justification of an increase in the auditor's fee if the absences were the cause of inefficiencies in the conduct of the audit. In the preparation of his report the auditor should remember that the controller has been employed for six months, long enough for him to have demonstrated his managerial abilities.

It may be that the auditor's report will lead to a subsequent discussion with management which the auditor would welcome as an opportunity for gaining increased confidence from the client. Perhaps management, aware of the controller's deficiencies, has been seeking confirmation of its own evaluation. The auditor therefore may be in a position to draw upon his experience, probably more varied than management's, to offer guidance in determining the corrective steps to be taken.

3. If numerous errors are found in the books they should be brought to the attention of the controller so that corrections can be made. Although these

errors may not be due exclusively to internal control weaknesses, management should be told of them because they spring in part from deficiencies in the system of internal control. Furthermore, the numerous errors would cause the auditor to extend his auditing procedures and to test a greater number of transactions.

4. If the auditor finds certain records and accounting evidence to be unreliable because of numerous substantial errors, he must determine whether they are so unreliable as to cause him to qualify his opinion or, in gross circumstances, disclaim an opinion on the financial statements.

b. 1. Management is primarily responsible for financial statement presentation. The auditor has the responsibility of determining whether the president's salary which is apparently material in amount, is adequately disclosed in the financial statements. The president's salary would be adequately disclosed if it were shown as a separate item in the income statement and if the increase in salary were also readily apparent because of the use of comparative statements. The president's salary could be adequately disclosed also by a footnote which gave the prior year's salary as well for comparison purposes. Should the client object to the disclosure of the president's salary as a separate item in the income statement or as a footnote, the auditor would be compelled to decide whether to qualify his opinion because the financial statements failed to disclose information of material importance or to render an adverse opinion because the financial statements are not a fair presentation.

2. (a) The auditor would be concerned with the fairness of the presentation of the financial statements because of the need for disclosure, as discussed in the preceding paragraph, and the possibility that a portion of the salary of the president, who is a substantial stockholder, may be deemed excessive by the income tax authorities and treated as a dividend instead of as a business expense. Tax authorities may attach great significance to the fact that much of the potential increase in profits was distributed in the form of salary.

A discussion should be held with the client to consider the possibility of salary expense disallowance by the tax authorities. If the auditor believes that a disallowance may occur, he should recommend an appropriate increase in the provision for income taxes or footnote disclosure of the potential liability. If the client prefers not to adopt either recommendation, the auditor would decide whether to qualify his opinion by taking an exception to the failure to disclose the potential income tax liability or to render an adverse opinion because the financial statements are not a fair presentation.

(b) The consistency of the application of accounting principles has not been disturbed by the use of a different basis for determining the president's salary. The change in the method of computing the president's salary is not grounds for a consistency qualification in the auditor's opinion because it is not a change in accounting methods.

Answer 4

The internal control weaknesses in the Robinson Company's procedures related to customer billings and remittances include the following:

1. No evaluation is made of the customer's credit rating. Substantial bad debts may be incurred by selling an open account to existing customers delinquent in their remittances or to new customers in weak financial positions.
2. The functions of authorizing shipment (preparation of the sales invoice with copies to the shipping department) and of billing should be separated to preclude the possibility of an individual initiating shipment to a personal account and later, after shipment, destroying the shipping notice (copy #3) and the invoicing copies (#1 and #2).
3. The sales invoices are not prenumbered and their numerical sequence is not accounted for. The use of prenumbered invoices and accounting for their numerical sequence provides a means for ascertaining that all invoices prepared are included in the totals posted to the general ledger control accounts and in the details posted to the accounts receivable ledger cards. Such prenumbering and accountability would also serve to thwart the potential fraudulent practice outlined in #2 above. Accounting for all numbers should be done by an individual independent of the filing function after the invoices have been posted.
4. Invoices are not checked for accuracy of quantities, prices, extensions, discounts or totals. Unless the invoices are checked, undue reliance is placed on the work of only one person who is subject to human fallibility.
5. There is no follow-up of unprocessed sales invoices held by the accounts receivable clerk. Other sales invoices for which notices of shipment have not been received should be investigated to ensure that orders are filled and invoiced promptly.
6. Collections on account are not restrictively endorsed at the earliest possible time upon receipt by the Company. To ensure the deposit of the funds to the credit of the Company, checks should be endorsed with the Company endorsement stamps at the earliest possible time, preferably by the clerk opening the mail.
7. The accounts receivable clerk performs the billings, posts the accounts receivable ledger cards, and receives the remittances prior to endorsement. This mingling of the functions of billing and posting of billings and collections is unwise because it permits the possibility of the clerk's not recording a sale to a customer and later diverting the collection.
8. Best internal control over collections is obtained by having the funds deposited intact and as quickly as possible with as few people as possible having access to the receipts. The internal control of the Robinson Company can be strengthened by having the clerk opening the mail prepare a list of collections which, together with accompanying correspondence and vouchers, would be the basis of posting receivables and receipts. Checks, restrictively endorsed, should be forwarded directly to the cashier for deposit.
9. Authority for approval of customer deductions for discounts, freight and advertising allowances, returns, etc., should be vested in a person of authority because unauthorized deductions and operating inefficiencies of the Robinson Company would be otherwise undetected. Furthermore, to place this authority

with the person doing the posting of cash receipts leaves open the opportunity for diverting a cash collection and subsequently authorizing a credit of like amount for an allowance or returned goods.

10. The preparation of the monthly trial balance of open accounts receivable and comparison of the resultant total with the general ledger control account for accounts receivable should be done by someone other than the accounts receivable clerk. The purpose of this separation of duties, which would disclose an out-of-balance condition, is to prevent the protracted concealment of posting errors by the accounts receivable clerk who may be attempting to avoid personal criticism. Although the posting errors can lead to no direct material benefit to the accounts receivable clerk who would not handle cash under the revisions suggested by #7 and #8 above, the errors can result in losses for the company where an individual account balance is understated and the customer remits for the lesser amount appearing on his monthly statement. On the other hand, if posting errors result in an overstatement of his account, the customer may become dissatisfied.

Answer 5

a. The examination of the asset account representing the equipment leased to contractor-lessees would include the following procedures:
   1. Reconcile the cost of the machines shown on the file cards and the general ledger control account. Review the general ledger account for unusual entries. To eliminate the possibility of cards being removed or altered, control of the file cards should be retained from the time of the reconcilement until all audit steps pertaining to the cards have been completed.
   2. Vouch the invoices for the purchase of all machines owned for leasing purposes. Compare the details on the invoices and the file cards. In the vouching process determine that machines traded in by The Smith Equipment Corporation have been removed from the records. Also consider the reasonableness of the ages of the machines in relation to their use as rental equipment.
   3. Examine the lease agreements and compare the details with the file cards.
   4. Compare the file cards and insurance policies covering the equipment. The policies may identify individual machines and lessees by policy endorsements.
   5. Compare the lease rental payment records on the file cards with the rental income account and with cash receipts.
   6. Analyze expense accounts for equipment maintenance and repairs. An invoice for repairs may identify the machine and thus constitute evidence of the existence and ownership of the machine at the date of the repair work.
   7. Compare sales records and file cards to determine whether any machines recorded as sold are being carried on the file cards as equipment being leased. Also review miscellaneous income accounts for sales of equipment that may still be listed as being leased.

8. Prepare positive confirmation requests to be mailed to all contractor-lessees. The requests should include a description of the machines under lease, manufacturers' serial numbers, pertinent features of the lease agreement, and the date of the last rental payment.
9. Inspect the equipment on hand on the Corporation's grounds and compare descriptions and serial numbers with the file card data. Where feasible, inspect machines being leased to contractors. Determine that equipment held in inventory for sale and equipment held for lease are properly classified in the accounts.
10. Compare assessments of personal property for tax purposes with assets held for leasing purposes.
11. Obtain a letter of representation from the client stating that the equipment is properly recorded in the accounts. This letter will be a reminder to the client that the primary responsibility for the fairness of the financial statements rests with management.
12. Examine depreciation accounts on the books for reasonableness and compare with depreciation schedule included in the corporate tax return.

b. An auditor's feeling that Mr. Smith and some contractor-lessees collaborated to deceive him is a strong indication that the results of his audit procedures failed to satisfy him. Therefore the auditor should expand his audit procedures or apply additional ones in the hope that he can arrive at conclusive results without mental reservations.

The auditor should remember that it is not the purpose of his examination to uncover defalcations such as those arising from collusion. In this audit he has obtained a letter of representation from the client and confirmations from the lessees which, in the absence of information to the contrary, should have dispelled much of his concern about the existence and ownership of the leased equipment.

The auditor's opinion should be based upon the findings of his examination and should be arrived at objectively. His intuition may affect the kind and number of his procedures but must not affect his opinion other than through his findings.

It would be unwise for the auditor to voice his fear to the bank president. Undoubtedly the bank president is aware of Mr. Smith's reputation. Indeed, his request for audited financial statements is an attempt to obtain objective information on which to base a decision. For the auditor to report an unverified belief to the banker would merely impair his own professional reputation.

On the other hand the auditor may have serious doubt as to the validity of the confirmations because he believes that the contractor-lessees, due to their strong allegiance to Mr. Smith, cannot be considered independent external sources of information. If, as a result, the auditor believes that he has not obtained sufficient competent evidential matter to form an opinion on the fairness of presentation of the financial statements as a whole, he may decide either to disclaim an opinion on the financial statements or to issue a piecemeal opinion on those items in the financial statements that he believes are fairly presented.

Answer 6

a. **AUDITOR'S ADJUSTING ENTRY**

Vouchers payable	$510	
Travel expense advance	260	
Bank charges	80	
Imprest cash fund		$490
Travel expense		360

To adjust the above accounts at December 31, 1964 in accordance with the following schedule:

Draft #	Imprest Cash Fund	Vouchers Payable	Travel Expense	Travel Expense Advance	Bank Charges
2372	$ 10	$(10)			
5304			$(260)	$260	
4060	(150)	150			
1816		560	(560)		
1000	(270)		270		
2918		(190)	190		
Bank charges	(80)				$80
Totals	$(490)	$510	$(360)	$260	$80
Debit (Credit)					

b. **Glatfelt Rural Electric Power Cooperative**

RECONCILEMENT OF IMPREST FUND BANK ACCOUNT
December 31, 1964

Balance per bank statement		$5,650
Add deposit in transit		730
Total		6,380
Deduct outstanding sight drafts		1,600
Total		4,780
Unlocated difference calling for additional audit steps		
Total		270
		$4,510
Imprest fund balance per books		$5,000
Add excess reimbursement for draft #2372		10
Total		5,010
Deduct:		
Draft #4060 presented for payment in December but not reimbursed until January	$150	
Draft #1000 issued in December but not presented for payment until January	270	
Unrecorded December bank charges	80	500
Balance to appear in financial statements		$4,510

Answer 7

a. The characteristics of a satisfactory plan of organization for an EDP department are as follows:
   1. The manager of the department should have an autonomous position and report directly to a responsible official rather than be placed in a subordinate position within, for example, the accounting department.
   2. Within the data processing department there should be physical and organizational separation of the computer processing unit, the program and tape library, and the systems and programing units. Duties of the programers and the operators should be distinctly separated, and access to the computer center and to control data should be restricted to authorized persons.
   3. A separate control group performing internal audit functions should review the activities of the data processing center.

b. From an internal control viewpoint the basic characteristics of a satisfactory system of input controls for a batch-controlled EDP system employing punched cards would include the following:
   1. To avoid the internal control weaknesses implicit in oral instructions, the following written instructions or manuals should be available:
      (a) Procedure or current operating manuals to explain the forms and records and to describe precisely the processing steps. Appropriate approvals should be made for all changes in procedure.
      (b) Detailed flow charts of the program or sequential operations performed from the initial source document to the final report.
      (c) Decision tables that analyze the content of the flow charts.
   2. Source documents should be prepared in punched card form whenever feasible.
   3. Source documents that are in the same form as employed under the older-type accounting system, whether received from other business firms or generated internally, should be checked as to authenticity, completeness and accuracy, and approved by methods similar to those used under the older-type accounting systems. For example, it may be possible to use serially prenumbered forms to guard against omission of source documents; the computer is able to control the introduction of data into the system by controlling serial numbers.
   4. The duties of the persons performing the key punch operation should not overlap the duties of those who process the original source documents or those who utilize the punched cards. Verification of the key punching should be done by someone other than the original key puncher. Repetitive data should be gang punched into the cards whenever possible. Sight-checking of punched cards may be of limited use. In some systems the validity of account numbers should be tested by means of a programed mathematical formula.
   5. The accuracy of the key punch operation for batches of source documents should also be verified by comparing the totals of the dollar amounts

punched into the cards with the predetermined totals of the dollar amounts of the source documents. The distribution of the amounts to the proper accounts may be partially verified by comparing the totals of the account numbers (a kind of "hash total") with predetermined totals of the account numbers. These predetermined totals should be preserved by batches for subsequent comparison with "hash totals" accumulated by the computer as it processes the punched cards. Provision should be made for cancelling the batches of punched cards to avoid their being processed a second time by the computer in error.

6. To facilitate reconciliations if discrepancies are found, the number of items comprising a batch should be limited in size and batch numbers key punched into each detail unit record. To provide inherently consistent control totals, the types of transactions included in any batch should be as homogeneous as possible.

Answer 8

a. Although the application of statistical sampling techniques does not relieve the CPA of his responsibilities in the exercise of his professional judgment, they are a useful tool in fulfilling those responsibilities. The application of statistical sampling techniques to audit testing results in the CPA having greater confidence in his conclusions with respect to an auditing procedure because it is possible to quantify the degree to which the results of the sample may be expected to be representative of the characteristics of the population.

Furthermore, when the CPA has made a judgment as to the degree of assurance he requires in terms of reliability and precision, statistical sampling provides a mathematical means for arriving at sample sizes. A somewhat smaller or larger sample (selected on a random basis) might be required than his judgment would have indicated if a statistical approach had not been used.

b. The procedure previously used for selection of accounts receivable for confirmation would not produce a valid statistical sample. Since each of the 50 routes is serviced by a different driver, it may not be appropriate to consider them as constituting one universe for statistical purposes.

However, assuming that the routes can be considered one universe, each item in the universe must have a known (within a stratum equal) chance of selection. The previous method of selecting accounts for confirmation was not statistically valid because an account included in a larger route had a lesser chance of selection than an account included in a smaller route. Furthermore, the use of statistical sampling requires a "randomly" selected sample. Randomness is insured by methodical selection, i.e., use of tables with a random start, etc., all of which are designed to minimize the possibility of bias in the sample. Selections made in a haphazard manner, as in the previous method, do not generally conform with the statistical requirements.

c. The audit objectives or purposes in selecting 90-day accounts for confirmation include obtaining assurance as to their validity and obtaining information as to the adequacy of the allowance for doubtful accounts.

The application of statistical sampling techniques would be of benefit to the CPA in attaining these audit objectives or purposes. In obtaining assurance as to the validity of the accounts the weakness in internal control over the receivables may result in the decision to stratify the entire population (both current and delinquent accounts) on the basis of age and to require a greater degree of confidence with respect to the older accounts. Whether or not statistical sampling techniques are applied, the CPA should recognize in this case that the driver who may become aware of the special attention given to delinquent accounts would take pains to see that a fictitious account appeared to be current.

In confirming 90-day accounts to obtain information as to the adequacy of the allowance for doubtful accounts the CPA would consider applying to *the old accounts* a precision limit related to the materiality of the anticipated balance of the allowance account. On the other hand it may be found that analytical comparisons and discussions with credit department personnel may provide sufficient information to judge the reasonableness of the allowance without requiring any increase in the sample of the old accounts.

d. There can be no substantial assurance that the errors in the sample are in exact proportion to the errors in the population. The rate of errors in the population may be greater or less than 3 per cent. Based on the sample, probabilities can be determined that the error rate is no greater than, say, 5 per cent and no less than, say, 1 per cent, but only an examination of the entire population (all accounts receivable) can disclose the exact number or proportion of errors present in the accounts.

COMMERCIAL LAW

May 14, 1965; 8:30 a.m. to 12:00 m.

Answer 1

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

Answer 2

61. True
62. False
63. False
64. True
65. True
66. True
67. False
68. False
69. False
70. False
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72. True
73. True
74. True
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100. False
101. True
102. False
103. True
104. True
105. False
106. False
107. True
108. True
109. True
110. True
111. False
112. False
113. True
114. False
115. True
116. True
117. False
118. True
119. True
120. True

Answer 3

121. True	136. True	151. False	166. True
122. False	137. False	152. True	167. False
123. False	138. False	153. False	168. True
124. True	139. True	154. True	169. True
125. False	140. False	155. True	170. False
126. False	141. False	156. True	171. False
127. True	142. True	157. True	172. True
128. False	143. False	158. True	173. False
129. False	144. True	159. True	174. True
130. False	145. False	160. True	175. True
131. True	146. True	161. False	176. True
132. True	147. False	162. False	177. False
133. True	148. True	163. True	178. True
134. True	149. False	164. False	179. True
135. False	150. False	165. True	180. False

Answer 4

Part a.

1. Yes. There is a contract because there was a valid acceptance of supplier's offer prior to the receipt of the revocation by the offeree. Whether fourteen days is a reasonable time within which to accept Supplier's offer is a question of fact to be resolved in light of the surrounding circumstances. Considering the subject matter of the offer—steel rails—and the amount—3,000 tons—it would seem that a fourteen day period which User took to make up his mind is not unreasonable and therefore the offer had not lapsed and was still open.
2. (1) Under the common law a contract was formed when the telegram reached Supplier. According to common law an acceptance is effective upon posting if the offeree uses the same method of communication as the offeror. If a different method of communication is used, then the acceptance is effective upon receipt by the offeror. Revocation is effective in all cases upon receipt by the offeree. Here, Supplier sent his offer by mail and User accepted by wire. Therefore his acceptance was effective at 3 P.M., March 25. Obviously Supplier's letter of revocation was ineffective because it reached User the following day.

   (2) Under the Uniform Commercial Code a contract was formed when User dispatched the telegram. The Uniform Commercial Code provides that, unless otherwise unambiguously indicated by the language or circumstances, an offer to make a contract shall be construed as inviting acceptance in any manner and by any medium reasonable in the circumstances. In this case there was no unambiguous indication that the acceptance should be by mail, and under the Code the telegraphed acceptance would be effective as of its delivery to the telegraph office. The same rule concerning effectiveness of revocation is found under the Uniform Commercial Code.

Part b.

No. The Statute of Frauds requires that certain agreements be evidenced by a note or memorandum in order that such contracts be enforceable. It is true that one class of contracts which comes within the purview of the Statute consists of those which are not capable of performance within a year from the time of their formation. Brian was to repay Lynch two years from the date of the loan, and hence the Statute of Frauds would ordinarily apply and render the contract unenforceable. However, judicial interpretation of this provision of the Statute makes it applicable only to executory bilateral contracts and not to unilateral contracts. The loan was made with the oral promise of repayment two years hence. This is a unilateral contract and need not be evidenced by any writing.

Part c.

1. No. Although a contract exists, it may be disaffirmed by Young. Except as to certain contracts, e.g., where the minor is engaged in business, minority is a defense to the person upon whom liability is sought to be imposed for breach of contract. Thus, Olds cannot hold Young liable for breach of contract.
2. No. While a minor is generally liable for his torts, the negligence committed by Young in repairing the television set grew out of the contract, i.e., the negligence would not have occurred had there been no contract and the negligence is interwoven into the contract. To allow recovery for the tort would be indirectly to enforce the contract and in effect deprive the minor of his right of disaffirmance.

Answer 5

Part a.

No. The insured must have an insurable interest in the subject matter insured if there is to be a valid insurance contract. Some courts hold that in the case of property insurance the insurable interest must exist both at the time of the contract and at the time of the loss; all jurisdictions agree that it must exist at least at the time that the loss occurs. If there is no such interest, the insurance contract is void. A person does not have an insurable interest if his only right is based upon an unenforceable contract. Here, the agreement between Byer and C Corporation for the sale of Blackacre, including the building, was oral and not evidenced by a writing as required by the Statute of Frauds. Hence, it was not enforceable and Byer acquired no contractual right upon which to base the requisite insurable interest. A valid insurance contract was not created when he paid the premium to the insurance company.

Part b.

Yes. The Corporation will be able to collect on the policy but not the face amount. Under the "key personnel" doctrine, a business enterprise has an insurable interest in the life of an executive or officer because his death would impose a pecuniary loss upon the business to the extent that he would not be readily replaced without a period of waiting. In the case of life insurance, it is required only that the insurable interest exist at the time the policy is taken out because a

life insurance policy is not considered as being a true indemnity contract, such as a fire insurance contract, but as being more in the nature of a chose in action against the insurer. The fact that the insurable interest no longer exists is immaterial to the validity of the contract. Bilder, as an officer of the Corporation, qualifies under the "key personnel" doctrine. The fact that at the time of his death he is no longer in the Corporation's employ is immaterial. The payment of premiums having been continued, the Corporation can collect on the policy. However, Bilder stated his age as being 40 when in fact it was 47 years. Formerly a misrepresentation of the insured as to his age would defeat recovery on the ground of fraud or, at least, breach of warranty. This rule has been modified by statute or judicial construction in the majority of jurisdictions, and today in most states the Corporation can recover the amount of insurance which the premium paid would have purchased had the insured given his correct age.

Part c.

Yes, in respect to the payment it made on the property insurance policy; no, in respect to the payment it made on the life insurance policy.

When the insurance company indemnified Arthur's estate for the property loss, it became subrogated or succeeded to Arthur's rights against the wrongdoer and can enforce them in a suit against the wrongdoer. Thus, X Insurance Company has a cause of action against the neighbor who, by his negligence, caused the destruction of the house.

However, the principle of subrogation is not applicable in life insurance as valuation of human life is difficult and insurance may be written for any amount. For this reason the X Insurance Company is not subrogated to the right of decedent's estate to recover damages from the wrongdoer for Arthur's death. Arthur's estate is entitled to recover the proceeds of the life insurance policy without the applicability of subrogation as well as damages in a separate action against the wrongdoer.

Part d.

No. The law makes a distinction between friendly and hostile fires. If the fire burns in a place where it is intended to burn, although damages may have resulted where none were intended, the fire is a friendly fire whereas a hostile fire means one not confined to the place intended. An insurer is liable only in the case of a hostile fire. Since the fire took place in the trash burner where it was intended to burn, it was a friendly fire. Even though the friendly fire was the direct cause of the loss of the manuscript the insurer would not be liable.

If the fire that destroyed the manuscript had been a hostile fire, Roger's negligence would not have affected his right to recovery under the insurance policy.

Answer 6

Part a.

1. Under the Uniform Sales Act title to the 100 boxes of shirts would pass to the buyer, Bell, upon the making of the contract because these are specific goods and nothing remains to be done by the seller to put them in a deliverable condition. The fact that the date of delivery or payment is postponed

beyond the time of the agreement does not delay the passing of title. The Store's action in tying the boxes into separate bundles and tagging them with Bell's name was not for the purpose of putting the goods in a deliverable state but merely to facilitate their handling. The risk of loss would follow title and consequently the loss falls upon Bell. Bell owned the 40 boxes of shirts destroyed by the fire as well as the 60 boxes of shirts saved. The Store can recover from Bell the full price of the 100 boxes.

2. Under the Uniform Commercial Code the result is different. The Code's provisions as to the rights, obligations and remedies of the seller and buyer, including those involved with the question of risk of loss, apply irrespective of title to the goods. In cases other than those in which the seller is to ship the goods by carrier or the goods are to be held by a bailee to be delivered without being moved, the risk of loss does not pass to the buyer until he has received the goods if the seller is a merchant. If the seller is not a merchant, the risk passes to the buyer on tender of delivery. The Store is a merchant and therefore the risk of loss would not pass to Bell until his receipt of the goods. The fire occurred before Bell took delivery and therefore at the time of the fire risk of loss was on the seller, the Store. Moreover, under the Code, since the casualty to the identified goods is partial, Bell has the option either to treat the contract as avoided or to accept and pay for the remaining 60 boxes of shirts at $10 per box.

Part b.

The Store is not liable according to either the Uniform Sales Act or the Uniform Commercial Code.

1. Under the Uniform Sales Act, when goods are delivered to the buyer "on approval," "on trial," or with other similar terms, title remains in the seller until the buyer evidences in some way an intention to adopt the transaction. In this case the agreement stated the outfit to be "subject to 10 days' free trial" and thus indicated that the intention of the parties was not to effect a present transfer of title such as occurs in a "sale and return." A "sale and return" has the effect of transferring title, with its corresponding risk of loss to the buyer; a "sale on trial or approval" throws no risk of loss upon the buyer until he adopts the transaction and thereby assumes title.
2. The Uniform Commercial Code provides "Unless otherwise agreed, if delivered goods may be returned by the buyer even though they conform to the contract, the transaction is (a) a 'sale on approval' if the goods are delivered primarily for use. . . ."

   As the sewing machines were primarily for the use of the buyer, the Store, the transaction is therefore a sale on approval. Neither title nor risk of loss passed to the Store upon delivery and installation of the machines but remained with Curtis and, since the accidental fire occurred prior to any adoption of the contract by the Store, Curtis cannot recover the purchase price from the Store. If the goods had been delivered to the Store primarily for the purpose of resale, under the Code the transaction would be a "sale or return" by which title and risk of loss would be transferred to the Store with the privilege of divesting itself thereof within the stated period of 10 days' free trial period.

Answer 7

Part a.

1. As a matter of law the directors are not entitled to compensation for performing the ordinary duties of their offices. It is customary for them to be paid a small fee, or honorarium, for attendance at meetings. The amount of the honorarium is usually provided for in the by-laws. In order that a director may legally demand compensation for services as a director, it must appear that a by-law or resolution, fixing the compensation to be paid, was adopted before the services were rendered. This is to be distinguished from the situation where a director performs services for the corporation outside his role of director; for example, a director may also serve as an officer of the company. In such a case, the laws of some states require that the compensation for his services be fixed by a vote of the stockholders. Generally speaking, directors cannot fix their own salaries unless expressly given the power by the charter or by the stockholders to do so. The auditor should examine the by-laws, the minutes of the directors' meetings, and the minutes of the stockholders' meetings to discover the authorization for directors' compensation.
2. The officers of a corporation are entitled to compensation for performing the ordinary duties of their offices. Because they are named by the board of directors, their salaries are usually fixed at board meetings, although the by-laws may fix their compensation. The auditor should examine the by-laws and the minutes of the directors' meetings.
3. If the state of incorporation has no statute imposing a liability for promoters' organization expenses, a corporation upon its formation is not liable upon any prior contract or for any pre-incorporation expense, even one made or incurred in its name, unless the corporation adopts the contract expressly, impliedly, or by knowingly accepting benefits under it. To be examined are the statute under which the corporation was created, the minutes of the first stockholders' meeting and the minutes of the first few board of directors' meetings

Part b.

A corporation does not have implied or apparent power to enter into a partnership agreement, though express authority may be provided by state statute, charter, or by-laws. Should the corporation, in the absence of any express authority, enter such an arrangement, any contracts entered into by the partnership will be *ultra vires* as to the corporation, and the president of the corporation will be personally liable for any loss sustained by the corporation as a result of the agreement.

Part c.

According to the prevailing view, a pre-incorporation subscription is considered as being a continuing offer open for acceptance or revocation at least until the corporation is formed. Thus a pre-incorporation subscriber may cancel his subscription at any time before the corporation is chartered. Some state corporation statutes provide that immediately upon the granting of the charter, i.e., the creation of the corporation, the subscriptions are automatically accepted by the corporation. Hence, in such states the balance sheet should show these pre-incorporation subscriptions as current assets, unless the cancellations came before incorpora-

tion. On the other hand, some state corporation statutes provide that some affirmative action must be taken by the newly-formed corporation concerning the acceptance of the subscription offers. In the absence of such affirmative action of acceptance the subscribers are able to revoke their offers and thereby cancel their subscriptions. In such a situation the subscriptions covered by letters of cancellation should be omitted from representation in the balance sheet as current assets.

A postincorporation subscription is usually considered a subscriber's offer to purchase, which ripens into a contract upon acceptance by the corporation. Of course, a corporation, in soliciting subscriptions, may so word the subscription agreement that it amounts to the corporation's offer to sell which becomes accepted when the subscriber agrees to purchase. Here, if the corporation solicited offers to purchase and the offers were made, then the subscribers' cancellations prior to acceptance by the corporation are valid — the subscriptions cannot be treated as assets because the offers were revoked before they ripened into a contract. On the other hand, if the postincorporation subscriptions are considered as acceptances of offers made by the corporation, then they should be represented as current assets because they were accepted by the individual subscribers and the attempted revocations (cancellations) are without legal efficacy.

Answer 8

Part a.

1. No. This is a contract for personal services which has an implied provision of the contract that the party who is to perform the services shall be physically and mentally competent during performance. Therefore if subsequent physical disability prevents performance, the contract is discharged under the principle of impossibility of performance. Keen was prevented from completing the engagement by his paralyzing disability which resulted in retirement. Keen had no partners or associates who might have taken over for him and completed the work. Therefore Keen's inability to conclude his performance is an "excusable" breach of contract which is not actionable.
2. No. By the terms of the contract, Keen was engaged to perform a completed job, i.e., audit the company's books and prepare a financial report. The firm's only interest lay in this completed engagement which would enable it to submit the contemplated report to the prospective partners. The fact that Keen's compensation was fixed on a per diem basis does not alter the obvious intention of the parties, which was that Keen would submit a completed report and the firm would pay him for the number of days he worked. The work done by Keen, although a substantial amount of the finished job, was of no value to the firm. Therefore Keen is unable to obtain any recovery, either for the agreed per diem fee or the reasonable value of his services, even though his failure to complete the engagement was not his fault.
3. Arthur & Son cannot recover working papers prepared by Keen supporting his intended report to it; the firm can recover papers originating in its offices and loaned to Keen. Working papers are prepared by a CPA for his own use and as a basis for his reports. These papers belong to the CPA and should be retained by him. However, any records belonging to the client remain its

property and must be returned by the CPA. The cancelled checks, copartnership agreement, and other firm records originated in the firm's offices and were loaned to Keen merely to assist him in his work. They do not become part of the working papers and must be returned to the firm.

Part b.

1. A certified public accountant owes a contractual duty to his clients to exercise reasonable care and skill in performing the engagement. Since the profession of accounting requires a peculiar skill, the CPA is understood as holding himself out to the public as possessing the degree of skill commonly possessed by others in the same employment. Determination of what constitutes a reasonable degree of care and skill is a question of fact answered within the frame of reference of the extent of professional diligence and competence normally exercised by accountants in the same community in similar circumstances. The CPA undertakes to perform his engagement with good faith and integrity, but not with infallibility or as an insurer; and he is liable to his clients for negligence, bad faith or dishonesty, but not for losses resulting from mere errors of judgment.
2. With the exception of his liability to third party beneficiaries, i.e., those persons primarily intended to benefit from the contractual engagement of the accountant, to whom the CPA owes the duty of performance as outlined above, the CPA's legal responsibility to third parties who have relied upon his report is limited to those cases where the errors or omissions in his report are so grave as to constitute fraud.

   Ordinary negligence in the performance of his professional duties does not form a basis for a claim against the public accountant by such third parties. However, gross negligence will suffice to permit the inference of fraud. When a CPA certifies a representation as true to his knowledge when in fact he has no such knowledge, or makes a reckless misstatement or gives an opinion on grounds so flimsy as to lead to the conclusion that there was no genuine belief in its truth, or when he refuses to see the obvious or investigate the doubtful, he will be liable to third parties injured by their reliance on the financial statements even though deliberate or active fraud is lacking.

THEORY OF ACCOUNTS

May 14, 1965; 1:30 p.m. to 5 p.m.

Answer 1

1. M	10. C
2. C	11. B
3. B	12. I
4. E	13. K
5. H	14. G
6. H	15. K
7. D	16. K
8. F	17. F
9. N	18. L

Answer 2

Part a.

1. If the value of by-products is immaterial, the treatment can be justified on the grounds that it is simple and easy to use. The time and expense of estimating the sales value of by-products and accounting for it at the point of of separation may not be warranted by the additional precision and information to be gained in the measurement and control of production costs and inventories.
2. The possible shortcomings of this treatment include the following:
   a. Such a casual treatment of by-products may result in poor by-product inventory control and lead to waste, theft, mismanagement, and, over a period of time, a loss of substantial amounts of revenue.
   b. Crediting cost of production with the revenue derived from the sale of by-products introduces a factor into the costing of major product inventories and cost of goods sold that has nothing to do with the period's operations. If the volume of by-product sales per period varies from the total volume of production, production costs may be significantly distorted. If recognition of the sales value of by-products is deferred until they are sold, it should be credited directly to income instead of to the cost of production of a period in which the by-products were not produced.
   c. In addition to distorting the amount of cost assigned to major product inventories, accounting for by-products only when they are sold will misstate

the total inventory valuation on the balance sheet by omitting the value of by-products in inventory. This value may be significant when by-product inventory quantities accumulate due to irregular sales.

d. Because of irregular sales, reported net income in successive periods may also be distorted under this treatment of by-products.

Part b.

Joint Cost Included in Ending Inventory Valuation Relative Sales Basis

1. a.

	Products A	Products B	Products C	Inventory
(1) Number of units	1,000	500	500	
(2) Unit sales price	$20	$200	$160	
(3) Sales value [(1)×(2)]	$20,000	$100,000	$80,000	
(4) Percent of sales value	10%	50%	40%	
(5) Allocation of joint cost of $100,000	$10,000	$50,000	$40,000	
(6) Allocated joint cost per unit [(5)÷(1)]	$10	$100	$80	
(7) Units in ending inventory	100	300	200	
(8) Joint cost included in ending inventory valuation [(6)×(7)]	$ 1,000	$30,000	$16,000	$47,000

b. **Physical Unit Basis**

	A	B	C	Inventory
(1) Number of units	1,000	500	500	
(2) Percent of total units	50%	25%	25%	
(3) Allocation of joint cost of $100,000	$50,000	$25,000	$25,000	
(4) Allocated joint cost per unit [(3)÷(1)]	$50	$50	$50	
(5) Units in ending inventory	100	300	200	
(6) Joint cost included in ending inventory valuation [(4)×(5)]	$5,000	$15,000	$10,000	$30,000

2. a. The allocation of joint costs on a physical unit basis makes the implicit and unrealistic assumption that it is equally desirable to produce all of the resulting products, irrespective of their individual sales value. Products having a high unit sales value are assigned the same unit cost as products having a low unit sales value.

By disregarding sales value this method may result in an inventory valuation for a product which exceeds its sales value. Product A is an example of how untenable the results of this method can be. Its assigned unit cost is $50 while its unit sales value is only $20. Joint product inventory valuations based on this method can be materially over- or understated because the method disregards completely the relative benefits to be derived from the sale of the various products. Gross profit (and net income) would also be affected and could vary substantially without any real significance.

The allocation of joint costs on the relative sales value basis provides a much more reasonable basis for inventory valuation and income measurement than does the physical unit basis. This method allocates joint product

costs in proportion to the revenue generating ability of each product. With this approach the anomaly of having one product in inventory priced far above its sales value and another at a small percent of its sales value is precluded. Instead, each product is assigned a share of the joint cost in proportion to its ability to absorb that cost and still show a profit under normal marketing conditions.

b. Neither of these two bases of joint cost allocation provides information that is useful in deciding whether joint products should be sold at the split-off point or processed further. Total joint costs and assigned joint costs, whatever the basis, are irrelevant to these decisions. Instead, the decisions should be based on information about the incremental costs of further processing and the incremental revenues that can be obtained as a result of the additional processing.

Answer 3

a. The point of sale is the most widely used basis for the timing of revenue recognition because in most cases it provides the degree of objective evidence accountants consider necessary to measure reliably periodic business income. In other words, sales transactions with outsiders represent the point in the revenue generating process when most of the uncertainty about the final outcome of business activity has been alleviated.

It is also at the point of sale in most cases that substantially all of the costs of generating revenues are known, and they can at this point be matched with the revenues generated to produce a reliable statement of a firm's effort and accomplishment for the period. Any attempt to measure business income prior to the point of sale would, in the vast majority of cases, introduce considerably more subjectivity in financial reporting than most accountants are willing to accept.

b. 1. Though it is recognized that revenue is earned throughout the entire production process, generally it is not feasible to measure revenue on the basis of operating activity. It is not feasible because of the absence of suitable criteria for consistently and objectively arriving at a periodic determination of the amount of revenue to take up.

Also, in most situations the sale represents the most important single step in the earning process. Prior to the sale the amount of revenue anticipated from the processes of production is merely prospective revenue; its realization remains to be validated by actual sales. The accumulation of costs during production does not alone generate revenue; rather, revenues are earned by the entire process, including making sales.

Thus, as a general rule the sale cannot be regarded as being an unduly conservative basis for the timing of revenue recognition. Except in unusual circumstances, revenue recognition prior to sale would be anticipatory in nature and unverifiable in amount.

2. To criticize the sales basis as not being sufficiently conservative because accounts receivable do not represent disposable funds, it is necessary to assume that the collection of receivables is the decisive step in the earning process and that periodic revenue measurement, and therefore net income;

should depend on the amount of cash generated during the period. This assumption disregards the fact that the sale usually represents the decisive factor in the earning process and substitutes for it the administrative function of managing and collecting receivables. In other words, the investment of funds in receivables should be regarded as a policy designed to increase total revenues, properly recognized at the point of sale; and the cost of managing receivables (e.g., bad debts and collection costs) should be matched with the sales in the proper period.

The fact that some revenue adjustments (e.g., sales returns) and some expenses (e.g., bad debts and collection costs) may occur in a period subsequent to the sale does not detract from the over-all usefulness of the sales basis for the timing of revenue recognition. Both can be estimated with sufficient accuracy so as not to detract from the reliability of reported net income.

Thus, in the vast majority of cases for which the sales basis is used, estimating errors, though unavoidable, will be too immaterial in amount to warrant deferring revenue recognition to a later point in time.

c. 1. During production. This basis of recognizing revenue is frequently used by firms whose major source of revenue is long-term construction projects. For these firms the point of sale is far less significant to the earning process than is production activity because the sale is assured under the contract, except of course where performance is not substantially in accordance with the contract terms.

To defer revenue recognition until the completion of long-term construction projects could impair significantly the usefulness of the intervening annual financial statements because the volume of completed contracts during a period is likely to bear no relationship to production volume. During each year that a project is in process a portion of the contract price is therefore appropriately recognized as that year's revenue. The amount of the contract price to be recognized should be proportionate to the year's production progress on the project.

It should be noted that the use of the production basis in lieu of the sales basis for the timing of revenue recognition is justifiable only when total profit or loss on the contracts can be estimated with reasonable accuracy and its ultimate realization is reasonably assured.

2. When cash is received. The most common application of this basis for the timing of revenue recognition is in connection with installment sales contracts. Its use is justified on the grounds that, due to the length of the collection period, increased risks of default, and higher collection costs, there is too much uncertainty to warrant revenue recognition until cash is received.

The mere fact that sales are made on an installment contract basis does not justify using the cash receipts basis of revenue recognition. The justification for this departure from the sales depends essentially upon an absence of a reasonably objective basis for estimating the amount of collection costs and bad debts that will be incurred in later periods. If these expenses can be estimated with reasonable accuracy, the sales basis should be used.

Answer 4

a. The difference between the book value and the current fair value of the road building equipment may be due to one or a combination of the following factors:
   1. Its purchase at a bargain price.
   2. Excessive depreciation due to errors in the estimate of its useful life and salvage value.
   3. The use of an accelerated method of depreciation for accounting purposes.
   4. Increases in the general price level since the equipment was purchased.
   5. Increases in the prices of comparable road building equipment due to changes in the economic conditions in the industry. The underlying cause here would be an increase in the amount of probable future earnings, discounted to their present value, from investments in road building equipment.

b. 1. Reproduction cost. Reproduction cost is the estimated cost of constructing or acquiring, at current prices, substantially identical assets. From this amount a deduction is made for observed depreciation.

   The primary limitation of this method of estimating the current fair value of fixed assets is that the productive capacity represented by the old assets often can be obtained by acquiring less expensive assets, built with modern methods and materials. Under these circumstances revaluation data based on the cost of reproducing substantially identical assets can result in materially overstated estimates. The cost of reproducing assets that have become obsolete due to the efficiencies of new technology has no current economic significance. If new technology can provide the same productive capacity at less cost than reproducing the old assets, then it is replacement cost that is significant, not reproduction cost.

   2. Replacement cost. Replacement cost is the estimated cost at current prices of acquiring new substantially equivalent assets, less a deduction for observed depreciation.

   The primary difficulty that may be encountered in applying this method is in defining what constitutes substantially equivalent assets. This difficulty is especially applicable in situations where rapid changes in technology have taken place. In some cases substantially equivalent assets may no longer be obtainable, and thus there may be no basis on which to estimate what the current cost of acquiring the old assets would be.

   3. Capitalization of earnings. This method of arriving at the current fair value of an asset consists of estimating the future net earnings that the asset will generate, then discounting them to their present value.

   Conceptually, this approach to the valuation of assets is superior to all others. It is also, however, the most difficult and subjective method to apply, especially for purposes of valuing specific assets. While it is usually feasible to use this method when valuing entire businesses, any attempt to estimate the future income-generating contribution of individual fixed assets or groups of fixed assets on anything other than a marginal basis is all but impossible. Earnings result from the efficient utilization of the total resources of a business. They are not usually assignable in any meaningful way to specific assets.

c. The propriety of introducing into the accounts the current fair value of the equipment depends in part on why it exceeds book value. To the extent that the difference is clearly due to a bargain purchase or excessive past depreciation, there can be little objection to adjusting the accounting records and preparing revised statements. The revised statements should disclose clearly both the adjustment and the objective evidence upon which it is based.

Any adjustment of the value at which the equipment is carried in the balance sheet should also be reported in the income statement to the extent that periodic charges to depreciation are affected.

To the extent that the difference represents increases in the general price level or increased prices for road building equipment, however, its introduction into the accounting records lacks general acceptance. The accounting profession, business management, and regulatory agencies have not felt that changes in the general price level have been great enough to justify the adjustment of accounts and reports for such changes. Recognition in the accounts of changes in the level of prices of road building equipment (for reasons other than changes in the general price level) would represent a departure from the cost principle and hence would not be in accord with generally accepted accounting principles. Under these circumstances the best approach would probably be for the contractor to prepare a special purpose statement of financial position which reports the current fair value of the equipment and clearly indicates the basis and source of the revaluation data.

Answer 5

a. 1. The objectives of issuing rights to existing stockholders on a pro rata basis is to raise new equity capital. This method of raising equity capital may be used because of pre-emptive rights on the part of a company's stockholders and also because it is likely to be less expensive than a public offering.

2. The purpose of issuing stock rights to certain key employees, usually in the form of a qualified stock option plan, is to increase their interest in the long-term growth and profits of the company and to attract new management talent. Also, this issuance of stock rights to key employees under a qualified stock option plan frequently constitutes an important element in a company's executive compensation program. Though such plans result in some dilution of the stockholder's equity when shares are issued, the plans provide an additional incentive to the key employees to operate the company efficiently.

3. Rights to purchase shares of its common stock may be issued to purchasers of a company's bonds in order to stimulate the sale of the bonds by increasing their speculative appeal and aiding in overcoming the objection that rising price levels cause money invested for long periods in bonds to lose purchasing power. The use of rights in this connection may also permit the sale of the bonds at a lower interest cost.

b. 1. Because the purpose of issuing rights to existing stockholders is to raise new equity capital, the price specified in the rights must be sufficiently below the current market price reasonably to assure that they will be exercised. Because the success of the offering depends entirely on the cur-

rent market price of the company's stock in relation to the exercise price of the rights, and because the objective is to raise capital, the length of time over which the rights can be exercised is very short, frequently 60 days.

2. When rights are now offered to key employees by a stock option plan, the terms almost invariably conform with the Internal Revenue Code's rules pertaining to qualified stock options. Failure to conform with the rules results in the loss of the full income tax benefit of stock option plans, long-term capital gain treatment of the sale of the stock after exercise of the option and holding the stock for at least three years.

   Rights may be offered to key employees below, at, or above, the market price of the stock on the day the rights are granted. Under the current income tax rules if the option price is less than the market price, at the time of exercise of the option the employee has ordinary income equal to 150 per cent of the spread between the option price and the value of the stock at the time of the grant, or if lower, the spread at the time of exercise of the option. In either case the basis of the stock is correspondingly increased.

   If a stock option plan is to provide a strong incentive, rights that can be exercised shortly after they are granted and expire, say, within two or three years usually must be exercisable at or near the market price at the date of the grant. Rights that cannot be exercised for a number of years after they are granted, or those that do not lapse for a number of years after they become exercisable may, however, be priced somewhat above the market price of the stock at the date of the grant without eliminating the incentive feature. Tax rules provide that the options may run for a maximum period of five years after the grant. This does not upset the principal objective of stock option plans, heightening the interest of key employees in the long-term success of the company.

3. In contrast to rights granted to key employees under qualified stock option plans, income tax laws impose no restrictions on the exercise price of rights issued to purchasers of a company's bonds. The exercise price may be above, equal to, or below the current market price of the company's stock. The longer the period of time during which the right can be exercised, however, the higher the exercise price can be and still stimulate the sale of the bonds because of the increased speculation appeal. Thus, the significance of the length of time over which the rights can be exercised depends largely on the exercise price (or prices). A low exercise price in combination with a short exercise period can be just as successful as a high exercise price in combination with a long exercise period.

c. 1. Financial statement information concerning outstanding stock rights issued to a company's stockholders should include a description of the stock being offered for sale, the option price, the time period during which the rights may be exercised, and the number of rights needed to purchase a new share.

   2. Financial statement information concerning stock rights issued to key employees should include the following: The number of shares under option, the prices at which the rights may be exercised, the time periods and conditions under which they may be exercised, and the number of rights exercised during the year and the prices at which they were exercised.

3. Financial statement disclosure of outstanding stock rights that have been issued to purchasers of a company's bonds should include the prices at which they can be exercised, the length of time they can be exercised, and the total number of shares that can be purchased by the bondholders.

Answer 6

Interest on mortgage bonds. An amount equal to the interest cost incurred in 1963 ($30,000) is clearly a cost which can be associated with the normal construction period and can be regarded as a normal element of the cost of the physical assets of the shopping center because the construction period would have ended at the end of the year if the tornado had not occurred. The decision to use debt capital to finance the shopping center was made with full knowledge that interest would accrue during the construction period and add to the total cost of building the center and bringing it to the point at which it would produce revenue. The future income to be generated by the shopping center must have been estimated to be more than sufficient to recover all of the expected costs of building the center and preparing it for occupancy, including interest during the construction period.

In lieu of treating interest during construction as an element of the cost of the physical assets, it can be argued that it represents an element of the general cost of bringing the business to the point of revenue production and should therefore be treated as an organization cost. This view regards interest during construction as just another of the many expenditures that are necessary to acquire and organize the physical assets of a new business but do not attach to any specific assets. Treated as an organization cost, interest during construction would be capitalized as a permanent asset or, alternatively, amortized over the period principally benefited.

The only alternative to capitalizing an amount equal to the 1963 interest cost is to treat it as a loss. This treatment is clearly inappropriate because it necessarily assumes that the decision to use debt capital to finance construction is a decision deliberately to incur a loss to the extent of the interest that accrues during the expected construction period.

The amount of interest cost for the first nine months of 1964 is the measure of the 1963 loss resulting from the tornado. The extension of the construction period to October 1964 because of the tornado does not warrant its capitalization as construction period interest. It is in effect an uninsured loss resulting from the tornado. Had it not been for the tornado the entire amount would have been a normal operating expense chargeable against the rental revenue that would have been earned during the first nine months of 1964.

Cost of obtaining tenants. Both the 1963 and 1964 costs of obtaining tenants should be capitalized and amortized over the life of the leases. The fact that all of the tenants who were signed when the tornado occurred accepted the October occupancy date indicates that the total cost of obtaining tenants was not affected by the delay.

The cost of obtaining tenants has a direct and easily identifiable relationship to the rental income to be earned over the terms of the leases. Under these circumstances the problem of reliably measuring periodic net income is best solved by matching costs with the revenues to which they are directly related.

Promotional advertising. The 1963 cost of promotional advertising should be written off as a loss. The 1964 cost of promotional advertising should be capitalized as an organization cost.

The initial expense treatment of the 1963 advertising cost is appropriate because to treat it otherwise would inflate the "Organization Costs" asset on the balance sheet. Organization costs are capitalized because they represent expenditures that are made with the expectation that they will be recovered over the life of the business. The 1963 advertising costs no longer qualify under this criterion for the capitalization of organization costs.

The 1964 advertising cost, together with other organization costs, may be retained indefinitely on the books as an intangible asset or amortized over the periods principally benefited.

Answer 7

a. 1. Reduction in a cost otherwise chargeable in a greater amount to future accounting periods. Under this method, assuming the tax liability has been computed and recorded net of the allowed investment credit, the amount of the investment credit that has been used to reduce the income tax liability (recorded by a charge to Provision for Taxes or Depreciation Expense) plus the amount of allowable carryback of the unused investment credit, if any (recorded by a debit to an asset account, e.g., Claim for Refund of Income Taxes), is credited to the cost or other basis of the acquired property, either directly or through an offsetting account (e.g., Allowance for Investment Credit), or to a deferred income account. This amount is then amortized over the useful life of the acquired property either through reduced depreciation charges or as a credit to income.

Material amounts of unused carryforward investment credits should be disclosed in a footnote. If these amounts become allowable in later years they should be accounted for in the same manner as above.

This method allocates the net income tax savings which result from the investment credit over the useful life of the acquired property.

2. Reduction in taxes otherwise applicable to the income of the year in which the credit arises. This method reduces the current year's Provision for Taxes (computed without regard for the investment credit) by the amount of the allowed investment credit. Allowable carrybacks are recorded by charges to an asset account, e.g., Claim for Refund of Income Taxes, and credits to an income account or Provision for Taxes. As with the cost reduction method, material carryforward credits should be disclosed in a footnote and, if they become allowable in future years, should be recorded as above.

This method treats the net benefit from investment credits as income in the year in which they are allowed. Other things being equal, net income will be higher in those years in which investment credits are allowed.

b. Arguments advanced for the use of the reduction in cost method of accounting for an investment credit include the following:

1. Income is realized not by the mere purchase of equipment but by its utilization. Therefore the benefit derived from investment credits which arise

from the purchase of equipment should not be treated as income but should be allocated over the useful life of the equipment whose purchase brought it about. Furthermore, treating investment credits as income at the time of purchase of equipment makes possible the manipulation of the net income figure by advancing or delaying planned purchases of qualified investments.

2. Because of the recapture provisions in the statute which become operative in the event of early dispositions of qualified investments, the ultimate realization of an investment credit is contingent upon the future. To treat the benefit from an investment credit as income at the earliest possible point in time is, in the face of this uncertainty, difficult to support.
3. The actual cost of qualified investment property is the contract price less the savings in the form of a tax reduction. This is the amount foregone and it cannot be assumed that the property is worth more to the purchaser. The property might not have been purchased at its full price in the absence of the tax credit.
4. The intent of the legislation which gave rise to the investment credit is to induce additional purchases of qualified property by reducing its net cost and thereby to make such investments more prudent than they would otherwise be.

Arguments advanced for the use of the tax reduction method of accounting for an investment credit include the following:

1. Investments in qualified property should be recorded at the price paid in a transaction with another entity. It is illogical to record identical assets acquired from the same suppliers at uniform market prices at different costs, depending on the availability of the investment credit. The tax reduction approach results in a more reasonable and consistent basis for accounting for the cost of qualified investment property.
2. By not permitting the availability of an investment credit to influence recorded cost, comparability will be preserved among the costs of identical units purchased from the same suppliers at uniform prices, whether by the same company or different ones.
3. Since the investment credit is in substance a selective reduction in taxes in the year allowed, the benefit to those who qualify should be treated as income in that year.
4. By requiring all purchases of qualified investments to be uniformly recorded at their contract price, the tax reduction approach, in the event that the allowed credit is less than 7 per cent of qualified investments, avoids the problem of arbitrarily designating the assets for which both cost and depreciation charges will be reduced.
5. The anticipated income tax benefits from a proposed capital expenditure are no more or less relevant to that investment decision than are other anticipated cost benefits, i.e., reduced labor, material or other costs. There is no more justification for adjusting the cost of the capital expenditure by the amount of the tax benefit than for the amount of labor, material, or other benefits. The effects of acquiring a capital asset on costs or expenses, including income taxes, should be separately measured and disclosed as they occur.

Answers to Examinations, November 1965

ACCOUNTING PRACTICE—PART I

November 3, 1965; 1:30 to 6:00 p.m.

Solution 1

1. B	11. C
2. B	12. A
3. D	13. D
4. E	14. D
5. A	15. B
6. E	16. C
7. C	17. D
8. A	18. A
9. B	19. C
10. B	20. D

Solution 2

a. COMPUTATION OF NUMBER OF SHARES TO BE EXCHANGED BASED ON CURRENT MARKET VALUES OF STOCK

$$\frac{\text{Current market value—Waning Corporation}}{\text{Current market value—Thriving Corporation}} = \frac{\$20.00}{\$24.00} = \frac{1}{1.2}$$

Current market value per share of Thriving Corporation capital stock is equal to 1.2 times the current market value per share of Waning Corporation capital stock.

	Shares
Thriving Corporation capital stock outstanding	100,000
Held by parent company	72,000
Held by minority interest	28,000
To be purchased on July 1, 1965	10,000
Held by minority interest and to be exchanged	18,000
Ratio of current market values	1.2
Waning Corporation shares to be exchanged	21,600

b. COMPUTATION OF NUMBER OF SHARES TO BE EXCHANGED BASED ON NET BOOK VALUE OF STOCK

Net book value of Thriving Corporation stock to be exchanged	$198,000
Net book value per share of Waning Corporation stock	$16.50
Number of shares of Waning Corporation stock to be exchanged for Thriving Corporation stock ($198,000 ÷ $16.50)	12,000

Minority interest to receive 12,000 shares of Waning Corporation stock for 18,000 shares of Thriving Corporation stock.

Computation of Net Book Value of Thriving Corporation Capital Stock Held by Minority Interest

Net book value at June 30, 1965	$1,230,000
Less purchase of 10,000 shares of treasury stock @ $24.00	240,000
Book value of 90,000 (100,000 — 10,000) shares	$ 990,000
Book value per share ($990,000 ÷ 90,000)	$ 11
Shares held by minority interest (100,000 — 72,000 — 10,000)	18,000
Net book value of stock held by minority interest to be exchanged. ($11 × 18,000)	$ 198,000

Computation of Net Book Value of Waning Corporation Capital Stock

Net book value at June 30, 1965		$1,415,000
Less purchase of 400 shares of treasury stock @ $20.00		8,000
Book value of 79,600 (80,000 — 400) shares		1,407,000
Less reduction due to purchase of Thriving Corporation treasury stock		
Original equity (72% of $1,230,000)	$885,600	
Present equity (80%* of $990,000)	792,000	93,600
Adjusted book value after purchase of all treasury stock		$1,313,400
Book value per share ($1,313,400 ÷ 79,600)		$16.50

***Computation of Present Equity in Thriving Corporation**

Original shares outstanding	100,000
Treasury stock purchased	10,000
Total outstanding after purchase	90,000

$$\text{Present equity} = \frac{72,000}{90,000} = 80\%$$

Solution 3

The Decorator Paint Co., Inc.

WORKSHEET FOR PREPARATION OF FINANCIAL STATEMENTS

For the Year Ended December 31, 1964

	Trial Balance		*Adjusting Entries*		*Income Statement*		*Balance Sheet*	
	Debit	*Credit*	*Debit*	*Credit*	*Debit*	*Credit*	*Debit*	*Credit*
Cash—general account	$ 23,600						$23,600	
Cash—imprest payroll account	1,000		(1) $ 4,900				5,900	
Inventory, January 1	1,700			(6) $ 300			1,400	
Trucks and equipment	24,800			(10) 3,000			21,800	
Accumulated depreciation—trucks and equipment		$ 10,100	(10) 2,250	(9) 3,000				$10,850
Suspense		10,350	(8) 10,000					
			(10) 350					
Prior years' adjustments			(9) 400				400	
Retained earnings		5,450						5,450
Capital stock		5,000						5,000
Sales		363,000	(4) 3,700	(3) 13,500		$372,800		
Paint and supplies	75,000		(6) 300	(5) 700	$ 74,600			
Subcontractors	9,800		(2) 900	(5) 500	10,200			
Labor	210,000			(5) 4,200	205,800			
Payroll taxes	8,500				8,500			
Officers and other salaries	23,000				23,000			
Other expenses	16,500			(7) 600	15,900			
	$393,900	$393,900						

	Trial Balance		*Adjusting Entries*		*Income Statement*		*Balance Sheet*	
	Debit	*Credit*	*Debit*	*Credit*	*Debit*	*Credit*	*Debit*	*Credit*
Accrued payroll taxes				(1) $ 4,900				$ 4,900
Accounts payable				(2) 900				900
Accounts receivable			(3) $13,500 (4) 2,500				$16,000	
Jobs in process—billings				(4) 6,200				6,200
Jobs in process—costs			(5) 5,400				5,400	
Investments			(7) 600				600	
Loan payable, officers				(8) 10,000				10,000
Depreciation—trucks and equipment			(9) 2,600		$ 2,600			
Loss on sale of truck			(10) 400		400*			
Provision for income taxes			(11) 16,264		16,264			
Liability for income taxes				(11) 16,264				16,264
Net income after taxes					15,536			15,536
			$64,064	$64,064	$372,800	$372,800	$75,100	$75,100

*As an alternative treatment, this item may be reported in the retained earnings statement.

Adjusting Entries
(Not Required)

(1)

Cash—imprest payroll account	$ 4,900	
Accrued payroll taxes		$ 4,900

To record cash deposited in payroll account to cover payroll taxes.

$1,100	December F.I.C.A.
2,100	December federal withholding
900	4th quarter state unemployment
800	Federal unemployment for 1964
$4,900	Total

(2)

Subcontractors	900	
Accounts payable		900

To record $700 unpaid subcontractor's invoice for job #602 and $200 subcontractor's invoice for job #604 not billed at year end.

(3)

Accounts receivable	13,500	
Sales		13,500

To record sales not entered on the books.

Job #602	$ 6,200
Job #604	7,300
Total	$13,500

(4)

Accounts receivable	2,500	
Sales	3,700	
Jobs in process-billings		6,200

To record unpaid billings and to remove customer advances from sales.

	Paid Billings	*Unpaid Billings*	*Total*
Job #603	$3,000	$1,000	$4,000
Job #605	700	1,500	2,200
Total	$3,700	$2,500	$6,200

(5)

Jobs in process—costs	5,400	
Paints and supplies		700
Direct labor		4,200
Subcontracts		500

To record costs of jobs in process.

Job	*Paint*	*Direct Labor*	*Subcontracts*	*Total*
#603	$400	$3,200	$500	$4,100
#605	300	1,000	—	1,300
Total	$700	$4,200	$500	$5,400

(6)

	Dr.	Cr.
Paint and supplies	300	
Inventory		300

To adjust inventory per books to the year end physical inventory.

2/3 × $2,100 =	$1,400
January 1 inventory	1,700
Adjustment	$ 300

(7)

	Dr.	Cr.
Investments	600	
Other expenses		600

To correct accounting for country club membership bond.

(8)

	Dr.	Cr.
Suspense	10,000	
Loans payable—officers		10,000

To properly record loan from the Corporation president.

(9)

	Dr.	Cr.
Prior years' adjustments	400	
Depreciation—trucks and equipment	2,600	
Accumulated depreciation—trucks and equipment		3,000

To adjust prior years accumulated depreciation and to record depreciation for 1964.

Adjustment—Prior Years' Accumulated Depreciation

	Misc. Equipment	*Office Equipment*	*Total*
Date acquired	1/1/59	1/1/59	
Cost	$12,000	$2,000	
Life	10 yrs.	10 yrs.	
Accumulated depreciation—12/31/63	$ 4,800	$1,800	$6,600
Correct accumulated depreciation—12/31/63	6,000	1,000	7,000
Adjustment—(over) under	$ 1,200	$ (800)	$ 400

Depreciation Expense—1964

Truck #1 (6 months)	$ 250
Truck #2	600
Truck #3 (1/6 × $4,200 × ½)	350
Misc. equipment	1,200
Office equipment	200
Total	$2,600

(10)

	Dr.	Cr.
Accumulated depreciation—trucks and equipment	2,250	
Suspense	350	
Loss on sale of truck	400	
Trucks and equipment		3,000

To remove truck #1 from books and to record loss on its sale.

(11)

	Dr.	Cr.
Provision for income tax	16,264	
Liability for income tax		16,264

To record provision and liability for income tax.

Computation of Taxable Income

Sales		$372,800
Paints and supplies		74,600
Subcontractors		10,200
Labor		205,800
Payroll taxes		8,500
Officers and other salaries		23,000
Other expenses	$15,900	
Less unallowable entertainment expense	960*	14.940
Depreciation	2,600	
Less unallowable depreciation ($200-$40**)	160	2,440
Loss on sales of truck (Section 1231 asset)		400
Total		339,880
Taxable income		$ 32,920
Provision for tax @ 50%		$ 16,460
Less investment credit (7% × 2/3 × $4,200)		196
Liability for income taxes		$ 16,264

*An alternative treatment would include this item in Officers and Other Salaries.
**The adjusted basis (book value) of Office Equipment at December 31, 1963 is allocated over its remaining useful life for tax purposes.

	Date Acquired	*Cost*	*Depreciation allowed to 12/31/63*	*Adjusted Basis 12/31/63*	*Remaining Life*	*Depreciation Expense*
Office Equipment	1/1/59	$2,000	$1,800	$200	5 yrs.	$40

Solution 4

a. COMPUTATION OF THE INCREASE IN SELLING PRICE

$$\text{Increase in selling price} = \frac{\text{Increase in variable labor costs}}{1 - \text{PV ratio}}$$

$$= \frac{\text{Variable labor cost} \times \text{Expected percentage increase in wages}}{\left[1 - \left(\frac{\text{Selling price} - \text{Total variable cost}}{\text{Selling price}}\right)\right]}$$

$$= \frac{\$12.00 \times 10\%}{\left[1 - \left(\frac{\$80.00 - \$48.00}{\$80.00}\right)\right]}$$

$$= \underline{\underline{\$2.00}}^{*}$$

*Schedules also may be used to obtain the solutions.

b. COMPUTATION OF UNIT VOLUME REQUIRED

$$\text{Unit volume required} = \frac{\text{Total dollar sales volume}}{\text{Selling price}}$$

$$= \frac{\left[\dfrac{\text{Contribution to fixed costs}}{\text{New PV ratio}}\right]}{\text{Selling Price}}$$

$$= \frac{\left[\dfrac{\text{Present Annual sales volume} \times \text{Profit contribution per unit}}{\left[\dfrac{\text{Selling price} - \left(\text{Total variable cost before wage increase} + \text{Estimated increase in variable labor cost}\right)}{\text{Selling price}}\right]}\right]}{\text{Selling price}}$$

$$= \frac{\left[\dfrac{5{,}000 \text{ units} \times \$32.00}{\left[\dfrac{\$80.00 - (\$48.00 + \$1.20)}{\$80.00}\right]}\right]}{\$80.00}$$

$$= \underline{\underline{5{,}195 \text{ units}^*}}$$

c. COMPARISON OF ESTIMATED NET INCOME BEFORE AND AFTER CAPACITY INCREASE IF THE WAGE INCREASE GOES INTO EFFECT

$$\text{Estimated net income before capacity is increased} = \left(\text{Current capacity} \times \text{Selling price} \times \text{New PV ratio}\right) - \text{Current fixed costs}$$

$$= (5{,}300 \text{ units} \times \$80.00 \times 38.5\%) - \$51{,}000$$

$$= \underline{\underline{\$112{,}240^*}}$$

$$\text{Estimated net income after capacity is increased} = \left(\text{Current capacity} \times \text{New capacity as percentage of current capacity} \times \text{Selling price} \times \text{New PV ratio}\right) - \left(\text{Current fixed costs} + \text{Increase in fixed costs}\right)$$

$$= (5{,}300 \text{ units} \times 130\% \times \$80.00 \times 38.5\%) - (\$51{,}000 + \$19{,}000)$$

$$= \underline{\underline{\$142{,}212^*}}$$

*Schedules also may be used to obtain the solutions.

Solution 5

a.

The Little Corner Sporting Goods Store

COMPUTATION OF INVENTORY AT LIFO COST UNDER THE RETAIL INVENTORY METHOD

June 30, 1965

			Cost	Selling Price
Inventory, January 1			$ 26,900	$ 40,000
Add:				
Purchases			86,200	111,800
Less purchase returns and allowances			(1,500)	(1,800)
Markups				19,500
Less markup cancellations				(4,500)
Goods available for sale			$111,600	165,000
Less:				
Sales at retail		$122,000		
Sales returns and allowances		6,000		
Net sales		116,000		
Markdowns	$10,500			
Less markdown cancellations	6,500	4,000		120,000
Ending inventory at retail				$ 45,000
Inventory, January 1			$ 26,900	
Add:				
LIFO layer:				
[70% of ($45,000 — $40,000)]			3,500	
Inventory, June 30, at LIFO			$ 30,400	

Cost to Retail Ratio

$$\frac{\text{Net purchases at cost}}{\text{Net purchases at retail + net markups — net markdowns}} = \text{Cost to Retail Ratio}$$

$$\frac{\$86{,}200 - \$1{,}500}{\$111{,}800 - \$1{,}800 + \$19{,}500 - \$4{,}500 - \$10{,}500 + \$6{,}500} = 70\%$$

b. COMPUTATION OF INVENTORY UNDER THE DOLLAR-VALUE LIFO COST METHOD

June 30, 1965

Ending inventory at retail at January 1 price level ($44,100 ÷ 1.05)	$42,000
Less beginning inventory at retail	40,000
Inventory increment at retail, January 1 price level	$ 2,000
Inventory increment at retail, June 30 price level ($2,000 × 1.05)	$ 2,100
Beginning inventory at cost	$26,900
Inventory increment at cost at June 30 price level ($2,100 × .80)	1,680
Ending inventory at dollar-value LIFO cost	$28,580

Solution 6

Estate of Albert Brown, Deceased
Charles Dawson, Executor

CHARGE AND DISCHARGE STATEMENT
February 1, 1964 through December 31, 1964

		See Schedule
Principal		
I charge myself with		
Original capital of estate	$357,100	1
Gain on disposal of estate assets	5,000	2
Total	362,100	
I credit myself with		
Funeral, administration and other expenses	14,000	3
Debts of decedent paid	2,400	4
Legacies paid or delivered	175,700	5
Total	192,100	
Balance, December 31, 1964	$170,000	6
Income		
I charge myself with		
Income collected	$ 4,400	7
I credit myself with		
Expense applicable thereto	1,200	8
Distribution to Sunnydale Orphanage	2,200	9
Total	3,400	
Balance, December 31, 1964, consisting of cash in checking account	$ 1,000	

Estate of Albert Brown, Deceased
Charles Dawson, Executor

ORIGINAL PRINCIPAL OF ESTATE
February 1, 1964

Schedule 1

Checking account, First National Bank	$ 6,000
$60,000 City of Laguna School Bonds, 2%	59,000
Accrued interest on same, January 1 through February 1, 1964	100
2,000 shares Jones Corporation capital stock	220,000
Dividend receivable on same	2,000
Personal residence and furnishings	50,000
Term life insurance	20,000
Total	$357,100

Estate of Albert Brown, Deceased
Charles Dawson, Executor
GAIN ON DISPOSAL OF ESTATE ASSETS
February 1, 1964 through December 31, 1964

Schedule 2

Sale of 1,000 shares Jones Corporation capital stock @ $105	$105,000
Inventory value	100,000
Gain on disposal of estate assets	$ 5,000

$$\frac{\$220{,}000}{2{,}000 + 200} \times 1{,}000 = \$100{,}000$$

Estate of Albert Brown, Deceased
Charles Dawson, Executor
FUNERAL, ADMINISTRATION AND OTHER EXPENSES
February 1, 1964 through December 31, 1964

Schedule 3

Funeral expenses	$ 2,000
Attorney's and accountant's fees	12,000
Total	$ 14,000

Estate of Albert Brown, Deceased
Charles Dawson, Executor
DEBTS OF DECEDENT PAID
February 1, 1964 through December 31, 1964

Schedule 4

Real estate taxes (1/12 × $900)	$ 75
Accrued wages (1/4 × $500)	125
Final illness expense	1,500
April 15 income tax remittance	700
Total	$ 2,400

Estate of Albert Brown, Deceased
Charles Dawson, Executor
LEGACIES PAID OR DELIVERED
February 1, 1964 through December 31, 1964

Schedule 5

Legacies paid to Sunnydale Orphanage:		
July 1	— Sale of City of Laguna School Bonds	$ 59,000
July 1	— Accrued interest on City of Laguna School Bonds	100
September 2	— Sale of Jones Corporation capital stock	105,000
December 31	— Balance of corpus cash on hand (see schedule of executor's cash account)	11,600
Total		$175,700

Estate of Albert Brown, Deceased
Charles Dawson, Executor
EXECUTOR'S CASH ACCOUNT
February 1, 1964 through December 31, 1964
(Schedule not required)

Receipts	*Total*	*Principal*	*Income*
Transfer from First National Bank	$ 6,000	$ 6,000	
Sale of Jones Corporation capital stock	105,000	105,000	
Collection of life insurance policy	20,000	20,000	
Interest collected on City of Laguna School Bonds	600	100	$ 500
Sale of City of Laguna School Bonds	59,000	59,000	
Jones Corporation cash dividends			
March 1	2,000	2,000	
December 1	1,200		1,200
Rent	2,700		2,700
Total receipts	196,500	192,100	4,400
Disbursements			
Funeral expenses	2,000	2,000	
Final illness expenses	1,500	1,500	
Income tax remittance	700	700	
Attorney's and accountant's fees	12,000	12,000	
Real estate taxes	900	75	825
Wages	500	125	375
Sunnydale Orphange legacy payments:			
City of Laguna School Bonds and interest	59,600	59,100	500
Sale of Jones Corporation capital stock	105,000	105,000	
Year-end distribution	13,300	11,600	1,700
Total disbursements	195,500	192,100	3,400
Balance, December 31, 1964	$ 1,000	—0—	$1,000

Estate of Albert Brown, Deceased
Charles Dawson, Executor
ASSETS (CORPUS) ON HAND
December 31, 1964

Schedule 6

Residence and furnishings	$ 50,000
1,200 shares Jones Corporation capital stock	120,000
Total	$170,000

Estate of Albert Brown, Deceased
Charles Dawson, Executor
INCOME COLLECTED
February 1, 1964 through December 31, 1964

Schedule 7

City of Laguna School Bonds	$ 600
Less accrual	100
	500
Dividends on stock—Jones Corporation	1,200
Rent	2,700
Total	$4,400

Estate of Albert Brown, Deceased
Charles Dawson, Executor
EXPENSES CHARGEABLE TO INCOME
February 1, 1964 through December 31, 1964

Schedule 8

Real estate taxes	$900	
Less accrual	75	$ 825
Wages of gardner-handyman	500	
Less accrual	125	375
Total		$1,200

Estate of Albert Brown, Deceased
Charles Dawson, Executor
CALCULATION OF ACCRUALS WHICH CONSTITUTE ESTATE ASSETS
February 1, 1964
(Not required)

Interest accrued on $60,000 City of Laguna School Bonds, 2%, 7/1/68, interest payable January and July 1.

$60,000 × 2% × 1/12 = $100

Estate of Albert Brown, Deceased
Charles Dawson, Executor
DISTRIBUTIONS OF INCOME
February 1, 1964 through December 31, 1964

Schedule 9

July 1—Interest on City of Laguna School Bonds	$600	
Less accrual	100	$ 500
Year-end distributions of income to Sunnydale Orphanage		1,700
Total		$2,200

November 4, 1965; 1:30 to 6:00 p.m.

Solution 1

a.

Victoria School District

COMPUTATION OF ESTIMATED TOTAL FUNDS TO BE OBTAINED FROM LOCAL TAXATION

For the School Year Ending June 30, 1967

Total budgeted expenditures			$2,248,600
Revenue from grants-in-aid:			
From state government:			
Equalizing grants (5,000 × $150)		$750,000	
From federal government:			
Contribution for vocational education (200 × $150 × 60%)	$18,000		
Contribution for bus transportation and school lunches (5,000 × $10*)	50,000	68,000	
Total grants-in-aid		818,000	
Miscellaneous receipts:			
Interest on temporary investment of school tax receipts and rents of school facilities		75,000	893,000
Estimated total funds to be obtained from local taxation			$1,355,600

*Maximum, $12; actual 6-2/3% × $150 or $10.

b. **COMPUTATION OF ESTIMATED CURRENT OPERATING COST PER REGULAR PUPIL AND PER VOCATIONAL PUPIL**

	Total Pupils (5,000)	*Regular Pupils* (4,800)	*Vocational Pupils* (200)
Instructional costs	$1,513,600	$1,401,600	$112,000
Other costs prorated (4,800:200)	510,000	489,600	20,400
Total current operating costs	2,023,600	1,891,200	132,400
Less grants-in-aid:			
State equalizing grants ($150 per pupil)	750,000	720,000	30,000
Federal grants for vocational pupils	18,000		18,000
Federal grants for transportation and lunches ($10 per pupil)	50,000	48,000	2,000
Total grants-in-aid	818,000	768,000	50,000
Current operating costs to be paid by local tax funds	$1,205,600	$1,123,200	$ 82,400
Current operating cost per pupil to be paid by local tax funds	$ 241.12	$ 234.00	$ 412.00

c. **COMPUTATION OF VICTORIA SCHOOL DISTRICT ESTIMATED TAX RATE**

Estimated total tax funds ($1,092,000 ÷ 91%)	$ 1,200,000
Assessed valuation for school district	$80,000,000
Estimated tax rate per $100 of assessed valuation ($1,200,000 ÷ $80,000,000/100)	$ 1.50

Solution 2

a. **Bisto Corporation**

COMPUTATION OF EQUIVALENT UNITS AND COSTS INCURRED PER UNIT
For the Month of December 1964

	Raw Material	*Grinding*	*Assembling*	*Finished Valves*
Beginning inventory	1,100	800	600	900
Add receipts during month	5,000	3,400	2,200	2,500
Total	6,100	4,200	2,800	3,400
Deduct ending inventory	2,700	2,000	300	2,250
Units transferred out	3,400	2,200	2,500	1,150
Add equivalent units in ending inventory	2,700	700	100	
Total	6,100	2,900	2,600	
Deduct equivalent units in beginning inventory	1,100	200	240	
Equivalent units for December	5,000	2,700	2,360	
Costs incurred in December	$10,500	$2,430	$5,664	
Average cost per equivalent unit	$2.10	$.90	$2.40	

b.

Bisto Corporation
COMPUTATION OF INVENTORIES ON FIFO BASIS*
December 1 and 31, 1964

	December 1, 1964 Inventory			December 31, 1964 Inventory							
				Valued at December Average Cost				Valued at December 1, 1964 Cost			
	Units	Cost Per Unit**	Amount	Total Units	Units	Cost Per Unit	Amount	Units	Cost Per Unit	Amount	Total Amount
Material costs:											
Raw material	1,100			2,700							
Work-in-process:											
Grinding	800			2,000							
Assembling	600			300							
Finished	900			2,250							
Total	3,400	$1.60	$5,440	7,250	5,000	$2.10	$10,500	2,250	$1.60	$3,600	$14,100
Grinding costs:											
Work-in-process:											
Grinding	200			700							
Assembling	600			300							
Finished	900			2,250							
Total	1,700	.80	1,360	3,250	2,700	.90	2,430	550	.80	440	2,870
Assembling costs:											
Work-in-process:											
Assembling	240			100							
Finished	900			2,250							
Total	1,140	2.00	2,280	2,350	2,350	2.40	5,640				5,640
Total inventory cost			$9,080				$18,570			$4,040	$22,610

*An alternative treatment would compute inventories on the basis of departmental costs.
**80% of seller's cost.

Solution 3

The Garner Manufacturing Corporation

COMPUTATION OF LIABILITY FOR INCOME TAXES
For the Year Ended December 31, 1964

Net income per books		$ 48,950
Add unallowable deductions and additional income:		
Provision for sales returns and allowances		29,400
Provision for income taxes		36,800
Cost depletion		3,000
Depreciation recorded for 1964 on production line sold		3,000
Ordinary gain on production line sold		12,000
Adjustment of depreciation recorded for new production line (basis reduced to $98,000)		100
Total		133,250
Deduct nontaxable income and additional deductions:		
Actual sales returns and allowances	$32,700	
Depreciation of electrical wiring (10% of $6,000)	600	
Dividends received deduction (85% of $1,000)	850	
Gain on sale of land to state highway department	4,000	
Severance damages received from state highway department	5,000	
Percentage depletion (23% of $80,000)	18,400	
Additional first-year 20% depreciation (limited to 20% of $10,000)	2,000	
Total		63,550
Taxable income before net operating loss deduction		69,700
Less net operating loss deduction		13,000
Taxable income		$ 56,700
Income tax @ 50%		$ 28,350
Income tax on long-term capital gain (25% of $5,000)		1,250
Total		29,600
Less investment credit (7% of $100,000)		7,000
Liability for income taxes		$ 22,600

Computation of Provision for Sales Returns and Allowances

Gross sales ($950,600 ÷ .97)	$980,000
Net sales	950,600
Provision	$ 29,400

Computation of Actual Sales Returns and Allowances

Reserve for sales returns and allowances, January 1	$ 27,500
Add 1964 provision	29,400
Total	56,900
Reserve for sales returns and allowances, December 31	24,200
Actual sales returns and allowances for 1964	$ 32,700

Computation of Cost Depletion

$$\frac{\$75,000}{25,000} \times 1,000 = \$3,000$$

Computation of Gain on Sale of Production Line

Sales price			$ 50,000
Cost		$60,000	
Depreciation allowed:			
Prior to January 1, 1962	$15,000		
After December 31, 1961 (1962 and 1963)	12,000	27,000	
Adjusted basis			33,000
Total gain			17,000
Less ordinary gain			12,000
Long-term capital gain			$ 5,000

Computation of Net Operating Loss Deduction

(Losses incurred in the years 1955 through 1958 cannot be applied to 1964 income because of the 5-year limitation on carryovers.)

Taxable income for 1963	$41,000
Less net operating loss carryover from 1958	31,000
Total	10,000
Less net operating loss carryover from 1959	23,000
Net operating loss carryover applicable to 1964 income	$13,000

Solution 4

Primo Corporation and Subsidiary

WORKING PAPERS FOR CONSOLIDATED BALANCE SHEET
December 31, 1964

	Primo Corporation	*Secondo Corporation*	*Adjustments and Eliminations*		*Consolidated Balance Sheet*
			Debit	*Credit*	
Cash	$ 50,000	$(1,800)	(2) $ 1,800		$ 50,000
Notes receivable	42,000			(7) $ 15,000	27,000
Accounts receivable	68,000	68,800		(4) 24,000	112,800
Inventories	177,000	22,500	(3) 1,500		201,000
Plant, property and equipment	290,000	240,000		(5) 2,000	528,000
Allowance for depreciation	(40,000)	(60,000)	(5) 100		(99,900)
Investment in Secondo Corporation	70,000			(1) 70,000	
Investment in Secondo Corporation bonds	35,000			(8) 35,000	
Advance to Secondo Corporation	25,000			(9) 25,000	
Accrued interest receivable	1,450			(8) 525	925
Other assets	7,000	3,000			10,000
	$725,450	$272,500			$829,825
Accounts payable	$ 85,400	$ 36,800	(4) 24,000		$ 98,200
Notes payable	45,000	25,000	(6) 10,000		60,000
Notes receivable discounted	15,000		(7) 15,000		
Accrued interest payable	300	1,750	(6) 250		1,275
			(8) 525		
Accrued liabilities	13,000	9,075			22,075
Advance from Primo Corporation		25,000	(9) 25,000		
Bonds payable		100,000	(8) 35,000		65,000
Capital stock $5 par value	300,000				300,000
Capital stock $1 par value		40,000	(1) 40,000		
Capital in excess of par value	150,000		(1) 30,000		120,000
Retained earnings	116,750	34,875		(3) 1,500	151,225
			(5) 1,900		
	$725,450	$272,500			
Cash-bank overdraft				(2) 1,800	1,800
Notes payable—officers				(6) 10,000	10,000
Accrued interest payable—officers				(6) 250	250
			$185,075	$185,075	$829,825

Primo Corporation and Subsidiary

ADJUSTING AND ELIMINATION ENTRIES
December 31, 1964
(Not required)

(1)

Capital stock—Secondo	$40,000	
Capital in excess of par value	30,000	
Investment in Secondo Corporation		$70,000

To eliminate reciprocal elements in investment and equity accounts.

(2)

Cash	1,800	
Cash-bank overdraft		1,800

To classify Secondo Corporation bank ovedraft as a current liability.

(3)

Inventory	1,500	
Retained earnings		1,500

To value Secondo's inventory under the FIFO method and to eliminate intercompany profit in inventory.

Inventory at Secondo's cost under FIFO method	$32,000
Intercompany profit in inventories (25%)	8,000
Adjusted inventory under FIFO method	24,000
Inventory per trial balance	22,500
Inventory adjustment	$ 1,500

(4)

Accounts payable	24,000	
Accounts receivable		24,000

To eliminate intercompany receivable and payable.

(5)

Allowance for depreciation	100	
Retained earnings	1,900	
Plant, property and equipment		2,000

To eliminate intercompany profit and to adjust accumulated depreciation on production machine sold to Secondo by Primo.

	Machine	*Depreciation*
Sales price	$8,000	$400
Cost	6,000	300
Excess	$2,000	$100

(6)

Notes payable	10,000	
Accrued interest payable	250	
Notes payable—officers		10,000
Accrued interest payable—officers		250

To set out separately note payable and accrued interest payable to the president of Primo Corporation. ($10,000 × 5% × 6 mos. = $250)

(7)

Notes receivable discounted	15,000	
Notes receivable		15,000

To eliminate intercompany notes discounted.

(8)

Bonds payable	35,000	
Accrued interest payable	525	
Investment in Secondo Corporation bonds		35,000
Accrued interest receivable		525

To eliminate intercompany bond holdings and accrued interest.

(9)

Advance from Primo Corporation	25,000	
Advance to Secondo Corporation		25,000

To eliminate intercompany advance.

Solution 5

a. Graystone Electronics Corporation

COMPUTATION OF ESTIMATED TOTAL ADJUSTED PRICE FOR FIXED-PRICE INCENTIVE CONTRACT
December 31, 1964

		Cost	*Profit*	*Total*
Target		$700,000	$ 80,000	$780,000
Estimated costs in excess of target:				
Incurred	$602,000			
Estimated amount to complete	138,000			
Estimated disallowance of overhead costs [.01 ($240,000 + $60,000)]	(3,000)			
Depreciation on excess equipment	(1,000)			
Special recruiting costs	(4,000)			
Lost cash discounts	(2,000)			
Total	730,000			
Less target costs	700,000	30,000		30,000
Less decrease in profit because of excess costs (20% of $30,000)			(6,000)	(6,000)
Estimated total adjusted price		$730,000	$74,000	$804,000*

*No change since amount is less than $810,000.

b. COMPUTATION OF WORK-IN-PROCESS INVENTORY

Total costs incurred		$602,000
Estimated costs to complete contract		138,000
Total		740,000
Deduct estimated disallowable costs:		
Unassignable estimate based on prior experience	$ 3,000	
Depreciation on excess equipment	1,000	
Special nonrecurring recruiting costs	4,000	8,000
Estimated cost of 8 computers		$732,000
Total costs incurred		$602,000
Deduct:		
Costs assigned to computers delivered (5/8 of $732,000)	$457,500	
Estimated disallowable costs:		
Unassignable estimate (1% of $240,000)	2,400	
Depreciation on excess equipment	1,000	
Special nonrecurring recruiting costs	4,000	464,900
Work-in-process inventory		$137,100

c. COMPUTATION OF ESTIMATED TOTAL AMOUNT RECEIVABLE FROM FEDERAL GOVERNMENT FOR COMPUTERS DELIVERED

Revised selling price for 5 computers delivered	$\left(5 \times \frac{\$800,000}{8}\right) =$	$500,000
Less progress payments received		375,000
Estimated balance due on 5 computers shipped		$125,000

AUDITING

November 4, 1965; 8:30 a.m. to 12:00 m.

Answer 1

a. The auditing procedures that would be employed to verify the total annual sales of the Bali Pearl Restaurant would include the following:

1. Examine the lease agreement to determine the exact terms of the agreement defining the kinds of sales to be included in or exempt from the rental calculation.
2. Obtain a copy of the Restaurant's annual financial statements or its general ledger trial balance and trace significant amounts to the general ledger.
3. Foot the daily sales book and compare with sales entries recorded in the general ledger. Foot the general ledger sales account and compare the year's sales with the sales reported to the landlord. Scan the general ledger sales account and investigate unusual entries.
4. Test the sales figures entered in the daily sales book by comparing with the source of the figures which may be the cash register tapes, or with the auditor's adding machine tapes of the Restaurant checks.
5. If the daily sales figures are obtained from a cumulative sales dial in the cash register and if the dial can not be turned back to zero, ascertain whether the total sales for the year can be computed by comparing the register dial reading at the beginning of the year and at the end of the year. If the daily sales are summarized on a daily cash report before posting to the daily sales book, review these reports and compare with daily sales book. Inquire about any abnormal cash overages or shortages.
6. Review the daily sales book for deviations from sales patterns and obtain explanations for the deviations. On a test basis, for days showing such deviations obtain all the Restaurant checks and add the check totals to verify the total daily sales. In addition, determine that there was a proper cut-off of sales at year-end.
7. Test the files of Restaurant checks to determine that the checks are being used in numerical sequence and that all are accounted for. Review invoices from supplier of restaurant checks to determine, if possible, that all checks purchased are accounted for. Inspect inventory of unused sales books.
8. As an over-all test of sales, obtain the Restaurant's bank statements. Reconcile the total cash deposits for the year, adjusted for miscellaneous cash disbursements such as freight charges, withdrawals, etc., with total annual sales.
9. As another over-all check, determine the Restaurant's net cost of food for the year and apply a mark-up percentage to arrive at the approximate

total annual sales. The net cost of food should be adjusted for meals furnished to employees.

10. Compare the total sales reported to the landlord with sales reported on the Restaurant's sales tax or gross receipts return, if any, and on its income tax return.

b. Board of Directors,
Quaker Valley Shopping Center, Inc.

We have examined the accounting records of the Bali Pearl Restaurant for the year ended December 31, 1964 pertaining to its sales during 1964 as defined in the agreement dated January 1, 1964 covering the lease of property by Quaker Valley Shopping Center, Inc. to Bali Pearl Restaurant. Our examination of such records was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the sales of the Bali Pearl Restaurant for the year ended December 31, 1964 as defined in the lease are fairly stated at $390,000.

/s/ John Smith, CPA

Answer 2

a. The use of over-all checks in an audit has two general advantages to a CPA: (1) a broad view is obtained of the data under audit, and (2) his attention is focused on exceptions or variations in the data.

A broad view of the data under audit is needed by the CPA to draw conclusions about the data as a whole—such conclusions cannot be drawn by merely looking at individual transactions. The application of over-all checks to obtain this broad view requires a discerning analysis of the data, which results in over-all conclusions upon which the CPA's audit satisfaction rests. The CPA is thus able to satisfy himself as to the reasonableness, validity and consistency of the data in view of the surrounding circumstances.

The focusing of the CPA's attention on exceptions or variations in the data results in a more efficient and economical audit because there is a reduction in the amount of detailed testing which would be required, in the absence of over-all checks, to uncover these exceptions or variations. Furthermore, manipulations of accounts may be revealed because the double-entry bookkeeping system extends the effects of manipulations to additional accounts, which will then bear a changed relationship to other accounts.

In addition, managerial problems and trouble spots will be highlighted for the CPA and may lead to the opportunity for him to be of additional service to his client.

b. The ratios that a CPA may compute during an audit as over-all checks on balance sheet accounts and related nominal accounts may include the following:

1. Accruals of individual expenses to related total expenses.

2. Accounts payable to purchases (days of purchases outstanding).
3. Long-term debt and interest expense thereon.
4. Return on equity. (Relationship of net income to ownership equity.)
5. Return on investments. (Relationship of investment income to investments.)

c. 1. The possible reasons for a decrease in the rate of inventory turnover include the following:
   (a) Decline in sales.
   (b) Increase in inventory quantities, intentional or unintentional.
   (c) Incorrect computation of inventory because of errors in pricing, extensions or taking of physical inventory.
   (d) Inclusion in inventory of slow-moving or obsolete items.
   (e) Erroneous cutoff of purchases.
   (f) Erroneous cutoff of sales under the perpetual inventory accounting method.
   (g) Unrecorded purchases.
   (h) Change in inventory valuation method.
2. The possible reasons for an increase in the number of days' sales in receivables include the following:
   (a) Change in credit terms.
   (b) Decreasing sales.
   (c) Change in the sales mix of products with different sales terms.
   (d) Change in mix of customers.
   (e) Improper sales cutoff.
   (f) Unrecorded sales.
   (g) Lapping.
   (h) Slower collections caused by tighter economic conditions or lowering of the quality of the receivables.

Answer 3

a. The fidelity bonding of employees has the functions of
1. Assuring recovery of losses incurred in a discovered defalcation and thus safeguarding the total assets of the company.
2. Assuring the employment only of individuals with backgrounds that have passed the test of the bonding company's thorough investigation. There is less likelihood that applicants of dubious character, who might be prone to irregular practices, will be employed.
3. Creating an awareness that any discovered defalcation will result in prosecution because the bonding company in all probability will insist upon legal proceedings which the typical employer may prefer to avoid. This awareness will be a deterrent for employees and should discourage the committing of defalcations.

b. The budgeting of capital expenditures is included in a system of internal control for the purposes of

1. Preventing unauthorized capital expenditures by limiting expenditures to planned or budgeted expenditures.
2. Enabling management to assign priorities to capital acquisition so that available funds will be disbursed in a manner that will result in the greatest benefit to the company.
3. Permitting management to forecast cash requirements over the budget period so that provision can be made for working capital and for other demands upon cash.
4. Providing accounting control over expenditures by classifying them as items to be expensed or to be capitalized.

c. The listing of mail remittances by the mail department when the mail is opened is an internal control procedure for the purposes of
   1. Providing a method of accounting control for all mail remittances from the time they are received until they are delivered to the cashier so that responsibility can be determined in the event of loss or theft of remittances.
   2. Providing a means for subsequent determination that all mail remittances have been deposited, which reduces the opportunity for the abstraction of miscellaneous receipts such as those obtained from scrap sales.
   3. Establishing a record, in some instances, which may be used for subsequent comparison purposes to ascertain that remittances from customers have been credited to the proper account receivable and thus provide ready disclosure of the manipulation of accounts by methods such as lapping.

d. Maintaining a plant ledger for fixed assets is an internal control procedure for the purposes of
   1. Providing accountability for each fixed asset. Internal control is strengthened because the comparison of the physical inventory of the fixed assets with the plant ledger and the balancing of the ledger with the control account may disclose differences which may have been caused by improper accounting for disposal of assets, misclassification of acquisitions, or the loss of assets through theft or other loss.
   2. Making available data concerning the cost, age and accumulated depreciation of specific assets so that a basis is provided for the computation of depreciation charges and calculation of gains or losses upon disposal of the assets for reporting and income tax purposes.
   3. Supplying management with a comprehensive history of each asset, such as length of service and major repairs, that is helpful in arriving at decisions regarding efficiency, replacement, etc.

Answer 4

a. When the inventory is a material item in the financial statements that the CPA is examining, his observation of the taking of the physical inventory is in compliance with the auditing standard pertaining to field work that requires

his obtaining sufficient competent evidential matter to afford a reasonable basis for an opinion regarding the financial statements. Observation is a generally accepted auditing procedure applied in the examination of the physical inventory.

By observation of the taking of the physical inventory, the CPA is seeking to satisfy himself as to the effectiveness of the methods of inventory-taking and as to the measure of reliance which may be placed upon the client's inventory records and its representations as to inventory quantities. He must ascertain that the physical inventory actually exists, that the inventory quantities are being determined by reasonably accurate methods, and that the inventory is in a salable or usable condition.

b. The CPA makes test counts of inventory quantities during his observation of the taking of the physical inventory to satisfy himself that an accurate count is being made by the individuals taking the inventory. The extent of his test counting will be determined by the inventory-taking procedures; for example, the number of his test counts would be reduced if there were two teams, one checking the other, taking the inventory. On the other hand the CPA's test count would be expanded if he found errors in the inventory counts.

Some test counts are recorded by the CPA for the purpose of subsequent comparison with the client's compilation of the inventory. The comparison procedure goes beyond the mere determination that quantities have been accurately transcribed. In addition the CPA seeks assurance that the description and condition of the inventory items is accurate for pricing purposes and that the quantity information, such as dozen, gross, cartons, etc., is proper.

Another reason for recording test counts in the CPA's working papers is to provide evidence of the extent of his test in the event that audit procedures are questioned at some future date.

c. 1. The CPA does not regard the inventory certificate of an outside service company as a satisfactory substitute for his own audit of the inventory. The service company has merely assumed the client's function of taking the physical inventory, pricing it, and making the necessary extensions. To the extent that the service company is competent, the system of internal control with regard to the inventory has been strengthened. Nevertheless, as he would under other strong systems of internal control, the CPA would investigate the system to satisfy himself that it is operating in a satisfactory manner. The CPA's investigation would necessarily entail an observation of the taking of the inventory and testing the pricing and calculation of the inventory.

2. The inventory certificate of the outside specialists would have no effect upon the CPA's report. He must satisfy himself that the inventory was fairly stated by observing the taking of the inventory and testing the pricing and calculation of the inventory.

On the other hand if the taking of the inventory was not observed and no audit tests applied to the computation of the inventory, the CPA

would be compelled to disclaim an opinion on the financial statements as a whole if the amount of the inventory is material.

If it has been impracticable or impossible for the CPA to observe the taking of the physical inventory but he has been able to satisfy himself by the application of other auditing procedures, he would so state in the scope paragraph of his report. However, he should not refer to the inventory in the opinion paragraph.

3. The CPA would make no reference to the certificate of the outside specialists in his report. The outside specialists are serving as adjuncts of the company's staff of permanent employees, and, as such, are in somewhat the same guise as temporary employees. The outside specialists are not independent in that they are not imbued with third party interests. The CPA is compelled, under certain circumstances, to mention in his report the reports of other independent auditors, but this compulsion does not extend to the certificate of outside specialists who are not independent auditors.

Answer 5

a. A CPA cannot avoid responsibility in connection with a set of financial statements with which his name is associated when he knows the statements are not in conformity with generally accepted accounting principles even though he labels the statements "Prepared Without Audit." In fact issuance of a disclaimer of opinion would not relieve him of responsibility.

The $135,000 writeup of the assets to their appraisal value is a departure of a substantial amount from the generally accepted practice that assets should ordinarily be reported in financial statements at their unexpired cost to the accounting entity. Under the circumstances, the CPA should insist upon disclosure of the facts by a footnote or parenthetically in the statements.

If the client refuses to disclose the writeup in the financial statements, the CPA is compelled to render an adverse opinion on the statements because they are grossly misleading. The adverse opinion should state that the statements were not prepared in accordance with generally accepted accounting principles and set forth the circumstances. If the client refuses to accept the financial statements with the related adverse opinion, the CPA should refuse to have his name associated with them.

An adverse opinion, rather than a disclaimer of opinion, is required in this situation because the CPA has knowledge of a distortion in the financial statements. A disclaimer of opinion would merely warn the reader that there may be things wrong with the financial statements which the CPA did not know about because he did not make an audit. It does not imply that he takes no responsibility for fairly presenting any important information that he does know.

Furthermore, since he has knowledge of the appraisal, it seems possible that the CPA might leave himself open to legal liabilities by permitting his

name to be associated with misleading statements even if he disclaimed an opinion.

b. The CPA's responsibility for disclosure of pertinent information of which he has knowledge is the same whether he prepares financial statements from the client's records without having performed an audit or whether he prepares his audit report after a typical examination of the financial statements. Under both conditions the CPA is compelled to determine that all financial statement information of which he is aware has been adequately disclosed and that the statements are not false or misleading.

c. It would be improper for the CPA to prepare the 1964 federal income tax return of the Alba Nursing Home and to sign the tax return as the preparer if the client insisted on valuing the house, a depreciable asset, on the basis of its appraisal. The basis for computation of depreciation on the house is $10,000 plus conversion costs. As a consequence, the computation of depreciation on the appraisal basis of $100,000 plus conversion costs results in an incorrect expense deduction on the tax return.

If the CPA were to sign the partnership's tax return as the preparer he would be subjecting himself to the penalties of perjury because, in affirming that the return was true, correct and complete, he would be denying that he has knowledge of the incorrect expense deduction for depreciation.

On the other hand, the writeup of the land to its appraised value would not enter into the CPA's consideration of whether he can prepare the tax return. The writeup of the land, which is not subject to depreciation or, in its present usage, to depletion, would have no effect upon the determination of taxable income.

Answer 6

a. Gelard Manufacturing Corporation

WORKSHEET TO COMPARE COMPUTATIONS OF WORKERS' WAGES

Worker	*Gross Wages Per Books*	*Gross Wages Per Auditor*	*Wages Per Book Over (Under)*
Long	$ 82.00	$ 89.00	$ (7.00)
Loro	91.00	98.20	(7.20)
Huck	84.00	92.00	(8.00)
Nini	120.00	110.00	10.00
Boro	67.00	76.00	9.00
Wiss	92.00	100.80	8.80
Alan	118.00	114.20	3.80

Computations of Wages

Long:	400 pieces @ $ .20	$ 80.00
	5 hours @ $1.80	9.00
	Total	89.00
	Wages per books	82.00
	Wages per books under	$ 7.00
Loro:	410 pieces @ $ .20	$ 82.00
	6 hours @ $2.70	16.20
	Total	98.20*
	Wages per books	91.00
	Wages per books under	$ 7.20
Huck:	370 pieces @ $ .20	$ 74.00
	4 hours @ $2.70	10.80
	4 hours @ $1.80	7.20
	Total	92.00*
	Wages per books	84.00
	Wages per books under	$ 8.00

Nini:

$$\frac{250 \div 40}{200 \div 40} = 125\%$$

$125\% \times \$2.20 = \$2.75$

$2.75 × 40	$110.00
Wages per books	120.00
Wages per books over	$ 10.00

*Depending upon the terms of the union contract, alternative computations might be as follows:

Loro:	410 pieces @ $ .20	$82.00
	45 pieces @ $ .30	13.50
	Total	95.50
	Wages per books	91.00
	Wages per books under	$ 4.50
Huck:	370 pieces @ $ .20	$74.00
	50 pieces @ $ .30	15.00
	4 hours @ $1.80	7.20
	Total	96.20
	Wages per books	84.00
	Wages per books under	$12.20

Boro:	40 × $1.90	$ 76.00
	Wages per books	67.00
	Wages per books under	$ 9.00
Wiss:	$\frac{240}{300}$ = 80% or 20% bonus	
	120% × $2.10 = $2.52	
	40 × $2.52	$100.80
	Wages per books	92.00
	Wages per books under	$ 8.80
Alan:	$\frac{38}{40}$ × 600 = 570 or standard production for 38 hours	
	$\frac{590}{570}$ = 104% or 45% bonus	
	145% × $2.00 = $2.90	
	38 × $2.90	$110.20
	2 × $2.00	4.00
	Total	114.20
	Wages per books	118.00
	Wages per books over	$ 3.80

b. Should an auditor find a substantial number of computational errors in a weekly payroll that he selected for examination, the following courses of action are available to him:

1. Inasmuch as workers frequently calculate their wages independently to determine that they are being properly paid, the auditor should ascertain whether the errors discovered were corrected in a subsequent week or by a supplemental payroll.
2. The auditor should select payrolls of additional weeks for examination to determine the extent of the errors. The original week under audit may have been the first work of a new payroll clerk whose work was not carefully checked.
3. The auditor should investigate the errors in the original week and the other weeks, if any, to ascertain whether the errors consistently benefit the workers and whether the wages of the same workers are regularly being miscalculated. If there is a remarkable similarity of favorable errors, it may be an indication of collusion between the payroll clerk and certain workers.
4. A responsible official of the client should be advised of the errors and the results of the auditor's expanded procedures. If numerous errors are found in the additional weeks selected for audit, the client might be requested to check more payrolls to obtain an estimate of the total amount of the errors.

5. A discussion should be held with the client when the results of the detailed investigation are known. If the decision is made to adjust for underpayments by a supplemental payroll or for overpayments by deductions from subsequent payrolls, the adjustments should be recorded before the financial statements are prepared. If the client decides to make no adjustments, consideration should be given to the need for disclosure of possible penalties that might be imposed under wage and hour laws. In any event the auditor would weigh the materiality of the amounts involved and the client's treatment of the items in the financial statements to determine their impact upon his report.
6. If numerous errors are found in the additional weeks selected for audit, the CPA should review his other testing procedures to see if they should be expanded since these errors indicate a lack of internal control over payroll procedures and this lack of internal control could extend to other areas.

Answer 7

a. During an audit of a manufacturing company the CPA reviews the cost system for the following purposes:
   1. To determine that costs are properly allocated to current and future periods and hence that cost figures used in arriving at balance sheet and income statement amounts are supported by internal records.
   2. To obtain assurance that the cost system, as an integral part of the system of internal control, provides proper accounting control over costs incurred and related inventories.
   3. To ascertain, as a service to management, that the cost system is economical and effectively provides information for reducing or controlling costs and for determining the cost and profitability of products, and other related data necessary for informed managerial decisions.

b. The audit procedures to be applied to determine that cost standards and related variance accounts applicable to materials are acceptable and have not distorted the financial statements would include the following:
   1. Review the system of internal control to estimate the amount of testing necessary.
   2. Test check the arithmetic of the standard cost cards.
   3. Determine that the data on the standard cost cards are reasonably current. Out-of-date standards may result in abnormal variances.
   4. Ascertain the accuracy of the specifications on the standard cost cards by comparison with engineering specifications or other independent sources. Determine that the procedure for establishing standard material yields gives consideration to spoilage, scrap loss and by-products of the process.
   5. Determine that, in establishing standard material prices, consideration was given to the following factors: normal quality, normal quantity,

normal sources, and delivery by normal carrier. The treatment in the accounts of discounts, whether excluded or included in the standard costs, should be investigated for consistency.

6. The accounting system for recording standard costs should be reviewed for reasonableness, and test checks should be applied to determine that the system is functioning effectively. Source documents (vendors' invoices, requisitions, production reports, and other internally generated accounting evidence) should be examined and related to the transactions flowing through the cost system. In this connection reference would be made to the standard cost cards to determine that standard cost data flowing through the accounting system are being accurately compiled.
7. Review the material price variance and material usage variance accounts for over-all reasonableness. The variance accounts should also be reviewed for excessive variations in the month to month charges, and satisfactory explanations should be obtained where necessary.
8. The impact of the variances on the financial statements should be considered. If the variances are of amounts so substantial that placing them in the income statement would distort current operating results and inventory valuations, then consideration should be given to allocating them on a pro rata basis to cost of goods sold and inventories.

Answer 8

1. The procedures for auditing the typed invoices and the source documents would include the following:
   (a) Determine that the Company sales order forms are being used in numerical sequence and account for all numbers.
   (b) Compare the information on customers' purchase orders with the information restated on the sales order forms. Ascertain that customers' account numbers are being properly assigned. Determine that proper approvals of credit are noted on the forms.
   (c) Determine that the Company invoice forms are being used in numerical sequence and account for all numbers.
   (d) Compare the copies of the bills of lading with the related invoices.
   (e) Compare the information on the sales order forms and the typed invoices. Determine from a responsible authority that the billing clerk's list of billing prices is current and correct. Compare the unit prices on the typed invoices with those on the list of billing prices. Test the cross-multiplication and addition of the invoices.
2. The procedures for auditing the punched cards would include the following:
   (a) Obtain the punched cards and related typed invoices for as many batches of cards as deemed appropriate.
   (b) Prepare independent adding machine tapes of the figures on the typed invoices by batches. Compare the totals of the independently prepared tapes with the totals in the client's daily record book of predetermined

batch totals. Scan the figures in the daily record book for reasonableness.

(c) If the punched cards within the batches are not in the same numerical order as the related typed invoices, arrange for the client to have the cards placed in similar numerical order under the CPA's observation.

(d) Request the client to arrange for "print-outs" or "tab runs" of the cards by batches. The CPA should retain control of the cards during the tab-runs and afterward until his audit procedures are completed.

(e) Compare the data in the "print-outs" for the individual invoices with the related typed invoices.

(f) Foot the "print-outs" by batches and compare the totals of the invoice figures with the tapes independently prepared in procedure 2(b).

COMMERCIAL LAW

November 5, 1965; 8:30 a.m. to 12 m.

Answer 1

1. True
2. False
3. False
4. False
5. True
6. False
7. True
8. True
9. True
10. True
11. True
12. False
13. True
14. False
15. False
16. False
17. False
18. True
19. False
20. True
21. False
22. False
23. True
24. True
25. True
26. True
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31. False
32. True
33. False
34. False
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36. False
37. True
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39. True
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41. False
42. True
43. True
44. False
45. True
46. True
47. False
48. True
49. True
50. False
51. False
52. False
53. False
54. True
55. True
56. True
57. False
58. True
59. False
60. True

Answer 2

61. False
62. True
63. False
64. False
65. False
66. True
67. False
68. False
69. False
70. True
71. False
72. True
73. False
74. True
75. True
76. False
77. True
78. False
79. False
80. True
81. True
82. False
83. False
84. False
85. False
86. True
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93. False
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95. False
96. True
97. True
98. False
99. True
100. True
101. True
102. False
103. True
104. True
105. True
106. False
107. True
108. True
109. True
110. False
111. False
112. True
113. False
114. False
115. True
116. True
117. False
118. True
119. True
120. True

Answer 3

121. True
122. True
123. False
124. False
125. False
126. True
127. False
128. True
129. False
130. False
131. False
132. False
133. False
134. False
135. True
136. True
137. False
138. True
139. False
140. False
141. True
142. True
143. False
144. True
145. True
146. True
147. True
148. False
149. False
150. True
151. True
152. True
153. False
154. True
155. False
156. True
157. False
158. False
159. True
160. True
161. True
162. False
163. False
164. False
165. True
166. True
167. False
168. False
169. True
170. True
171. True
172. True
173. False
174. False
175. True
176. False
177. False
178. True
179. False
180. True

Answer 4

a. No. The Statute of Frauds requires that certain kinds of contracts be evidenced by a writing and signed by the party to be charged before an action can be brought on them. A contract for the sale of land is one such kind and must be evidenced by a signed writing in order to be enforceable. However, the doctrine of part performance is applicable to oral contracts for the sale of realty and results in an enforceable contract if the purchaser with the consent of the seller (1) took possession of the land, (2) made valuable improvements, and (3) paid a part of the purchase price. Here, the contract for the sale of the land comes within the Statute of Frauds and the lack of the requisite writing makes the agreement unenforceable. The doctrine of part performance is not applicable because Black merely paid a part of the purchase price and did not, in addition, take possession and make valuable improvements.

b. 1. Yes. The Statute of Frauds requires a signed writing. The required writing need not be made at the time the agreement is entered into but may be made at any time up to the time suit is filed. Here, the signed letter sent by Stone to Black on February 10, 1965 is a sufficient writing to satisfy the Statute because it set forth all material facts in connection with their oral agreement and was signed by the party sought to be charged.

2. Yes. The agreements being enforceable, a suit for specific performance will succeed because as a general rule the courts will decree specific performance of a contract to sell and convey land. The rationale is that since no two tracts of land are alike, a money judgment is not a fair substitute for the land for which the parties bargained. Therefore, a money judgment is not an adequate remedy whereas specific performance is.

c. No. Mutual mistake, which results in a void contract, applies only to those situations where the contracting parties believe or act under the mistaken belief that a material present or past fact exists when it does not, or that it does not exist when it does. If a person offers his property for sale at a price voluntarily determined by him and after he has sold the property discovers that it is more valuable than he or the buyer knew, the court will not set aside the sale on the ground of mutual mistake. This is not a mutual mistake of fact which voids the agreement; this is merely a mutual mistake or ignorance of the value of the property. Here, Stone and Black agreed to the sale and purchase of the apple orchard for $10,000. There is no indication of fraud, and there was a real agreement. Therefore, Stone will not succeed.

Answer 5

a. 1. No. The principal's revocation of the agent's authority effectively terminates such authority. However, in order to protect himself against liability for the future acts of his former agent, the principal must give notice to certain third persons of the termination of the agency. Where, as here, a third person (Richard) has previously dealt with the principal (Corporation) through its duly authorized agent, the Corporation must give him actual notice of the termination of Amos' agency. Since the facts do not indicate that Richard received actual notice from the Corporation, or otherwise, and since the published notice did not, in fact, come to his attention, he had no reason to suspect that the agency relationship between the Corporation and Amos had been terminated and was justified in paying his account to Amos. He thereby discharged his liability to the Corporation.

2. Yes. The authority of Amos had been terminated upon his discharge, which occurred before his dealings with Charles. While a principal is not required to give actual notice of termination of the agency to persons with whom neither he nor his agent has ever dealt, public notice is necessary as to those persons who have nevertheless knowledge of the agency. Here, the facts indicate that the Corporation satisfied its duty to give constructive notice of the agency's termination, which was effective notice as to Charles regardless of whether or not it came to his attention.

b. 1. An undisclosed principal, as well as his agent, may maintain an action on the contract against the third person. On the other hand, the third person has the right to enforce the contract against the principal upon disclosure of his identity or, if he so elects, hold the agent liable on the contract since he dealt with the agent relying upon his credit.

2. Defenses exclusively available to an undisclosed principal when sued upon the contract by the third party are
   a. That the contract was under seal;
   b. That the action is based upon a negotiable instrument which is not signed by or on behalf of the principal;
   c. That the third party had elected to hold the agent to the contract; and
   d. That before discovery by the third party of the existence of the undis-

closed principal, the principal had made a settlement of his accounts with the agent.

e. Performance by the agent.

Answer 6

a. Negotiable under both the Uniform Negotiable Instruments Act and the Uniform Commercial Code.

A promise or order otherwise unconditional is not made conditional by the fact that the instrument indicates a particular account to be debited or any other fund or source from which reimbursement is expected. The order to pay is unconditional and unqualified and the entire credit of the drawer supports it.

b. Nonnegotiable under the Uniform Negotiable Instruments Act; negotiable under the Uniform Commercial Code.

Under the Uniform Negotiable Instruments Act a promise to pay out of a particular fund is not unconditional. Here, the promise is to pay out of the particular fund that constitutes the "entire assets" of the maker partnership and not allow for the individual personal liability of the partners who make up the firm.

Under the Uniform Commercial Code an instrument otherwise negotiable is not made nonnegotiable even though payment is limited to the entire assets of a partnership by which the instrument is issued.

c. Negotiable under the Uniform Negotiable Instruments Act; nonnegotiable under the Uniform Commercial Code.

The Uniform Negotiable Instruments Act provides that the negotiable character of an otherwise negotiable instrument is not affected by a provision which gives the holder an election to require something to be done in lieu of payment of money. The promise or order insofar as the maker or drawer is concerned is still a promise or order that money be paid; the maker or drawer does not have it within his power to make the election. Hence, it retains its necessary basic characteristic of being paid in the medium of money.

The Uniform Commercial Code omits this provision contained in the Uniform Negotiable Instruments Act and its provision dealing with the form of negotiable instruments states that the instrument cannot contain any other promise or order except as authorized by the Code. Thus, the maker or drawer cannot authorize the holder to do more than collect money on the instrument.

d. Negotiable under the Uniform Negotiable Instruments Act; nonnegotiable under the Uniform Commercial Code.

The Uniform Negotiable Instruments Act requires that an instrument must be payable at a fixed or determinable future time. Hence, "five days after the death of the maker" is payable at a determinable future time, since death is certain, although the date is not.

The Uniform Commercial Code reverses this rule of the Uniform Negotiable Instruments Act with respect to instruments payable after events certain

to happen but uncertain as to time because it substitutes the words "definite time" for the Uniform Negotiable Instruments Act's fixed or determinable future time." The time of payment is definite if it can be determined from the face of the instrument. This cannot be done here.

Answer 7

a. 1. The following kinds of contracts are covered by the Statute of Frauds:
   (a) An agreement which, by its terms, cannot be performed within one year from the making thereof.
   (b) An agreement to sell or a sale of any interest in real property.
   (c) An agreement with respect to the sale of personal property above a specified minimum dollar amount.
   (d) A promise to answer for the debt or default of another.
   (e) A promise by the executor or administrator of a decedent's estate to pay a claim against the estate from his personal funds.
   (f) A promise (other than ordinary mutual promises to marry) made in consideration of marriage.

2. The Statute of Frauds, in order to reduce the evil of perjured testimony which might otherwise be introduced to prove or disprove certain oral agreements, requires that certain contracts be evidenced by a note or memorandum in writing.

3. A contract that is within the purview of the Statute but that has not been evidenced by the required writing will not be enforced by the courts.

4. No. The only question that arises under the Statute of Frauds is whether the contract could have been performed within one year after it was made. By the terms of the agreement performance could have been completed (the contract could have been terminated) within one year. Therefore the absence of a writing would not have prevented the enforcement of the contract.

b. No. Laurel does not have a cause of action in contract because no contract exists. The Corporation's offer stated that Laurel's compensation, a vital part of an employment contract, was to include "a large percentage of the net income before income taxes." This type of offer is considered too indefinite, vague and incomplete to allow for acceptance thereof and the formation of a contractual obligation.

c. Yes. Laurel has a cause of action in quasi contract. Even though the promise was indefinite, vague and incomplete, there has been complete or partial performance by the promisee and the promisor has benefited therefrom; a quasi-contractual obligation is imposed upon the promisor to pay a fair amount for the benefits received.

d. The CPA should advise his client that the determination of whether a liability to Laurel exists is basically a legal question which would have to be

answered by legal authorities. The CPA can only inform his client of the facts that he has ascertained.

The CPA might recommend to his client that he advise the stockholders with whom he is negotiating of his awareness of the impasse and that negotiations could not be completed until the matter is settled. The stockholders may then take the necessary steps to reach an agreement with the claimant or to obtain a legal determination of the validity of the claim.

Answer 8

a. 1. Fungible goods are goods of a homogeneous nature or goods of which any unit is the equivalent of any other unit or is treated as such by mercantile usage. Such goods are sold by weight or measure.
   2. Bulk transfers are transfers made by a merchant of all or the major portion of his inventory outside of the usual and ordinary course of business.
   3. A sale is the transfer of title to goods by the seller to the buyer for a consideration known as the price.
   4. A bailment is a legal relation created by the transfer of possession of personal property without transfer of title by one person (bailor) to another person (bailee), to accomplish a certain purpose.

b. Bell is the owner of an undivided 1/30th interest in the mass; Zeal has an interest in the remaining 1/30th interest in the mass which at the time of the levy was owned by Oiler.

The soy bean oil constitutes fungible goods because each gallon of oil is the equivalent of every other like unit. Upon delivery of the 10,000 gallons of oil to the Oil Tank & Storage Co., Oiler became an owner in common with the other depositors of oil. Oiler had an undivided 1/15th interest in the mass. Where the subject matter of a contract of sale is the undivided portion of a mass of fungible goods, a property interest may pass to the buyer without a separation of the portion from the mass. Therefore, upon the sale to Bell, he became owner of an individual 1/30th interest in the mass and has all of the rights that go with ownership. Zeal's interest attaches only to that 1/30th interest in the oil that at the time of the levy was owned by Oiler.

c. Will is entitled to the typewriter. The transaction between Will and Arthur was not a sale but was merely a bailment with at most a privilege of purchasing at the price named, which Arthur could exercise or not at his option. The bailment did not pass ownership of the typewriter to Arthur, and Curt could not acquire from Arthur any right to the typewriter as against Will. No facts are indicated which would give rise to an estoppel against Will. The situation is not one where the owner of the typewriter (Will) is precluded by his conduct from denying the seller's (Arthur) authority to sell. Nor is it the situation under the Uniform Commercial Code where any entrusting of possession of goods to a merchant who deals in goods of that kind gives him power to transfer all rights of the entruster to a buyer in the ordinary course of business.

THEORY OF ACCOUNTS

November 5, 1965; 1:30 p.m. to 5 p.m.

Answer 1

1. D	6. A	11. A	16. A
2. A	7. D	12. C	17. B
3. D	8. B	13. C	18. C
4. C	9. C	14. A	19. B
5. B	10. B	15. D	20. D

Answer 2

a. Accounting for depreciation is a system of accounting to distribute the cost (or other book value) of tangible capital assets, less salvage, over their useful lives in a systematic and rational manner. Under generally accepted accounting principles as presently understood, depreciation accounting is a process of allocation, not of valuation, through which the productive effort (cost) to be matched with productive accomplishment (revenue) for the period is measured. Depreciation accounting, therefore, is concerned with the timing of the expiration of the cost of tangible fixed assets.

b. The proposed depreciation method is, of course, systematic. Whether it is rational in terms of cost allocation depends on the facts of the case. It produces an increasing depreciation charge, which is usually not justifiable in terms of the benefit from the use of the asset because manufacturers typically prefer to use their new equipment as much as possible and their old equipment only as needed to meet production quotas during periods of peak demand. As a general rule, then, the benefit declines with age. Assuming that the actual operations (including equipment usage) of each year are identical, maintenance and repair costs are likely to be higher in the later years of usage than in the earlier years. Hence the proposed method would couple light depreciation and repair charges in the early years, while it would couple heavy depreciation and repair charges in the later years. Reported net income in the early years would be much higher than reported net income in the later years of asset life, an unreasonable and undesirable variation during periods of identical operation.

On the other hand, if the expected level of operations (including equipment usage) in early years of asset life is expected to be low as compared to that of later years because of slack demand or production policies, the pattern of the depreciation charges of the proposed method approximately parallels expected benefits (and revenues) and hence is reasonable. Although the units-of-production depreciation method is the usual selection to fit this case, the proposed method also conforms to generally accepted accounting principles in this case.

c. 1. Depreciation charges neither recover nor create funds. Revenue-producing activities are the sources of funds from operations: if revenues exceed out-of-pocket costs during a fiscal period, funds are available to cover other than out-of-pocket costs; if revenues do not exceed out-of-pocket costs, no funds are made available no matter how much, or little, depreciation is charged.

2. Depreciation may affect funds in two ways. First, depreciation charges affect reported income and hence may affect managerial decisions such as those regarding pricing, product selection, and dividends. For example, the proposed method would result initially in higher reported income than would the straight-line method; consequently, shareholders might demand higher dividends in the earlier years than they would otherwise expect. The straight-line method, by causing a lower reported income during the early years of asset life and thereby reducing the amount of possible dividends in early years as compared with the proposed method, could encourage earlier reinvestments in other profit-earning assets in order to meet increasing demand.

Second, depreciation charges affect reported taxable income and hence affect directly the amount of income taxes payable in the year of deduction.

Using the proposed method for tax purposes would reduce the total tax bill over the life of the assets (1) if the tax rates were increased in future years or (2) if the business were doing poorly now but were to do significantly better in the future. The first condition is political and speculative, but the second condition may be applicable to Superior Manufacturing Company in view of its recent origin and its rapid expansion program. Consequently, more funds might be available for reinvestment in fixed assets in years of larger deductions if the business is always profitable. If Superior is not profitable now, it would not benefit from higher deductions now and should consider an increasing charge method for tax purposes, such as the one proposed. If Superior is quite profitable now, the president should reconsider his proposal because it will delay the availability of tax-paid dollars. This decision should not affect the decision to use a depreciation method for stockholder reporting that is systematic and rational in terms of cost allocation under generally accepted accounting principles as presently understood.

Answer 3

a. The propriety of choosing one method or the other depends primarily on the degree of completion of the installment transaction at the time the sale is recorded and the objectivity of its measurement. No sound theoretical reason apparently exists for the use of the installment method for financial statement purposes in the case of completed transactions in which collection is dependent merely upon a lapse of time. The recognition of revenue in the period of the sale is accrual-basis accounting, whereas revenue recognition on the installment method is a hybrid of the accrual and cash bases which was developed and used primarily because of federal income tax provisions.

Recognition in the period of sale is more appropriate (and, hence, recognition on the installment method may be less appropriate) in the following circumstances:

1. When the seller is not obligated to perform any service in connection with the sale after the date it is recorded. In such cases the costs and expenses associated with the sale are known and can be matched in the same period with the revenue from the sale.

2. When the granting of credit to buyers is reasonable and not excessive. In such cases the expectation of future collection is reasonable.

3. When gross margin cannot be determined at the end of the fiscal period with reasonable accuracy. The gross margin percentage must be known if the installment method is to be used properly.

4. When the amount of net revenue is determinable (e.g., cases in which the price is not subject to further bargaining or revision and in which sales return and allowances in subsequent periods are negligible or can be estimated). In such cases the collection of the revenue is dependent merely upon a lapse of time.

5. When installment sales cannot be separated from other sales and when cash collected on accounts of the current period cannot be separated from cash collected on accounts of preceding periods. Separation is a necessary requirement of the installment method.

b. Installment contracts receivable which conform generally to normal trade practices and terms should be classified as current assets under both methods of revenue recognition. Current assets are amounts collectible within the next accounting year or operating cycle (the average time between the acquisition of materials or services which will affect the cost of goods sold and their cash realization), whichever is longer.

A parenthetic statement of annual maturity dates and amounts falling between them is recommended for full disclosure.

c. Classifying "deferred gross profit" as a deferred credit is the traditional treatment, but its support is diminishing with the decline in the use of the deferred credit caption and with the growing view that the credit side of the balance sheet should be reserved exclusively for equities (stockholders' and creditors'). The installment sales method is a hybrid application of the cash basis of revenue recognition. If a business uses it for financial reporting purposes, the records of such sales, including the deferred gross profit, are essentially memorandum in nature, and the method of reporting should be consistent with their

nature. Hence, deferred gross profit should be shown on the balance sheet as a contra or valuation account against installment receivables when the installment method is used for financial and tax reporting purposes. The difference between the amounts of the two accounts is the average unrecovered cost of merchandise; and the amounts of current assets, total assets, and proprietorship are shown unchanged by the (memorandum) recording of the sales transactions.

Answer 4

a. Expected selling prices are important in the application of the lower-of-cost-or-market rule because they are used in measuring losses of utility in inventory that otherwise would not be recognized until the period during which the inventory is sold. Declines in replacement cost generally are assumed to foreshadow declines in selling prices expected in the next period and hence in the revenue expected upon the sale of the inventory during the next period. However, the use of current replacement cost as "market" is limited to those situations in which it falls between (1) net realizable value (the "ceiling") and (2) net realizable value less a "normal" profit (the "floor"), both of which depend upon the selling prices expected in the next period for their computation.

b.

Paris Company
SCHEDULE FOR DETERMINING UNIT VALUE
December 31, 1964

	Market						
Product	*Cost to Replace*	*Floor**	*Ceiling***	*Market*	*Original Cost*	*Lower of Cost or Market*	*Unit Value*
A	$42.00	$41.00	$65.00	$42.00	$35.00	$35.00	$35.00
B	45.00	46.00	74.50	46.00	47.50	46.00	46.00/47.50
C	15.00	16.00	25.00	16.00	17.50	16.00	16.00
D	46.00	44.00	74.00	46.00	45.00	45.00	45.00

*Floor = (70% × expected selling price) — estimated cost to dispose.
**Ceiling =expected selling price — estimated cost to dispose.

c. The expected selling price of Product A is $10.00 more than the "normal" selling price and therefore supports the fact that "market" exceeds cost. Since a loss of utility is not in question, $35.00 (original cost) should be used in valuing the Product A inventory.

The expected selling price of Product B is the same as the "normal" selling price, and hence a loss of utility from a downward change in the selling price is not foreseen in the near future even though "market" is less than original cost. Falling production costs with rising demand or lack of competition might be responsible for this condition. However, the fact that the "floor" of Product B is $1.50 below original cost does indicate the units were acquired or manufactured at a price which will not allow the Company to earn its usual 30% normal profit margin in the next period unless a loss

of utility is recognized in the current period. Product B inventory would be valued at $47.50 per unit (original cost) by accounting authorities who believe that a loss of utility should not be recognized until the expected selling price actually falls as a result of a decline in potential salability at the "normal" selling price; it would be valued at $46.00 per unit ("market") by other accounting authorities who believe that losses of utility should include opportunity losses.

The expected selling price of Product C is lower than the "normal" selling price, a fact which supports the use of "market" instead of cost for valuing the Product C inventory. However, $16.00 (the "floor") should be used rather than $15.00 (current cost to replace) in order to avoid understating the current period's income and overstating the next period's income.

The expected selling price of Product D is $10.00 more than the "normal" selling price, which supports the fact that "market" exceeds cost. Since a loss of utility is not in question, $45.00 (original cost) should be used for valuing the Product D inventory.

Answer 5

a. The feature which differentiates the pay-as-you-go and funded pension plans is the method by which the pension benefits are financed. Organizations using pay-as-you-go plans pay benefits as they come due directly to the retired employees. Organizations using funded plans may arrange for the benefits to be paid from an annuity by an insurance company or from a pension fund administered by a trustee. Contributions for the purchase of the annuity or to the trusteed fund are determined by actuarial computations.

b. Factors which may influence the ultimate cost of a funded pension plan are as follows:
   1. Eligibility of employees.
   2. Retirement age (elective or compulsory) of employees.
   3. Benefits
   4. Vesting arrangements.
   5. Proportions of contributions paid by employer and employees.
   6. Limitations of employer's liability if plan is terminated.
   7. Rate of mortality within the group prior to and after retirement.
   8. Rate of turnover.
   9. Level of future wages paid to employees.
   10. Future returns on investments of accumulated funds.
   11. Trustee's fees or administrative costs.
   12. Flexibility of benefit payment options.
   13. Acceptability of the plan for tax purposes.
   14. Capital gains or losses on securities in the fund.

c. 1. Past-service cost is the cost related to benefits accruing to employees by virtue of their service prior to the inception of the pension plan. Current-service cost is the cost related to benefits accruing to employees by virtue of their service during the current period.
   2. Past-service cost should be charged to expense in equal amounts (including interest) over a reasonable period of time following the inception

of the plan inasmuch as pension plans with past-service credits are adopted because of current and future advantages of doing so. Because past-service credits generally are thought to result directly in a higher employee retention rate and only indirectly (if at all) in drawing better applicants for new jobs, the advantages of adopting this feature of the plan would be most obvious during the remaining service years of employees receiving past-service credits at the inception of the plan. Since the remaining service years cannot be calculated exactly because of attrition, a reasonable period of 10 to 40 years often is suggested. The fact that some of the benefits to employees are measured by service prior to the inception of the plan does not justify a charge to retained earnings or to operations of only the current period: the plan was not in effect during prior periods, and the advantages of adopting the plan are not limited only to the first period after the inception of the plan. To reject the need for recognizing past-service cost on the premise that it need not be funded also is not justified since cost expiration and cost outlay are not synonymous concepts.

Current-service cost is a cost of employment during the current period and should be matched with the revenues of the current period under the assumption that a portion of the revenues resulted from the effort expended by the employees because of the pension plan, even though some of the employees do not have vested rights to pension benefits. Although the form of the pension plan may restrict the legal liability of an employer on a liquidation basis, the going-concern concept emphasizes the need to determine cost under the assumption that the advantages of having a pension plan will enable the employer to attract and retain more employees than the few having vested rights at any one time.

The combined accrual of past- and current-service cost to be charged to operations of the current period should be adjusted for actuarial gains or losses (e.g., the excess or deficiency of actual earnings over estimated earnings in the pension fund) because they are decreases and increases in the actuarial estimate of the present cost of providing pension benefits. Treatment of the gains and losses as financial income or expense would be precluded because they result from transactions of the pension trust and not of the employer. Unless the adjustment results from a nonrecurring event (such as the closing of a plant, the employees of which would no longer be with the employer), the adjustment should be spread over the current and future years because it represents a correction of earlier estimates.

3. The amount of pension cost which has been charged to expense in excess of the amount which has been contributed should be classified as a liability of the employer. Conversely, contributions paid in excess of amounts charged to expense should be deferred. These recommendations are based on the assumption that the costs are calculated and charged to operations according to the recommendations in c(2).

   This position may be defended on the grounds that pension costs, even though measured by employee service in years prior and subsequent to

the inception of the plan, are incurred in expectation of advantages which accrue to the employer after the plan is adopted and, therefore, should appear as a liability only to the extent accrued and not contributed.

Some accountants, however, would show as a liability the unfunded portion of current- and past-service cost without regard to whether the past-service cost had accrued because they believe the costs attach to the service rendered rather than the expectation of future benefits or advantages.

Other accountants take the position that only the amount vested should be shown as a liability and, in some cases, without regard to whether the past-service cost has accrued. This position has for its foundation the liquidation basis and, in the cases where past-service cost is not allowed to accrue, the belief that costs attach to service rendered rather than to the expectation of future benefits or advantages.

Most accountants agree upon the importance of disclosure. The important features (and amendments of features) of the plan—such as the method of funding the plan, the estimated annual charge to operations and the basis on which the annual charge is determined—should be disclosed in the year of adoption and in the year of any significant amendment. Although disclosure cannot correct an inadequate treatment of pension costs, omissions of past-service or current-service costs of material amount should be disclosed as long as the omissions remain.

Answer 6

a. 1. An estimated liability is a known liability, uncertain only in amount, or one which is so likely to occur that only its amount is uncertain. A contingent liability, on the other hand, is a potential liability arising from past events and for which legal indebtedness is contingent upon a future event. Therefore, the distinction between an estimated liability and a contingent liability is the certainty of the existence of a legal debt, not of the amount.

2. Losses occasionally result from asset-destroying catastrophes, events which are regarded as general risk contingencies because their occurrence in any one organization cannot be predicted. These losses are called contingent losses prior to the catastrophe and may or may not be accompanied by liabilities when it occurs. A contingent loss is an anticipated loss from a future event which is neither more nor less probable because of a past event, whereas a contingent liability is an anticipated liability from a future event which is more probable because of a past event. Therefore, the distinction between a contingent liability and a contingent loss is the change in the risk of the future event.

Another distinction, more obvious but less conclusive, is in the expected result of the future event when it occurs. If the event is expected to result in a direct reduction of a company's assets, a contingent loss usually is involved; if the event is expected to result in an obligation to a third party, a contingent liability usually is involved.

b. 1. Self-insurance provisions are treated properly as estimated liabilities when an event has established the existence of a legal debt, only the amount of which is unknown. An example of self-insurance properly treated as an estimated liability is an unpaid workman's compensation claim for injuries sustained in an accident which has already occurred.

2. Self-insurance provisions are properly treated as contingent liabilities when the existence of the legal debt is uncertain. An example of self-insurance properly treated as a contingent liability is a possible claim for alleged damage to adjacent property caused by intermittent blasting done over a two-year period of road construction.

3. Self-insurance provisions are properly treated as contingent losses when the anticipated loss results from a general risk contingency, an event which is neither more nor less probable because of a past event. An example of self-insurance properly treated as a contingent loss is a loss which would result from catastrophes against which businesses often wish to protect themselves, such as fires, hurricanes, floods, and explosions.

c. 1. This treatment of the self-insurance provision for possible fire losses is not sound. A self-insurer absorbs fire losses as they occur under the assumption that the losses will average less than the premiums the firm would have to pay to shift the risk of fire to an outsider. Since fire is a general risk contingency which is neither more nor less likely to occur in a single firm because of a previous fire, future fire losses (and possible liabilities, if any) in one firm cannot be estimated actuarially. Therefore, the future losses in one firm cannot be estimated reasonably and cannot be related to operations of the current period. If estimates of losses are not reasonable and cannot be related to operations of the current period, the annual accrual by Risky Corporation is not warranted, even if done in lieu of payment of a premium to an outsider.

The Reserve for Self-Insurance Against Fire is therefore neither a liability nor a deferred credit; since it is applicable to contingent losses, it is in substance a reservation of retained earnings. Since such a reservation should be created by charges to retained earnings rather than to operations, the reservation has been created improperly.

2. A provision for self-insurance against fire losses should be treated as a contingent loss since fire is a general risk contingency. Accordingly, the preferable treatment is to appropriate retained earnings in an amount adequate to restrict the payment of dividends from past earnings calculated without regard to accruals of estimated losses which might result from a possible fire. Fire losses, however, should not be charged to the appropriation, and no part of the appropriation should affect the calculation of net income in any year. If the firm decides to acquire insurance to protect itself from fire losses, the appropriation should be restored to retained earnings directly. The appropriation should be classified as a part of stockholders' equity on the balance sheet.

The effect of this recommendation is to show that the firm intends to

absorb losses as they occur, which is the intent of Risky Corporation if it does not acquire insurance.

Answer 7

a. 1. Equivalent production is the amount of manufacturing done in a cost period. It is the number of units representing the amount of manufacturing needed to complete the initial in-process inventory; to start and complete the units begun and finished in the current cost period; and to bring the final in-process inventory to its actual degree of completion at the end of the current cost period. Equivalent production is computed as follows:

$$\text{E.P.} = \begin{matrix}\text{number of}\\ \text{completed}\\ \text{units}\\ \text{transferred}\end{matrix} + \begin{pmatrix}\text{number of}\\ \text{units in final}\\ \text{in-process}\\ \text{inventory}\end{pmatrix} \times \begin{pmatrix}\text{percentage}\\ \text{of}\\ \text{completion}\end{pmatrix} - \begin{pmatrix}\text{number of}\\ \text{units in initial}\\ \text{in-process}\\ \text{inventory}\end{pmatrix} \times \begin{pmatrix}\text{percentage}\\ \text{of}\\ \text{completion}\end{pmatrix}$$

2. Equivalent production is used in computing per unit costs for inventory valuation so that the productive work done to in-process inventories as well as the cost of the work will be included in the results of the computation. If only units completed were divided into total production costs for the period, the productive effort (cost) to manufacture the in-process inventories would be reflected in the numerator, but the productive accomplishment (the equivalent number of units manufactured) would not be reflected in the denominator. In order to obtain a valid measure of product cost when in-process inventories vary in cost and/or number of units or in percentage of completion, the denominator as well as the numerator must reflect the manufacturing work done on in-process inventories during the current period.

b. 1. (a) Inherent limitations in the process itself.
(b) Substandard materials or inputs.
(c) Careless workmanship.
(d) Poor supervisory planning and scheduling.
(e) Inadequate management, including lack of adequate records on which to base its production decisions.

2. "Normal" spoilage is substandard output inherently (uncontrollably) produced by the process under efficient operating conditions. "Abnormal" spoilage is substandard output which is unnecessary because the conditions resulting in the spoilage are controllable. Within the limits set by the state of the art of production the difference is a short-run distinction since in the long run management controls the purchase of all factors of productions (including production equipment, efficient or inefficient).

3. The most appropriate accounting treatment for "abnormal" spoilage is to

write it off as an operating loss because it is an expiration of cost from which no future benefit can be expected.

e. Ignoring unavoidably spoiled units in the computation of equivalent production spreads the cost of spoiled units to good units. Since management views unavoidable spoilage as an uncontrollable and hence acceptable by-product of producing good units, the higher cost of the good units appears justifiable when used for product costing purposes. However, ignoring unavoidably spoiled units may distort per unit product costs if the cost, number of units, or percentage of completion of the in-process inventories vary from period to period or if the identification of spoiled units occurs at any point other than at the beginning of the process in a department. This practice will not distort per unit product costs materially if the spoiled units are ignored and the in-process inventory can be reduced to the number of good units that will actually remain after inspection.

1. In factories with in-process inventories where spoilage is discovered at the end of the manufacturing process, however, spreading the costs of unavoidable spoilage over equivalent production understates the cost of completed units and overstates the cost of the final in-process inventory. The productive effort (cost) invested in the spoiled units should be spread over the number of good units which have passed inspection (completed units in this case) instead of equivalent production (which includes the in-process units that have not been inspected). Instead of ignoring unavoidably spoiled units in the computation of equivalent production (i.e., weighting them by zero), the factory should weight the unavoidably spoiled units by one in the computation of equivalent production. The effect will be to charge the known spoilage costs to completed units of output and not to the final in-process inventory which has not been inspected.
2. In factories with in-process inventories where spoilage (substandard material, for example) is discovered at the beginning of the manufacturing process, ignoring unavoidably spoiled units in the computation of equivalent production will spread the costs of such units properly to all good units which have passed the inspection, including those in the final in-process inventory.
3. In factories with in-process inventories where spoilage is discovered as it occurs in the manufacturing process, ignoring unavoidably spoiled units in the computation of equivalent production understates the cost of completed units and overstates the cost of final in-process inventory, some of which may be spoiled before it is completed. The spoiled units should be weighted by the percentage of completion instead of by zero; however, this refinement is not useful if the cost of the spoiled units is included in burden to be allocated over equivalent production, the computation of which ignores unavoidably spoiled units. To compute spoilage losses on the assumption that they occur during operations and then to allocate them on a basis that assumes the units were spoiled at the beginning of the process is not consistent.

INDEX

Absorption cost method
  Net income computed by 286
Accelerated depreciation
  See Depreciation
Accountants' fees
  Incomplete job 233
  Unsecured interest-bearing notes in payment 161
Accountants' liability
  Constructive fraud and negligence, compare 81
  In not discovering fraud 37
  Negligence 37
  Sources of guidance for CPA respecting 175
  Third party beneficiary 175
  To clients 234
  To third parties as to skill and care in engagement 234
  To third parties for negligence 129, 175
Accountants' responsibilities
  Disclosure of valuation basis of assets in statements "prepared without audit" and in typical examination 274
Accounting departments
  Functions 27
  Internal control 27
Accounting methods
  Cash basis 91
  Change in, prepare journal entries to record 105
  Vacation pay, change from cash to accrual basis, effect on financial statements 44
Accounting postulates
  Development and benefits 45
Accounting practice
  Client's employees, deportment 218
  New engagement, ethical problems 72
  Sale of, covenant not to compete 35
Accounting principles
  Consistency 23
  Development and benefits 45
  Generally accepted, change from one principle to another, disclosure 116
  Generally accepted, prepare income statement applying 93
Accounts receivable
  Audit program 22
  Statistical sampling 225
Accumulated earnings tax 9
Adam corporation 206
Adams, Baker and Crane 9
Additions
  Accounting treatment, define and discuss 89
Adverse opinion
  See Opinion
Advertising
  Rule against 25
Agency
  See also Principal and agent
  Law 127
Aging method
  Bad debts 178
Alba nursing home 273
Allowance method
  Accounting for bad debts 178
Annuities
  Taxable amount 9
Apartment house
  Sale of, adjusting journal entries to record 200
Ash corporation 216
Assets
  Fixed, as gift to corporation, accounting justification for recording on books 39
  Fixed, as gift to corporation, depreciation and depletion 40
  Fixed, current fair value 239
  Fixed, items included as part of acquisition cost 89
  Fixed, maintaining plant ledger as internal control procedure 271
  Fixed, items included in 38
  Intangible, written off against contributed capital 38
Assignment for benefit of creditors
  Common law or nonstatutory, requirements 227
  Requirements 33
Assignment of right 126
Audit program
  Trade accounts receivable, prepare in detail 22
Audit testing
  Statistical sampling techniques, advantages of application 30
  Statistical sampling techniques, professional judgment in applying, discuss 30

Auditing standards
Generally accepted, examination made in accordance with, implication 116
Generally accepted, for field work 28, 116
"Auditors' certificate"
Misnomer 28
Auditors' report
Date on 116
Deficiencies, list and discuss 119
Inventory report of outside specialists, effect upon type of 272
Azure company 145
Bad debts
Accounting for, allowance method contrasted with direct write-off method 178
Aging method 178
Percentage of sales method 178
Tax aspects 190
Bailment
Creation of relationship 228
Define 285
Examples 228
Mutual benefit, legal relationship between principals 36
Problem 285
Balance sheets
Comparative, factors contributing to misinterpretation 133
Consolidated, consolidation accounted for as pooling of interests, worksheet 55, 264
Bankruptcy
Debts proved and allowed against estate 33, 227
Discharge 33
Duties of bankrupt 33
Federal bankruptcy act 227
Fraudulent transfers and conveyances 33
Involuntary, persons or entities petitioned into 33
Involuntary petition 227
Involuntary petition, who must file 33
Law 227
Offenses, commission of 227
Partner's, priority of claimants as to personal property 34
Preference in 33
Priority 33, 227
Provable debts not discharged by 33, 227
Referee 227
Solvency 227
Trustee 33, 227
Bard corporation 92
Base stock method
See Inventories
Beneficiary trusts
See Trusts
Betterments
Define and discuss accounting treatment 89
Big company 55
Billings
Accounting 220
Internal control weaknesses 220
Bills of exchange
Negotiability in certain circumstances 283
Bisto corporation 261
Blood banks
Pints sold and withdrawn, schedule computing number 47
Taking and processing blood, accrual basis statement of total expense 47
Taking and processing blood, expense per pint, schedule computing 47
Board of directors
See Directors
Boller manufacturing company 167
Bond sinking funds
Methods of classifying on balance sheet 137
Bonds
Face and market value 184
Fidelity, purpose of including in internal control system 270
Payable, conversion to common stock 38
Book value
Accounting policies and methods in evaluation 40
Current fair value and, difference 239
Define 40
Ownership equities, computation 40
Branches
Home office and branch, prepare columnar worksheet 145
Income statement 145
Inventories 145
Branden company 27
Breach of contract
See Contracts
Breakeven chart
Components 187
Relevant range 187
Breakeven point
Sales, for subsidiary, computation 208
Budgets
Capital expenditure, purposes of including in system of internal control 270
Fixed and variable, difference 286
Bulk transfers
Define 285
Business gifts
As business expense 142
By-products
Crediting cost of production 235
Value, at point of separation 235

Cap sales company 65
Capital
  Contributed and earned, distinction 181
  Contributed in excess of par value, computation 93
  Contributions to, interest due partner 130
  Legal 171
Capital expenditures
  Budgeting, purposes of including in system of internal control 270
  Revenue and, criteria for classifying 131
  Revenue and, distinguish between 131
  Revenue and, impact on statements if improperly classified 131
Capital gains and losses
  Gain on sale of apartment house, installment sale method, computation 200
  Tax aspects 190
Capital stock
  See Stock
Capitalization of earnings
  Method of estimating current fair value, describe 239
Cash
  Increase in, statement accounting for 50
Cash dividends
  See Dividends
Cash flow
  Annual, under purchase and rental plans, schedule showing 158
  Define from accounting viewpoint 133
  Net present values under purchase and rental plans, schedule comparing 158
Cash forecast
  Prepare 147
Cash surrender value
  Life insurance policies on corporate executives, treatment on balance sheet 83
Charge and discharge statement, prepare 255
Charitable contributions
  Control over monies received by solicitors 68
  Donated stock 9
  Limitation of corporation's deduction 9
  Tax aspects 9, 190, 245
Charitable trusts
  See Trusts
Checks 77
Child care deductions 9
Claren corporation 218
Classification
  Defects regarding, in financial statements 176
Clients
  Deportment of client's staff 218
Coinsurance
  See Insurance
Colesar corporation 176
Collective bargaining
  Fairness in the bargaining process 172
Comity loan company 105
Common law artisan's lien
  Elements 172
  Right of lien claimant 172
Common stock
  See Stock
Competition
  Sale of Accounting practice 35
Competitive bidding
  Arguments against 26
  Government audits 26
Composition agreements 33
Conflict of interests
  CPA as officer of company he audits 161
Connau corporation 57
Conol sales company 95
Consideration 172
Consistency
  First audits 23
  Recognition in CPA's report of changes affecting comparability of financial statements 116
  Requirements of standard of reporting 83
  Statement on, in opinion 23
Consolidated financial statements
  See Financial statements
Contractors
  Federal income tax provision and liability, schedule showing computation 51
  Independent, injuries sustained by, workmen's compensation benefits 172
Contracts
  Applicability of Statute of frauds, basic requirement 284
  Avoidance on grounds of mental incompetence 280
  Between adult and minor 280
  Bilateral, acceptance of offer to enter into 172
  Breach of, confirmation of oral agreement 281
  Breach of, disability preventing performance 233
  Breach of, minor's liability 229
  Breach of, non-adherence to contract terms 79
  Breach of, oral agreement 281
  Breach of, unilateral mistake 79
  Completed-contract method 38
  Discharge from obligation 126
  Fraud as basis for rescission 280
  Illegal 280
  Illegal partnership 78

In process, computation of estimated direct costs 51
In process, computation of revenue 51
In restraint of trade 280
Law 126, 172, 280
Mutual mistake 282
Negligence, liability of minor 229
Percentage-of-completion, schedule showing computation 51
Promissory estoppel 79
Specific performance in enforceable agreement, suit for 281
Specific performance 172
Statute of frauds applicability to various contracts 35, 284
Substantial performance doctrine, requisites for recovery under 35
Substantial performance doctrine 126, 172
Third party creditor beneficiary 280
Third-party donee beneficiary 126
Unilateral, promise to pay not evidenced by writing 229
Unilateral 126
Within Statute of frauds 126

Contracts, Government
Amount receivable from government for material delivered, computation of estimated total 267
Fixed-price-incentive, schedule computing estimated total adjusted price 266
Work-in-process inventory at estimated cost, computation 267

Contracts implied in law 172

Contributed capital
Earned capital and, distinction between 181
Intangible assets 38

Contributions
See Charitable contributions

Contributions to capital
Interest due partner 130

Copyrights
Define 80
Time period and renewability period 80

Corporate distributions
Taxation 91

Corporations
See also Foreign corporations
Bylaws 77
Charters 171
Creation 77
Defectively formed 171
Directors
See Directors
Dissolution 228
Law 77, 171
Legal entity 171
Partnership agreement with, legal significance 232
Powers 77
Preincorporation contract 77
Preincorporation subscriptions, balance-sheet presentation and legal status 232
President 77
President's salary, disclosure in statements 219
Promoter's organization expenses 232
Promoters 171
Taxable income, computation 57, 94
Termination 77

Cost depletion
See Depletion

Cost of goods manufactured
Schedule computing 149

Cost of goods sold
Gross profit ratio method, computation 170

Cost of production report
Prepare 97

Cost systems
Cost standards and related variance amounts, audit procedures to determine acceptability 277
Review by CPA, purposes of 277

Cost-volume-profit analysis
Increase in selling price to cover wage rise 252

Cottonseed
Average maximum amount to be paid per ton, compute 109

Covenants not to compete
See Competition

Credit
Financial statements for 73
Statements "prepared without audit" 74

Current fair value
Adjusting accounting records to show, propriety of 240
And book value, difference 239

Customer billings and remittances
Internal control 220

Damages
Employee's liability for wrongs committed at direction of employer 80
Employer's duty to indemnify employee 80

Dawn mining company 204

Debtor and creditor
Co-sureties, liability 173
Extension agreement 173
Right of surety, explain 173

Decorator paint co., inc. 248

Defalcations
Audit procedures applied to company records to discover evidence 168

Collusion, audit steps to discover evidence of 168
Effect on auditor's report 169
Effect on financial statements prepared prior to discovery of 169
"Lapping," audit procedures used to uncover 165
"Lapping," define 164
Deferred maintenance
Accounting treatment, discuss 90
Define 90
Dekline corporation 11
Demand certificate of deposit 77
Dependents
Tax aspects 9
Depletion
Cost, describe 38
Depreciation and cost depletion, similarities and differences in accounting treatment 39
Fixed assets donated to corporation, accounting justification for recording on books 40
Percentage, describe 38
Percentage, origin 38
Percentage, under what conditions permitted 38
Deportment
Client's staff 218
Deposit slips
Duplicate, audit procedures to verify detail of deposits 166
Duplicate, reliance on, as accounting evidence 166
Depreciation
Accelerated 83
Accounting for, purpose and nature of 286
Charges, recover or create funds, explain 287
Cost depletion and, similarities and differences in accounting treatment 39
Farm equipment, computation 112
Fixed assets donated to corporation, accounting justification for recording on books 40
Fixed or variable cost 186
Machinery and equipment, adjusting journal entries 74
Replacement method 83
Retirement method 38
Straight-line method, change from 286
Dieck corporation 191
Direct costs
Contracts in process, schedule showing computation 51
Net income computed by direct costing method 286
Direct labor
See Labor
Direct write-off method
Accounting for bad debts 178
Directors
Board of directors meetings 171
Compensation, legal status 232
Compensation, records examined to discover authorization for 232
Disclaimers
See Opinion
Disclosure
Change from one generally accepted accounting principle to another 116
Defects in financial statements 176
Events subsequent to date of statements 116
Outstanding stock rights 240
President's salary 219
Valuation basis of assets, CPA's responsibility for statements "prepared without audit" and for a typical examination 274
Dissolution
Corporation 228
Partnership 34, 281
Partnership, define and give causes for 78
Dividends
Cash, computation, five-year summary 7
Cash, paid to holders of common stock, compute 7
Cash, paid to holders of preferred stock, compute 7
Stock, amount of retained earnings capitalized 85
Stock, define 84
Stock, distinguish from stock split-up 85
Stock, reasons for declaring 85
Dividends received credit 245
Dollar-value lifo
See Inventories
Donated stock
See Stock
Dopern company 196
Druid, City of 15
Du-Rite corporation 149
Earned capital
Contributed capital and, distinguish between 181
Earnings per share
Computation of, five-year summary 7
Education expenses 142
Electric cooperatives
Imprest fund bank account, reconcilement 223

Electronic data processing department
Input controls, characteristics of satisfactory system 224
Plan of organization, characteristics 234
Encumbrances
Define 286
Engagements
Deportment of client's staff 218
New, ethical problems 72
Entity concept 83, 286
Equivalent production
Define 294
Per unit costs for inventory valuation, use in computing 294
Report 196
Errors
Effect on opinion 219
Numerous errors found in the books, steps to be taken by CPA 218
Payroll, action by CPA upon discovery 276
Statistical sampling 226
Estates
Administration expenses, schedule 256
Calculation of accruals constituting estate assets 258
Charge and discharge statement 255
Debts of decedent paid, schedule 256
Distributions of income, schedule 258
Executor's cash account 257
Expenses chargeable to income, schedule 258
Gain on disposal of assets, schedule 256
Holder of life interest estate, duties 80
Income collected, schedule 258
Legacies paid or delivered, schedule 256
Life interest, define 80
Personal exemption deduction 9
Remainder in fee, define 80
Taxation 190
Vested remainder in fee, define 80
Ethics
See Professional conduct
Exchange of stock
See stock
Exemptions
Aged parents, tax aspects 9
Extraordinary repairs
Accounting treatment, discuss 89
Define 89
Farming
Estimated income and expense on cash basis 111
Fidelity bonds
See Bonds
Field work
Generally accepted auditing standards 28, 116
Fifo method of valuing inventories
See Inventories
Finance charges
Unearned portion as current liability 41
Unearned portion as deduction from total contracts receivable 41
Unearned portion as deferred income 41
Finance companies
Change in accounting methods, prepare formal journal entries to record 105
Financial statements
See also under specific type
Auditor's worksheet, journal entries to correct 95
Comparative, limitations of single-year statements overcome by use of 132
Consistency
See Consistency
Consolidated, exclusion of subsidiary from, list conditions 181
Consolidated, treatment of intercompany profits of consolidated inventories 182
Consolidated, use of other CPA's unqualified report of subsidiary 116
Corrected, prepare auditor's worksheet 144
Defects in terminology, disclosure, classification 176
Examination objectives 116
Footnotes, exact wording 216
Footnotes, prepare 167
From inadequate records, prepare 3
Going concern assumption 83
Historical cost 188
Parent and subsidiary, working papers 208
"Prepared without audit" 74
"Prepared without audit" and typical examination, CPA's responsibility to disclose valuation basis of assets 274
"Prepared without audit," CPA's responsibility to disclose method of valuation 273
Price level changes 187, 286
Reports for credit purposes 73
Single-year statements, limitations 132
Unaudited 116
Worksheet for preparation 248
Fire insurance
See Insurance
Fire losses
Friendly and hostile fires 230
Insurable interest of lessor and lessee of building, amount of recovery 175

Loss absorbed by company, computation 49
Lost gross earnings, computation 49
"Firm offers" 172
First audits
Consistency in auditor's opinion 23
Fixed assets
See Assets
Fixed budgets
See Budgets
Fixed costs
Explain 186
Footnotes
See Financial statements
Foreign corporations 171
Foreign exchange
Conversion of trial balance from pesos to dollars, worksheet 191
Frank manufacturing corporation 198
Fraud
See also Defalcations
Accountant's liability in not discovering 37
Accountant's responsibility for detection 116
Constructive and actual, distinguish between 81
Constructive, compare with accountant's liability for negligence 81
Constructive, unqualified opinion without verification of accounts receivable 175
Funds
Bond sinking, methods of classifying on balance sheet 137
Imprest fund bank account, reconcilement 223
Municipal, balance sheet worksheet 211
Municipal, worksheet 99
School, prepare journal entries to record transactions 155
Solicited funds, control over 68
Special assessment, prepare worksheet 15
Fungible goods
Define 285
Garner manufacturing corporation 262
Gelard manufacturing corporation 274
General ledger accounts
Balance at year end, prepare worksheet 32
General medical institute 50
Gercken corporation 158
Gifts
As business expense 142
Glatfelt rural electric power corporation 223
Going concern
Statement of financial position prepared contrary to assumption of 83
Goodwill
Distribution of, in partnership, computation 195
Government audits
Competitive bidding 26
Graphs
Behavior of cost, expense, income or valuation amount 235
Graystone electronics corporation 266
Gross profit method
See Inventories
Gross profit ratios
Computation 170
Cost of goods sold by, computation 170
Gross profits
Change in, analysis accounting 204
Manufacturing costs and, comparative statement 63
Groth corporation 11
Grover manufacturing company 168
Guaranty
Estimated liability for product guaranties, adequacy of balance in account 118
Estimated liability for product guaranties, audit program 117
Hardhyt corporation 107
Hardware wholesalers and retailers
Inadequate accounting records 3
Hartrey contractors corporation 51
Heft company 22
Hillcrest blood bank 47
Hiring practices
Internal control 116
Historical costs
Financial statements, preparation on basis of unadjusted 188
Holder in due course
Personal defenses 174
Holding companies and subsidiaries
Breakeven point in sales, computation 208
Consolidated balance sheet, working papers 264
Consolidated statements, use of other CPA's unqualified report on subsidiary 116
Consolidated working papers, prepare 18, 208
"Cost" or "legal" basis of accounting for investment 38
Subsidiary's exclusion from consolidation statement, list conditions 181
Hopewell mfg. company 72
Implied trusts
See Trusts

In process contracts
See Contracts
Inadequate records
Prepare financial statements 3
Incentive compensation plan
Credit to incentive compensation reserve, computation 153
Incentive base, compute 153
Net earnings in excess of incentive base, schedule computing 153
Income
Accounting concept, explain 86
Corrected, schedule computing 143
Net, computed by absorption cost method 286
Income
Net, computed by direct cost method 286
Net, understated 83
Realization convention, effect on valuation of assets 86
Realization convention, significance to periodic income determination 86
Taxable, corporation's, computation 57
Taxable, installment sales method, schedule computing 154
Taxable, prepare schedule computing 5, 94
Income and retained earnings statement
Finance company, prepare 106
Income statements
Comparative, factors contributing to misinterpretation 133
Generally accepted accounting principles, prepare statement applying 93
Income tax
Corporation's, computation of taxable income 57
Liability for, computation 202, 262
Rental income 9
Sale of gift stock 9
Income tax allocation 83
Independence
CPA as officer of company he audits 161
Meaning 160
Rules of professional conduct relating to 160
Unsecured interest-bearing notes in payment of fee 161
Indirect labor
See Labor
Indorsements
Unqualified 33
Insolvency
In equity sense 33
Installment method
Deferred gross profit for accrual-basis business, balance sheet classification 288
Profit recognition 288
Taxable gain on sale of apartment house, computation 200
Taxable income on, schedule computing 154
Installment sales
Accounting methods of recognizing revenue on 42
Allowance for defaulted contracts account, schedule computing adjustment to 154
Contracts receivable, presentation on balance sheet 288
Finance charges, unearned portion, current liability 41
Finance charges, unearned portion, deduction from total contracts receivable 41
Finance charges, unearned portion, deferred income 41
Profit in period of sale, recognition of 288
Insurable interest
Corporation's 280
Fire loss, amount of recovery by lessor and lessee of building 175
In insured property, principal purposes of requiring 37
Key employees 37, 175
"Key personnel" doctrine, misrepresentation of age 229
Oral contract, not evidenced by a writing 229
Real property 280
Insurance
Coinsurance clause, compute limitation on insurance company's liability imposed by 49
Coinsurance clause 126, 280
Contracts 78
Contribution 78
Fire, accountant's examination of company's policies 65
Fire, friendly and hostile fires 230
Fire, inadequate coverage, effect on CPA's opinion 66
Fire, inadequate coverage, mention in short-form report 66
Fire, personal property subject to coverage 78
Incontestable clause 78
Insured gross earnings, prepare schedule computing amount 49
Law 78, 126, 280
Life 126, 280

Life, incontestable clause in policy 280
Life, key personnel, misrepresentation of age 229
Life, subrogation 230
Property 126, 280
Reserve for self-insurance against fire, treatment in balance sheet 293
Self insurance, provisions for 292
Insurance companies 126, 280
Insurance law
Provisions 280
Insurance policies
Fire 78
Insurable interest in key employee 175
Physical and constructive delivery of policy 174
Insurance proceeds
Tax aspects 190
Interest
Legal rate 77
Maximum lawful rate 77
Nominal and effective, distinguish between 184
Usurious 77
Internal control
Accounting department 27
CPA's review of system, purposes of 70
Customer billings and remittances, weaknesses 220
Elements and basic characteristics of a system of 69
Fidelity bonding of employees, functions and purposes 270
Hiring practices 116
Mail remittances 271
Payroll procedures 116
Plant ledger for fixed assets 271
Purchasing department 27
Weaknesses in, discuss 27
Internal control questionnaires
Weaknesses in internal control 160
Inventories
At standard cost and actual cost, schedule comparing computation of ending 149
Base stock method 38
Branches 145
Consolidated, treatment of intercompany profits in consolidated statements 182
"Cost" as applied to valuation, define 140
Direct labor in, computation of 1
Disclosure of purchases ordered at balance sheet date for future delivery 38
Dollar-value lifo cost method, computation 254
Fifo basis, schedule of number of units manufactured, unit costs and amounts 261
Finished goods inventory at the lower of cost or market, computation 149
Gross profit method 38
Lifo cost, computation of, under retail inventory method 254
Lower of cost or market, arguments against use 141
Lower of cost or market 83
Lower-of-cost-or-market rule, expected selling prices in application of 289
"Market" as applied to valuation, define 140
Physical, computation of corrected 1
Physical, gross profits ratios, compute 170
Physical, observation of, other procedures 116
Physical, observation of, purposes 271
Physical, test counts of quantities during observation 272
Pricing, deferred until end of accounting period, state method 38
Reserve for possible future market decline 38
Retail method, accounting theory on treatment of net markdowns and markups 44
Retail method, advantages 44
Retail method, conditions which may distort results 44
Retail method, description and accounting features 44
Retail method, schedule computing 254
Slow-moving or obsolete, auditing procedures 124
Total amount, compute 95
Work-in-process, at estimated cost, computation 267
Work-in-process, computation 197
Work-in-process, overstated 83
Year-end computation 1
Inventory certificate
Information included 71
Outside specialists, CPA's reference to, in short-form report 273
Outside specialists, effect upon type of CPA's report 272
Outside specialists, reliance on, by CPA 272
Persons qualified to sign 72
Reasons for obtaining 71
Refusal of client to sign, effect on audit program and opinion 72
Investment credit
Benefits 286

Excess over income tax liability 190
Machinery and equipment, adjusting journal entries 74
Methods of accounting, effect on periodic income determination 243
Investments
Current or noncurrent assets, criteria for classifying 137
Invoices
Typed, procedures employed in examination of audit samples 278
Jarman corporation 53
Joint costs
Amount of, included in ending inventory valuation on basis of physical units 237
Amount of, included in ending inventory valuation on basis of their relative sales volume 237
Jones furniture company 2
Judgment
Statistical sampling techniques to audit testing, discuss decisions involving 30
Kelley-Thomas company 3
Key-man insurance
See Insurance
Kissena corporation 40
"Kiting"
Audit procedures used to uncover 165
Define 164
Kowal manufacturing company 116
Labor
Direct and indirect, reasons for distinguishing between 43
Direct, define 43
Direct, in inventory, computation 1
Indirect, define 43
Overtime direct, costing methods of accounting for premium costs 43
Land
See Real estate
"Lapping"
Audit procedures used to uncover 165
Define 164
Larnaca, City of 99
Law practice
Income, computation 113
Partners' capital account, statement 151
Leased equipment
Examination of asset account, audit procedures 221
Leases
Long-term, effect on financial statements, of recording liabilities on books of lessee 84
Long-term, provisions indicating lease is purchase of property 83
Percentage, audit procedures verifying total annual sales 268
Percentage, auditor's report 269
Restoration expenditures at termination, accounting treatment 87
Leash, P. K., company 40
Legal capital
See Capital
Liabilities
Contingent and estimated, distinguish between 292
Contingent liability and contingent loss, distinguish between 292
Current 286
Non-contingent 286
Unsecured, computation of estimated settlement per dollar 107
Liability of accountants
See Accountants' liability
Liens
Common law artisan's lien, elements 172
Common law artisan's lien, right of lien claimant 172
Life insurance
See Insurance
Life interest
Define 80
Lifo
See Inventories
Liquidations
Estimated settlement per dollar of unsecured liabilities, compute 109
Partnerships, schedule of cash payments 10
Statement of affairs 107
Little company 55
Long-form reports
See Reports
Lower-of-cost-or-market rule
See Inventories
Lowman paint company 44
Lumber dealers
Incorporation of business 102
Lumber manufacturers
Variances from standard costs 2
Luxury sales company 154
Machinery and equipment
Audit procedures in examining asset account representing leased equipment 221
Book value and current fair value, difference 239
Depreciation and investment credit, adjusting journal entries 74
McLean processing company 63
Mail remittances
Internal control procedure 271
Make or buy
Comparison of total costs 13

Mantis manufacturing company 96
Manufacturing costs
  Cost of goods, schedule computing 149
  Gross profit and, comparative statement 63
Marcia company 59
Margul corporation 202
Medical deductions
  Tax aspects 190, 245
Mergers
  Consolidated balance sheet worksheet 55
  Distribution of stock 11
  Exchange of stock 11
  Journal entries 11
  Ratio of stock distribution, computation 11
Meyers pharmaceutical company 278
Mining
  Change in gross profits, analysis accounting 204
Modern department store 28
Moss company 117
Moving expenses
  Tax aspects 190
Municipal
  Balance sheet for funds, worksheet 211
  Bond funds, prepare worksheet 99
  Estimated with actual revenue, encumbrances and expenditures with appropriations and other authorizations, prepare worksheet 61
  Funds 83
  General bonded debt and interest fund, prepare formal adjusting journal entries 101
  General fixed asset funds, prepare formal adjusting journal entries 100
  General fund, prepare formal adjusting journal entries 101
  Special assessment fund, prepare worksheet 15
Mutuality of obligation 172
Negligence
  Accountant's liability for, and liability for constructive fraud, compare 81
  Accountant's liability to third parties 129, 175
  Employee's eligibility for workmen's compensation 172
  Fraudulent accounts, failure to detect 175
  Unqualified opinion without verifying accounts receivable 175
Negotiable instruments
  See also under specific type
  Unauthorized completion of incomplete instrument 174
  Undisclosed principal, liability 79
  Uniform negotiable instruments law 33
Net income
  See Income
Net profit
  Negotiation of long-term contract on commission basis 205
Net worth
  Outstanding stock options and, computation 92
Newfield corporation 93
Nihill, Town of 211
Nonprofit organizations
  Blood banks, accrual basis statement of total expense 47
  Blood banks, schedule computing expense per pint 47
  Blood banks, schedule computing number of pints sold and withdrawn 47
  Increase in cash, statement accounting for 50
Novation 126
Objectivity
  Explain 46
Offers
  Acceptance of, to enter into bilateral contract 172
  Remedy of specific performance 127
  Revocation 172
  Revocation, letter of, ineffective 228
  Revocation prior to acceptance 127
  Silence by offeree 126
  Time of, according to common law 228
  Time of, according to Uniform commercial code 228
Officers' salaries
  See Salaries
Oil dealers
  Corrected financial statements, prepare auditor's worksheet 144
  Corrected income, schedule computing 143
Oil wells
  Income from, schedule showing 114
Opinion
  Adverse, define 66
  Adverse instead of qualified, in certain circumstances 116
  "Auditors' certificate," deficiencies 28
  Consistency, statement on 23
  Dating 28
  Disclaimer of, define 66
  Effect of substantial errors on 219
  Objective of examination of financial statements 116
  Piecemeal, relationship to other types of opinion 66
  Qualified, define 66
  Unqualified, conditions under which CPA may express an 66

Unqualified, without verification of accounts receivable 175
Options 172
See also Stock options
Organization expenses
Deduction for 142
Promoters', legal status 232
Other procedures
Physical inventories, observation of 116
Overhead
Element of cost of fixed assets constructed by company for its own use 90
Factory, unacceptable treatment of, at interim reporting date 286
Over- or underabsorbed, compute amount 1
Under- or overapplied, schedule 197
Overtime direct labor costs
See Labor
Paris company 289
Parol evidence rule 126, 172, 289
Partnership agreements
"Interest to be allowed on invested capital" 89
With corporation, legal significance 232
Partnership name 171
Partnerships
Admission of new partner 83
Assignee of partner's interest 34
Bankruptcy of partner, priority of claimants as to personal property 34
Cash distribution schedule in winding up affairs 9
Cash settlements between partners, computation 196
Commitments by individual partner 34
Contribution to capital, partner's demand for interest on loan 130
Creation 281
Dissolution 34, 171, 281
Dissolution, define and give causes for 78
Dissolution, effect on partners 78
Dissolution notice 34
Existence of 34
Goodwill, distribution 195
Illegal 78
Inadequate records, prepare financial statements from 3
Liability of firm and partners 281
Liability of incoming partner 34
Limited 281
Liquidation, cash payments schedule 10
Merchandising, acts requiring unanimous consent of partners 34
New, opening balances, prepare worksheet 193
Partners' capital accounts, prepare statement 151
Partner's interest 171
Profit and loss sharing arrangements, discuss 87
Retiring partner 171
Right of partner to formal accounting of affairs 34
Salary and bonus allowances as charges to operations, arguments for 88
Salary and bonus allowances as expenses, arguments for 88
Stock in partnership name, pledged as collateral by partner 130
Taxation 91
Trading and non-trading, distinguish between 130
Uniform partnership act 34, 171, 281
Patent infringement claim
Accounting treatment 87
Patents
Define 80
Time period and renewability period 80
Payroll taxes expense
Balance at year end, prepare worksheet 32
Payroll taxes payable
Employer, balance at year end, prepare worksheet 32
Payrolls
Errors, action by CPA upon discovering 276
Internal control 116
Pension plans
Allocation of corporation's contribution to each participant 54
Allocation of income and forfeitures 54
Corporation's contribution, schedule computing 53
Funded and pay-as-you-go, distinguish between 290
Funded, factors in determination of cost 290
Past service and current service costs, balance sheet treatment 291
Past service and current service costs, distinguish between 290
Past service and current service costs, how charged to accounting periods 290
Vested interests of participants terminating employment 54
Percentage depletion
See Depletion
Percentage leases
See Leases
Percentage-of-completion contracts
See Contracts

Percentage of sales method
  Bad debts 178
Personal property law 280
Physical inventories
  See Inventories
Piecemeal opinion
  See Opinion
Pine lumber company 102
Plant ledgers
  Maintaining as internal control procedure 271
Plant tours
  Benefits to CPA in conducting audit 123
Point of sale
  Timing of revenue recognition 237
Pooling of interests
  Consolidated balance sheet, worksheet 55, 264
  Requirements 38
Preferred stock
  See Stock
Preincorporation contracts 77
Preincorporation subscriptions
  Balance sheet presentation and legal status 232
"Prepared without audit"
  See Financial statements
Price-level changes
  Adjusting financial statements 187
  Adjustments of specific goods and services and adjustments in general purchasing power, distinction 189
Principal and agent
  Agency coupled with interest 36
  Binding principal to third persons 36
  Liability of agent for loss 36
  Liability of undisclosed principal on negotiable instrument 79
  Notice of termination 36
  Revocation of agent's authority by principal, notice to third persons 282
  Undisclosed principal and third person, rights and liabilities 282
  Undisclosed principal, suit by third person, defenses available 282
Priority in bankruptcy
  See Bankruptcy
Privileged communications
  Accountant-client relationship, common law rule 129
  Common types of relationships 129
  Explain meaning 128
  Recognition as valid reason for exclusion of evidence, policy factor 128
Privity
  Legal argument to avoid liability 175
Probability sampling
  Error rate exceeding predetermined confidence level, discuss course of action 30
Process costs 294
Productivity losses
  Causes 294
Products
  Contribution to profit by unit 59
  Contribution to profit per labor dollar 59
  Equivalent units and costs incurred per unit, computation 260
  Estimated liability for product guaranties, adequacy of balance in account 118
  Estimated liability for product guaranties, audit program 117
  Hours required to product estimated sales units 59
  Inventories on fifo basis, computation 261
  Manufacturing costs and gross profits, comparative statement 63
  Units lost, computation 96
Professional conduct
  Advertising, reasons for supporting rule against 25
  CPA as officer of company he audits 161
  Competitive bidding, arguments against 26
  Competitive bidding, government audits 26
  Employment offer to employee of other CPA 121
  Independence, meaning 160
  Independence, rules 160
  New clients, ethical means of obtaining 25
  New engagement 72
  Professional corporations 122
  Profession's adoption of code, reasons for 121
  Unsecured interest-bearing notes in payment of fee 161
Professional corporations
  Arguments supporting ethics rule that CPA firm cannot be a corporation 122
Promissory estoppel
  Primary importance in relation to law of contracts 79
  Requirements to establish 79
Promissory notes
  Negotiability under certain circumstances 283
  Negotiable 33
Promoters' organization expenses
  Legal status 232
  Records to be examined to discover authorization for 232

Property
  Personal 280
Property insurance
  See Insurance
Proprietorships
  Incorporation 102
Public utilities
  Imprest fund bank account, reconcilement 223
Punched cards
  Auditing 278
Purchase or rent plans
  See Rent or purchase plans
Purchasing departments
  Functions 27
  Internal control 27
Qualified opinion
  See Opinion
Quasi contracts
  Cause of action in 284
Ratios
  As over-all checks in auditing, advantages 269
  As over-all checks on balance sheet accounts and related nominal accounts 269
  Changes in, as compared to prior year's, reasons for 270
Real estate
  Options, cost of 131
Real estate brokers 227
Realization convention
  Periodic income determination 86
  Valuation of assets 86
Reasonable care
  Accountant's liability in not discovering fraud 37
Reconciliations
  Imprest fund bank account 223
  Receipts, disbursements and bank account 120
Rees company 153
Relevant costs
  Define 286
Remainder in fee
  Define 80
Rent
  Advance, reporting for tax purposes 9
Rent or purchase plans
  Estimated annual income from computer under both plans, schedule comparing 158
  Net present values of cash flows under both plans, schedule comparing 158
Repairs
  Extraordinary, accounting treatment 89
  Extraordinary, define 89
Replacement cost
  Current fair value, method of estimating 239
Replacement method of depreciation
  See Depreciation
Replacements
  Accounting treatment, define and discuss 90
Reports
  See also Auditor's report
  Long form, including wording of short-form type of opinion 116
  Short-form, after client's adoption of recommended footnotes, prepare 217
  Short-form, circumstances not requiring deviation from 116
  Short-form, inventory certificate of outside specialists 273
Reproduction cost
  Current fair value, describe method of estimating 239
Retail method of inventories
  See Inventories
Retained earnings
  Audit procedures 163
  Capitalized amount in connection with stock dividend 85
  Date, following quasi-reorganization 38
  Principal items reducing amount of 180
  Reasons for verifying 163
Retained earnings reserves
  Purpose of creation 38
Retirement income credit
  Limitation of amount 9
Retirement method
  See Depreciation
Revenue expenditures
  Capital expenditures and, distinguish between 131
Revenue recognition
  Timing of, during production and when cash is received 237
  Timing of, point of sale as basis 237
Ridgedale, Town of 61
Robinson company 220
Safe deposit box
  Examination of securities in 214
Salaries
  Officers', legal status 232
  Officers', records examined to discover authorization for 232
  President's, disclosure in financial statements 219
Salary expense
  Balance at year end, prepare worksheet 32
Sale
  Define 285

Sale of a business
  Valuation of common stock, factors 41
Sales "on approval"
  Liability of parties involved 231
Sampling
  See Probability sampling
    Statistical sampling
Schools
  Current operating cost per pupil, regular and vocational, compute 259
  Funds 155
  Funds obtained from local taxation, estimated total, computation 259
  Tax rate of school district, computation 260
Scoopa company 13
Secret reserves
  Creation of 286
Securities
  Examination of, in safe deposit box 214
  Investing in, reasons for 137
  Net loss on sale 245
Securities act of 1933 171
Self-employed
  Earnings taxable 9
Self-insurance
  See Insurance
Selling prices
  Application of lower-of-cost-or-market rule 289
  Increase in, necessary to cover wage increase, computation 252
Shopping centers
  Treatment of costs in accounts 242
Short-form reports
  See Reports
Sick pay 91, 151, 245
Sinking funds
  Bond, methods of classifying on balance sheet 137
Skelton fuel company 143
"Skill and care"
  Accountants' liability to third parties 234
Smith equipment corporation 221
Smoky mountain mfg. company 74
Soo company 32
Source and application of funds statement
  Formal, prepare 198
  "Funds provided" section 286
  Lease capitalization 84
  Uses of, discuss 135
Southern cottonseed company 109
Specific performance
  See Contracts
Spendthrift trusts
  See Trusts
Spoilage
  "Abnormal," accounting treatment 294
  "Normal" and "abnormal," distinguish between 294
  Unavoidably spoiled units in computation of equivalent production 295
Standard costs
  Advantages 139
  Define 138
  Variances from, schedule of 2
  Variances, methods of treating, arguments 139
Standard mercantile corporation 147
Statement of affairs
  Prepare 107
Statistical sampling
  Accounts receivable 225
  Advantages to audit testing, explain 30
  Benefits to CPA 225
  Errors in sample 226
  90-day accounts 225
  Professional judgment decisions in applying techniques to audit testing 30
Statute of frauds
  Applicability to various kinds of contracts 35, 284
  Basic requirement for contracts to which statute is applicable 284
  Contracts within, true or false statements 126
  Purpose of, explain 35
Stenger corporation 205
Stock
  Capital, audit program for examination of the account 162
  Common 77, 228
  Common, cash dividends paid to holders, computation 7
  Common, current equivalent number of shares outstanding schedule 7
  Common, earnings per share, computation 7
  Common, outstanding shares, schedule computing 7
  Default by subscriber after paying part of subscription price, methods of accounting 135
  Distribution in merger 11
  Donated to church, tax aspects 9
  Exchange of, based on current market value, computation 246
  Exchange of, based on net book value, computation 246
  Exchange in merger 11
  Preferred 171
  Preferred, cash dividends paid to holders, computation 7
  Preferred, outstanding shares, sched-

ule computing 7
Purchase and sale, gain or loss, tax aspects 9
Ratio of distribution in merger 11
Sale of gift stock, reporting for tax purposes 9
Subscriptions receivable, traditional treatment 136
Treasury, purchase or sale price, recognized as a profit or loss 181
Watered 83
Stock certificates 77
Stock dividends
See Dividends
Stock issue costs 286
Stock options
Outstanding, and net worth, computation 92
Stock rights
Outstanding, disclosure in financial statements 240
Price issued in relation to current market price 240
Use of 240
Stock split-ups
Stock dividend and, distinguish 85
Stock warrants
Classification of 286
Stockholders
Rights 171
Rights, common stock shareholder 171
Stockholders' equity 286
Subrogation
Life insurance 230
Right of surety 173
Subsidiaries
See Holding companies and subsidiaries
Substantial performance doctrine
Construction contracts 126, 172
Construction contracts, requisites for recovery 35
Sundex corporation 7
Surety
Compensated and noncompensated 34
Cosureties, contributive share 173
Cosurety relation 280
Creditor's rights against 173
Defense available against creditor 280
Law 78, 228
Subrogation 173
Tax allocation
Interperiod, deferred credit 286
Tax refunds
Claim for prior year's taxes, accounting treatment 87
Tax returns
Consolidated, requirements for filing 142
Joint 91, 190
Terminology
Defects, in financial statements 176
Testing
See Audit testing
Title
Goods destroyed by fire after sale and before pick-up, liability under Uniform sales act and Uniform commercial code 230
Goods obtained by fraud 129
Theft of goods 129
Trade acceptances
Negotiable 33
"Trading on the equity"
Meaning 83
Traveling expenses
Tax aspects 190
Treasury stock
See Stock
Trusts
Beneficiary 227
Charitable 227
Implied 227
Spendthrift 227
Trustee 227
Tuck company 120
Ultra vires act 77
Uniform negotiable instruments law 33
Uniform partnership act 34, 171, 281
Unilateral contracts 126
Unit costs
Output divisor for, computation 97
Unqualified opinion
See Opinion
Usury
Define 77
Vacation pay
Cash to accrual basis, effect on financial statements 44
Variable budgets
See Budgets
Variable costs
Explain 186
Vested remainder in fee
Define 80
Victoria school district 259
Wage increases
Selling price increase to cover 252
Wages
Gross, per books and per auditor's calculations, compare 274
Watered stock
See Stock
Wayne mfg. co. 1
Whitewall appliance company 41
Wholesalers
Cash forecast, prepare 149
Work-in-process inventories
See Inventories

Working papers
  Consolidated, prepare 18
  Ownership 233
  Ownership, explain reasons 81
  Ownership, restrictions on 81
Workmen's compensation
  Eligibility for, in gross negligence 172
  Independent contractor, injuries sustained by 172
Young manufacturing corporation 119
Zuba mfg. company 49